Brotherhood of St Laurence
in partnership with
Committee for Economic Development Australia

Affordable Housing Project
Background Paper

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Introduction

BSL/CEDA believe that the provision of adequate, appropriate and affordable housing is central to the development of a productive, growing economy and a stable, cohesive society. Based on an emerging consensus that a solution to this housing crisis is to attract a large volume of private investment into this sector, this paper outlines several models that may achieve this aim. The purpose of this paper is to inform a discussion of potential stakeholders about the investment in and development of affordable housing. This paper:
- explains why affordable housing is of critical economic and social importance
- describes how current policy approaches and settings are failing to deliver
- reviews a number of new policy approaches that promise to reverse this trend.

Today's Australian housing market is characterised by:

- relentlessly rising housing prices and a strengthening ‘housing affordability crisis’ (Berry and Hall, 2001)
- an increasing ‘mismatch’ between housing need and housing outcomes, resulting in both over and under-crowding and rising short-term and chronic homelessness (Chamberlain and Mackenzie, 2002)
- a falling stock of low-rent dwellings, especially in our capital cities (Yates, 1999)
- increasing social segregation expressed spatially in the creation of homogeneous enclaves of both rich and poor residents within the metropolitan areas and in greater socio-economic divisions between city and country (Baum et al., 1999)
- the creation of a vicious circle of multiple disadvantage in marginalised areas, raising the spectre of ‘social exclusion’ and the inter-generational perpetuation of unemployment and disengagement (Berry, 2000).

Problems surrounding declining affordability, in the current era of buoyant general economic growth and relatively low nominal interest rates, are particularly worrying:

- A quarter of a million low-income (tenant) households pay more than 30 per cent of their household incomes for housing, a clear sign of intense ‘housing stress’.
- If this trend continues at the same rate as for the past decade, this figure will rise to one million households by 2020 (Berry and Hall, 2001).
- Between 1986 and 1996, the proportion of low-income private tenants living in housing stress in the capital cities rose from less than two-thirds to almost three-quarters; the figure for Sydney was 80 per cent (ibid.).

Developments since 1996 are certain to have been adverse:

- Housing prices and rents have risen faster than the incomes of low-income households, especially in the last two years in Sydney and Melbourne, where the pressures and problems associated with declining housing affordability are greatest.
- A recent comparative international study of house price inflation placed Australia second behind the United Kingdom in the OECD. Housing prices rose by 18 per cent in the year to April 2002 (The Economist, 6 September 2002).
- It now takes Melbournians seven years of average income to purchase the average priced house, compared with four years in 1996 (Colebatch, 2002a).
- By mid-2000, low-income households could not afford to rent or buy the standard three-bedroom house in virtually any area of Sydney or Melbourne (Berry and Hall, 2001).

Increasing (trapped) demand in this segment of the housing market has demonstrably not resulted in a significant positive supply response—in fact, supply continues to fall. This fact
underscores the existence of pervasive market failure and the corresponding need for appropriate policy levers to intervene in the market.

**Lack of affordable private rental housing**

Housing-related poverty is strongly concentrated among private tenants in Australia. About two-fifths of this group have been renting for longer than 10 years—many are permanent or ‘trapped tenants’ (Wulff and Maher, 1998). Young people, in particular, are finding it difficult to become homeowners (Yates, 1999), in spite of the Commonwealth Government’s First Home Owners Scheme and low interest rates. This follows from the trend in the major cities for rising housing prices and rents to outstrip average incomes and the increasingly insecure nature of casual and part-time employment opportunities for the young. Other forces at work locking the young out of affordable home ownership and placing them at risk of serious housing stress as tenants are:

- the rapid gentrification of the inner areas of the cities, where a majority of the rental stock has historically been located; including the continuing conversion of rental dwellings to home ownership and the colonisation of much of the remaining rental stock by higher income households buying their way into central locations.
- longer periods spent in formal education, delaying entry to the paid workforce and saddling younger Australians with large tax debts, due to the Higher Education Charge Scheme.
- house price inflation, in part driven by the very favourable taxation treatment of ‘the family home’—owner occupiers do not pay capital gains tax on their home’s appreciating value nor income tax on its annual imputed rental value. This provides an incentive to ‘over-invest’ in housing for those who can afford to and raises a disincentive for older people to move or ‘trade down’ to smaller housing later in life.
- wealth, including housing wealth, strongly concentrated in the over 40-year-old population, especially the baby boomers (NATSEM 1999).
- demographic change leading to a rapid growth in single-person households, including independent younger people (Wulff, 2001).

**Why is affordable housing important to the economy?**

Lack of affordable housing imposes significant constraints on the economy as well as a threat to the cohesion of the broader community.

**A key to competitiveness**

**Innovation drivers**

Recent US work has stressed the degree to which successful regional economic development is critically dependent on attracting and keeping ‘creative workers’: those skilled workers in the design, knowledge-intensive, information-rich industries of the ‘new economy’. Florida (2002) has coined the term ‘the creative class’ to describe this diverse occupational group who, by his reckoning, account for about 30 per cent of the US economy. Florida and others argue that investment, growth and new jobs follow the locational decisions of the creative class—not the other way around. Hence, ‘world cities’ that succeed in the inter-regional competition for corporate head offices (command and control centres [Harvey 1989]) and investment inflow do so, in large part, because they are able to attract and keep the people (both corporate elite and up-and-coming younger workers) who drive the new economy.

This argument is, in turn, embedded in recent developments in economic thinking that focus on the central importance of ‘innovation’ in accounting for relative economic performance
between countries and regions. The ‘new growth theory’ and other theories of ‘path-dependent development’ see innovation as the main endogenous force for transformational economic change (Bryant and Wells, 1998). New ways of doing things, new products and processes and new, more effective organisational business forms—in particular, inter-firm networks or ‘industry clusters’ in space (Porter, 1998)—result in increasing returns, pushing some industries, clusters and regions further ahead of the pack. Innovation thrives on diversity, collaboration within and between the public and private sectors and growing numbers of creative residents. Residential diversity, in turn, requires a range of housing opportunities, from affordable to luxury levels. Successful regional economies cannot afford to turn their backs on young, creative workers at the beginning of their careers who are struggling to get a foothold in the local housing market.

**Livable cities**

In an increasingly unequal and polarised world, the social links and networks which help to create a cohesive, productive society are weakened, while the capacity of local communities to mobilise and deploy social capital is reduced. ‘Social capital’ refers to the inherited norms and social networks that support and nurture mutual trust, reciprocal activity and civic engagement, that in turn underpin and protect a safe, productive, high amenity environment (Putnam, 1998).

The social environment, especially the perceived safety and health of a city, is an important magnet for investment and the location of managerial staff and knowledge workers in the dynamic growth industries. Florida’s ‘creative class’, drawn from a range of social minority groups (including gays and lesbians), tend to locate in cities and regions they see as tolerant and secure—cities that rate highly on the so-called ‘Bohemian Index’. Tourism, a major export driver in diverse, multi-cultural and tolerant communities, depends critically on the image and substance of a city or region’s social (as well as physical) environment.

The reality—or even the public perception—of communities rent by polarising differences, visible poverty and homelessness, soaring crime and an impoverished public realm raises strong barriers to the influx of investors and key workers, reinforcing and hardening the emerging patterns of spatial inequality. Housing markets, if left unchecked, play a central role in this dynamic.

**Access to labour**

High housing costs encourage some low-to-medium paid workers to migrate elsewhere in search of affordable housing and sustainable life styles, raising the possibility of labour shortages in particular locations and occupations. This latter outcome may especially involve younger, more mobile and more entrepreneurial workers.

At a strictly functional level, successful metropolitan economies need plenty of low-paid service workers and medium-paid essential service workers, as well as high-paid knowledge workers. If office workers, cleaners, restaurant workers, shop salespersons, bus drivers—not to mention teachers, nurses, police officers and other professionals—are unable to afford to live near the centres of economic activity, their lives are impoverished and the regional economy also suffers from inefficient workers or labour shortages. This problem is evident in one of the world’s major cities, London (City of London, 1998). Furthermore, there is little incentive for casual and part-time workers to travel long distances from home for short shifts.

**Pressure on wages and salaries**

High housing costs contribute to upward pressure on wages and salaries, which tends to undercut the competitive position of local producers, especially in trade-exposed industries.

**Crowding out of other consumption**

High housing costs crowd out expenditure on other forms of consumption (Burke, 2002).
Macro-economic considerations

New housing construction is an important component of the national economy, accounting for around five per cent of the Gross Domestic Product. Moreover, housing investment often leads the overall economy, providing economic policy makers with useful indicators of the overall health of the economy and a capacity to intervene counter-cyclically to reduce the amplitude of the business cycle. A policy of expanding the supply of new housing targeted at the affordable end of the market is one way to stabilise the housing sector and general economy over time, moderating the boom-bust rhythm that might otherwise prevail.

A key to community cohesion

A study by Meen and Andrew (1999) highlighted the cumulative process of decline and segregation related to housing in London during the 1990s. The result was a self-reinforcing downward spiral of falling population, average incomes, employment and housing values in some inner areas. This made it even more difficult for poorer households to move out, especially if they held negative equity in their properties as home owners or faced ever-increasing relative rents elsewhere in London as tenants.

Although London’s particular situation differs from contemporary patterns in Australian cities, the overall thrust of the argument remains relevant. Poorer households disadvantaged in the labour market suffer reduced effective access to affordable housing. This helps to lock or entrap people in areas where employment opportunities are shrinking, reinforcing their low-income status and further limiting their effective housing choices in a cycle of decline and deprivation. In this way, different parts of the city—and, more broadly, different regions—diverge from each other rather than converge towards similar patterns and levels of development.

The exclusion and lack of mobility of the unemployed reduces the overall efficiency of the metropolitan and national economies. At the extreme, the phenomenon of ‘social exclusion’ results in the marginalisation or disconnection of multiply disadvantaged sub-groups from the mainstream institutions of civil society, entailing separation from work, leisure, cultural pursuits, family and other social networks.

Other benefits

The other major cost to the community of problems caused, at least in part, by inadequate housing, tied to broader exclusionary forces, is the rising fiscal cost to government in dealing with the many resultant social problems. This cost will often be difficult to estimate because the effects are usually complex and indirect. Nevertheless, sufficient evidence exists to suggest that by seriously attacking the issue of insufficient affordable housing, in total and in particular locations, governments can materially alleviate a range of economic and social problems while reducing the overall cost to taxpayers, in the longer term (Berry et al., 2002).

Current policy settings

Current government policy settings are demonstrably failing to deal with the problems of inadequate affordable housing or the broader exclusionary forces at work. Housing policy has been marginalised on political agendas for the past 15 years.

Housing assistance

The nominal expenditure on social housing has risen slowly over the past decade to plateau at approx $3 billion per annum. Real expenditure on these programs has begun to decline...
precisely at a time when the demand for available affordable housing is climbing. In the case of public housing this has meant lengthening waiting lists of eligible public tenants, in the face of more restrictive, segmented allocation procedures that ration available stock to households in extreme stress on low incomes.

**Commonwealth Rent Assistance (CRA)**
Research carried out for the Affordable Housing National Research Consortium (Berry and Hall, 2001) concluded that CRA, the Commonwealth's major attack on affordability problems, is failing to make a significant impact on reducing housing stress:

- In the three cities analysed—Sydney, Melbourne and Adelaide—current rent assistance entitlements did not allow low-income private tenants to affordably rent average value dwellings of any size in almost all suburbs in the respective metropolitan areas.
- The very narrow range of choice available to low-income tenants in those cities appeared to narrow further in the period 1994 to 2000.
- There was an absolute decline in the low rent housing stock in the period when CRA expenditure rose significantly (Yates and Wulff, 2000).

Moreover, this provides evidence of market failure at the bottom end of the rental market, where supply in that sub-market is *not* responding to chronic excess demand for cheap rental housing.

If the supply of low cost housing does not respond positively, then CRA is likely to feed into rising housing prices, to the extent that this form of income support is spent on housing at all (Burke et al., 2002).

**Taxation policy**

**Landlords**
Along with the $3 billion committed annually to social housing, Australian taxpayers subsidise small landlord-investors to the tune of almost $1 billion in tax relief from ‘negative gearing’, based on reported tax losses of $2.9 billion on rented dwellings (Australian Taxation Office, quoted in Colebatch, 2002b). Landlords are able to charge accounting losses on their rental investments against their other taxable incomes. Nevertheless, the ‘cottage industry’ nature of the rental market, personified by ‘mums and dads investors’, results in under-investment at the affordable end. Current taxation incentives reinforce this pattern of provision and under-provision. Indeed, Wood (2001) persuasively argues that tax benefits due to negative gearing for high marginal tax rate landlords, concentrated at the high value end of the rental market, actually reinforce relatively high rental levels at the low rent end. Rents at the bottom end may be higher than they would be without the distorting effects of current taxation policy.

**Owner-occupiers**
However, the tax benefits to landlords pale in relation to the benefits, currently running in excess of $20 billion annually, delivered to the home-owning majority (Yates, 2002). Owner-occupiers are taxed neither on realised capital gains nor on the imputed rental value of their homes. This permanent and growing incentive to over-invest in housing partly drives the strong upward trend in housing prices in a circular, self-reinforcing process.

**Home ownership assistance**
The current First Home Owners Grant (FHOG) was introduced in early 2000 in an attempt to head off a downturn in the Australian economy, in the light of weakening international economic forces—and was successful in this respect. However, from the viewpoint of affordability, FHOG was poorly targeted and much of the $2 billion went to higher-income
households bringing forward home purchase and for the purchase of existing rather than new housing. This outcome tended to underpin and accentuate the gathering inflation in house prices over the last two years, thereby intensifying the affordability crisis and the threats to regional and national competitiveness noted above.

What this all suggests is that the current uncoordinated provision of housing assistance reinforces, rather than attacks, the reality of housing inequality in Australia. Poorly targeted and inadequate assistance policies are part of the current growing housing affordability problem. These existing policies fail to deliver enough assistance to the right parts of the housing system—that is, to effectively assist households most in need at the critical points in the life course. The failures are most apparent and most serious for younger people at the beginning of their productive lives in the economy. At worst, existing housing assistance policies—particularly FHOG and negative gearing in the rental sector—may be intensifying the housing stress of vulnerable groups at critical junctures in their lives.

Policy fragmentation

There exists no national housing policy framework in Australia.

The Commonwealth-State Housing Agreement (CSHA) focuses on the relatively narrow fiscal politics of a very small public housing sector. Policies that influence housing outcomes, in the areas of urban planning, transport and other infrastructure provision, taxation and monetary policy, are implemented without any clear understanding of their housing impacts.

Constitutional and historic divisions of responsibilities between the different levels of government often leave gaps in provision. Political differences exist, especially between the Commonwealth and States, regardless of which major party is in government. Too often, housing policy debates seem to be about negotiating the lowest-common-denominator financial commitment by all levels.

A whole-of-government approach to housing is required at each government level in Australia, as housing is a whole-of-society issue.

Leveraging private investment into the provision of affordable housing: alternative approaches

In an era marked by the policy failures noted above and effective political limits on direct public expenditure, the only way that the stock of affordable housing can be increased substantially to meet the growing need is by attracting more private investment into the low-cost end of the housing market. In order to effectively assist those households in severe housing stress, government needs to use its fiscal powers and stretch the available public resources as far as possible. Leverage is the key here. For every dollar of public subsidy, several dollars of private investment must be captured and targeted on assisting tenants in most desperate need.

There are several approaches or models designed to attract private investment that figure in the current policy debates.

Given that the greatest affordability pressures are concentrated in the private rental sector, it is not surprising that attention has focused on stimulating the bottom end of that market. The detailed analysis of all options carried out for the Affordable Housing National Research Consortium concluded that the preferred model was indeed one that boosted the supply of rental housing and targeted it to households in the bottom two income quintiles (Hall, Berry
and Carter, 2001). This approach is described immediately below. Following that, three other approaches are sketched—two reliant on Commonwealth taxation benefits, the other on an unsubsidised shared equity arrangement (Caplin model).

Both the Consortium and the Caplin models have been placed on the agenda of an affordable housing taskforce established by the Prime Minister in September 2002.

**The Consortium model**

The Consortium’s preferred model require state and territory governments to each sell long-term bonds at market prices to private investors. Given the current low level of government borrowing in the Australian capital market, institutional investors like superannuation funds appear to be very keen to purchase such instruments.

Capital raised in this way would be used by each state housing authority (SHA) to acquire new or existing dwellings, to be let at affordable rents to eligible tenants. However, since investors are receiving commercial interest returns on their loans, affordable rents would fall short of operating costs and interest payments to bond holders. This gap is therefore met by a cash (outlay) subsidy paid by the Commonwealth Government to each state and territory for the term of the transaction (20 years). The transaction is cost neutral to the states as long as the estimated subsidy covers the actual gap between rental yield and SHA costs each year.

The model requires SHAs to progressively sell off the dwellings (after a minimum period) when they fall vacant and to use the proceeds to retire (pay back) debt. At the end of the period (20 years) any remaining dwellings in the transaction are sold and the remaining debt retired; sitting tenants are relocated. This keeps the total required Commonwealth subsidy to a manageable level. This model generates a high degree of leverage of private loan funds; for every dollar of subsidy, four or five dollars of private investment is secured (under the base case assumptions).

SHAs may, at any stage, decide to retain this stock by re-financing (selling more debt) or committing its own tax revenues. In addition, the Commonwealth and a State can at any time agree to launch another subsidised loan transaction to maintain or expand the dwellings under management. These decisions are made through time in the light of perceived housing need, available Commonwealth funding and the willingness of the State to bear the risks involved (see below) and/or commit its own funds to ‘topping up’ the scheme.

The size of the Commonwealth subsidy to each state is dependent on key factors: the relative rates of tenant turnover in the stock and the level of operating costs in each jurisdiction. The higher a SHA’s costs, the greater the gap between net revenue and interest costs on the borrowed funds and the larger the subsidy required to ‘break even’. Similarly, the more rapid the turnover of tenants in public stock, the more quickly the dwellings are sold into the private market and the faster debt is repaid, reducing the interest payments that have to be made and the size of the required subsidy.

The model, under the given assumptions, delivers a substantial leverage of private funds. For a $1 billion capital acquisition program across the States and Territories:

- 7,500 dwellings can be added to SHA stock and rented at affordable levels to eligible tenants
- the gross subsidy payable by the Commonwealth is $220 million—or a weighted national average of $2,288 per assisted tenant per year. This varies from a high of $3,413 in NSW to a low of $790 in W.A.
once the flow back of income tax revenues from debt holder to the Commonwealth treasury is included, this subsidy per tenant per year falls to $908 and the total net cost to $90 million.

Hence, for every gross dollar of government subsidy, $4.50 of affordable housing can be acquired. Put another way, the end result is four-and-a-half times as much extra affordable housing as if the government funds were directly committed to acquiring stock.

Whether or not the states have to subsidise the arrangement depends on the various risks involved and how they manage them. If, for example, property values increase more slowly than forecast over the 20 years, then there will not be enough money realised when all the dwellings are sold off to repay all the debt; this deficit will have to be met by the State. If the SHA manages its operations efficiently and reduces its costs below levels estimated in the transaction, then the surplus can be used to offset any deficits that arise from forces outside its control (like changes in housing values, inflation or interest rates). Therefore, the states have a very strong incentive to be efficient: if they are not, then their Treasury pays.

Apart from the high degree of leverage achieved, this model delivers a number of benefits:

- It establishes a firm basis for long-term cooperation between Commonwealth and States around housing issues of national importance.
- The Commonwealth is able to cap its total subsidy exposure upfront, with the knowledge that the states have a strong incentive to manage the affordable stock efficiently and target it effectively to those in need.
- Each state retains control over the stock and receives subsidies tailored to the conditions in its jurisdiction.
- This model meets the Consortium’s four key criteria for an acceptable model—it is equitable (targeted to need), efficient (high leverage), promises to deliver a high volume of extra affordable housing and is feasible, both with respect to the requirements of private investors and nature of fiscal politics in Australia.

In reality, the Consortium model reinvents public borrowing for social housing. But it does so in a very transparent way that imposes a strong discipline on governments at both levels to efficiently match available housing assistance to real housing need and continually monitor outcomes to generate maximum reach.

Research (Hall and Berry, 2001) clearly demonstrates that this model:

- has the capacity to double output compared with current policy—that is, double the number of households in need achieving affordable housing for any level of government subsidy—in Sydney and Melbourne and deliver excellent outcomes in Adelaide.
- is clearly the least-cost way for government to quickly stimulate a substantial expansion of the affordable housing stock.

It is very likely that an overall policy that mixes this approach with the existing measures of rent assistance and capital provision through the CSHA will have efficient outcomes in most if not all the major housing markets in Australia. The Consortium model is therefore best seen as complementary to, rather than a substitute for, existing housing assistance policies.

**The shared equity/listed housing trust model**

The model proposed by Caplin and Joye (2002), posted on the web site of the Menzies Research Centre, aims to reduce the costs of home ownership, especially in the early years of purchase when most households are heavily mortgaged. Instead of committing a large part of household income to servicing a large mortgage debt, a household could buy its
house in partnership with another investor. Equity would be shared and the household would only have to borrow to finance its share. The income saved from servicing a smaller debt (and splitting rates, insurance costs, etc.) could then be invested in a range of other assets (eg extra superannuation contributions), rather than locked into the house, a large illiquid and risky asset. In retirement the household would probably have generated more overall wealth than if it had kept all its savings eggs in one basket, the family home. Modern finance theory is based on the premise that diversification is the way to maximising investor wealth over time. By retirement, of course, the household would also have paid off the mortgage debt on whatever share it still retained.

Under this shared equity arrangement, the household is the managing partner and the investor the sleeping partner. The former decides when to sell, to whom and for what price. The household also decides on how the property is maintained, renovated and used. The sleeping partner ‘wakes up’ only when the dwelling is sold in order to receive its share of the sale proceeds. The household saves on housing costs each year because the sleeping partner foregoes any rental payment on its share in favour of receiving all its return at the end, when the house is sold. In effect, the investor is swapping rental income for a share of realised capital gain on the dwelling.

The equity instrument created for the investor can be securitised—that is, bundled up and traded in the rapidly growing secondary mortgage market. Caplin and Joye here envisage the creation of special purpose vehicles termed ‘partnership real estate funds’. This ‘deepens’ the market and makes it more attractive to long-term institutional investors. The ‘paper’ created can be traded and continuously valued in the secondary market. Investors are not locked into a partnership with an individual household for life. They can buy a tradable share in the future returns of many individual dwellings, spread across housing markets. This reduces the risks borne by the investor and therefore lowers the required return, leaving more of the value of the houses to each of the owner-occupiers.

The main problem with this model is that only an outline is available for assessment. The full study with detailed modelling and a clear specification of underlying assumptions and input data is not yet available. However, the outline itself raises serious questions about viability and applicability to most of the situations where affordability matters.

Spiller (2002) has persuasively argued that there are real doubts as to whether the numbers will stack up. If the silent partner foregoes recurrent rental income through the term of a normal mortgage loan, say 25 years, then its share of the final capital gain will balloon, thanks to the arithmetic of compound interest. To make a commercial return the investor may end up appropriating most or even all of the realised capital gain and more, turning the household partner into a tenant after the event.

The greater the initial equity share taken by the commercial investor, the more likely that the household will be left with less equity than he or she started with. For housing to be affordable by lower income households, commercial investors will need to take a large initial share. If the partial home owner ends up with little more equity than started with in the home, or even less, then his or her lifetime wealth and retirement income will be restricted, depending on whether and how successfully savings income released by lower mortgage repayments were invested.

Spiller also makes the point that the model favours the purchase of housing with high capital gains prospects. These opportunities are likely to restrict use of this approach to particular parts of the metropolitan housing markets, normally at the higher value end. Again, this is unlikely to help lower income people searching for affordable housing in areas where property values are growing more slowly.
This model has been the target of even more intense criticism by van Wyngen (2002, p. 27) who argues that the model does little to increase the supply of housing, but by increasing the funds available for the purchase of existing homes would force prices up, placing home ownership further out of reach to low-income households.

A more technical but very serious problem is that the banks that provide a large share of primary mortgage finance would be unlikely to get involved in this new market for shared equity. Bank regulators, especially the bank of International Settlements, treat a bank’s equity investments very differently from its loan book. Capital adequacy requirements, designed to prevent a bank from getting into liquidity problems, effectively penalise bank investment in shares and real estate, as opposed to extending house mortgage loans. The long-term equity instrument Caplin and Joye envisage will have to look elsewhere for buyers, mainly in the superannuation fund sector.

**The Macquarie Bank retail investors model**

**Pooled funds**

McNelis et al. (2002) provided Macquarie Bank (MB) with a brief to develop an investment vehicle that would mobilise the savings of professional retail investors for investment in affordable housing. MB proposed a ‘pooled fund’—a vehicle, managed by a funds manager, that would aggregate or pool the savings of individual investors seeking a commercial return from residential property. The funds would be used to acquire housing for rental, managed by a community housing organisation (CHO), which provides property and tenancy management services for a fee chargeable to the pooled fund. The fund operates akin to a listed property trust in the commercial property sector; hence, the investment is of an equity-like nature. The CHO selects moderate-income tenants in receipt of Centrelink payments (annual income in the $30,000 to $40,000 range) and charges rent at a level required to generate a rental yield of 6 to 6.5 per cent. Investors receive an overall return based on both the rental yield and capital gain, the latter assumed to be between 0.5 and 1.5 per cent real.

The financial appraisal of this model is pessimistic. MB suggests that, given the risks and property market inefficiencies, professional investors would require a return in excess of 10 per pre-tax from this investment. Base case modelling promises a pre-tax return in the vicinity of 3 per cent and an internal rate of return (reflecting capital growth) of 6 per cent, well short of the required levels. To make it work, significant government subsidies would need to be packaged into the arrangement. The subsidies could take one or more forms, including an equity gift or recurrent operating subsidies, paid to the CHO. Alternatively, particular tax concessions with respect to the rental income or capital gains components of the overall return could be directed to the participating investors. These subsidy streams would need to be very considerable if rents are to be lowered to house lower income people. As it is, some subsidy would be needed to affordably house households receiving annual incomes up to $40,000.

MB concludes that, in the absence of high subsidy levels, this model would only be likely to attract the genuine ‘social investor’; those investors willing to take lower than commercial rates of return in a good cause. This class of investor, they suggest, is numerically small in Australia. It could, of course, include the government, who could take equity in the fund at a less than commercial rate of return.

**Taxation exemptions**

MB also offered an alternative model, one that trades on the nature of the private rental sector as a ‘cottage industry’ or attractor of ‘mums and dads investors’ concerned with ‘bricks and mortar security, rather than full commercial returns. This approach simply rests on government providing specific incentives to small investors to leave more of their savings in affordable rental housing. The lever proposed is to offer landlord-investors a tax exemption
on part of their rental income when they lease their dwellings to CHOs for a minimum period. State government could also offer land tax and local rate exemptions. CHOs would be in a position to negotiate long-term leases and guarantee management, maintenance and so on, all serving to reduce the lease cost. These savings and subsidies can then be passed on to the tenant as lower rents. One consequence could also be that low rent stock currently resided in by higher income tenants may filter through to the lower income clients of CHOs.

**The low-income housing tax credits model**

The economist Gavin Wood (2001) also proposed a way of delivering greater incentives for small landlord-investors to provide more low cost rental housing. He argues that this stock has been declining in Australia (as Yates and Wulff, 2000, demonstrate) because the after-tax returns of landlords of low-cost dwellings are lower than the returns accruing to the landlords of higher-value dwellings. There are three reasons for this divergence:

- **Federal income tax**: negative gearing delivers higher after-tax returns to high marginal tax rate investors than to lower income investors. Since high-income investors tend to be concentrated in the high value end of the rental market—and low-income investors at the low rent end—after-tax returns are lower and rental yields higher in the low rent segment.

- **Economies of scope**: the management and associated costs (land tax, real estate agents’ fees) of holding one high value rental dwelling are less than the costs for two cheaper dwellings of equal total value.

- **Higher maintenance costs**: low rent stock tends to be older and in need of more maintenance than newer high value dwellings.

Lower after-tax net returns provide a financial incentive for landlord-investors to exit the low rent segment. Wood proposes two tax-related policies to offset or even reverse this disincentive to remain in the low cost rental business.

**Low-income housing tax credit**

A US-style tax credit paid to investors of dwellings renting below a threshold level (assumed in Wood’s base case to be $100 per week in 1996 prices). The tax credit is delivered as a reduction in the investor’s annual total tax liability. Wood (following the US example) calculates the annual credit at the rate of 4 per cent of the dwelling’s building value. Wood’s microsimulation analysis concludes that this would increase the annual after-tax return to low-income investors by almost 1 per cent of the total capital value of the dwelling. The gain, on average, to high income investors is only 0.1 per cent, suggesting that this measure would be effective in targeting the tax subsidy to the low rent segment of the market.

**Capital gains reform**

An annual threshold on capital gains taxation (CGT); i.e. tax is not payable on the first, say, $10,000 of capital gain. Wood’s analysis shows that if the current British capital gains tax regime (which has a GST threshold) replaced the Australian regime, landlords of low rent dwellings would gain an average of 0.3 per cent of dwelling value each year. This compares to an increase in CGT liability of about 0.1 per cent of dwelling value for landlords in the high rent segment.

Wood’s analysis suggests that, properly targeted, subsidies delivered through the income and capital gains tax systems could increase the financial incentive for existing and prospective private landlords to remain in and expand the low rent segment of the market.

However, this approach depends for its effectiveness on landlords who receive the tax benefit actually passing it on in lower rents and renting their dwellings to lower income tenants. The fact that the low-rent segment of the housing market is not efficient reduces the
likelihood that normal market forces will bring about the desired ‘rational’ response. In short, landlords may claim the tax benefit and yet rent to higher income people unless stringent and effective administrative checks are in place and efficiently imposed. In the United States, State and local government have developed such checks, at a further cost of program implementation. Similar arrangements would need to be introduced and funded in Australia, reducing the leverage effect.

The table below summarises the main advantages and disadvantages of each of the models outlined above.

**Overview of models discussed**

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<thead>
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<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consortium bond model</td>
<td></td>
</tr>
<tr>
<td>▪ Cost effective (efficient)</td>
<td>▪ Concentrates financial and operational risk on States</td>
</tr>
<tr>
<td>▪ Effective partnership between Commonwealth &amp; States</td>
<td>▪ Relies on public borrowing in a neo-liberal climate of public debt reduction</td>
</tr>
<tr>
<td>▪ Total subsidy capped for the Commonwealth</td>
<td>▪ Requires new management systems to be put in place in SHAs to manage risks</td>
</tr>
<tr>
<td>▪ Closely targeted to need</td>
<td></td>
</tr>
<tr>
<td>▪ High leverage of private investment</td>
<td></td>
</tr>
<tr>
<td>▪ Generates a large volume of private investment</td>
<td></td>
</tr>
<tr>
<td>▪ Draws on existing financial instruments (bonds)</td>
<td></td>
</tr>
<tr>
<td>▪ Helps maintain a deep market for govt. bonds in Australia</td>
<td></td>
</tr>
<tr>
<td>▪ Provides strong incentives for states to manage the expanded public stock efficiently</td>
<td></td>
</tr>
<tr>
<td>▪ Simple and straightforward financing procedure with minimal transaction costs</td>
<td></td>
</tr>
<tr>
<td>▪ Concentrates financial and operational risk on States</td>
<td></td>
</tr>
<tr>
<td>▪ Relies on public borrowing in a neo-liberal climate of public debt reduction</td>
<td></td>
</tr>
<tr>
<td>▪ Requires new management systems to be put in place in SHAs to manage risks</td>
<td></td>
</tr>
<tr>
<td>▪ Stimulates housing demand without necessarily stimulating supply, thus reinforcing rising housing prices</td>
<td></td>
</tr>
<tr>
<td>▪ Model has not emerged ‘naturally’ through market forces anywhere in world</td>
<td></td>
</tr>
<tr>
<td>▪ Unclear what government facilitation would be necessary to overcome market barriers</td>
<td></td>
</tr>
<tr>
<td>▪ Detailed modelling not yet available</td>
<td></td>
</tr>
<tr>
<td>▪ Of limited relevance to households in bottom three income quintiles</td>
<td></td>
</tr>
<tr>
<td>▪ Model driven by realising future capital gains, but institutional investors are yield-driven</td>
<td></td>
</tr>
<tr>
<td>▪ No track record, so high risk premium demanded by investors</td>
<td></td>
</tr>
<tr>
<td>▪ Model only suits dwellings and areas promising high capital gains</td>
<td></td>
</tr>
<tr>
<td>▪ Home-owner may be left with little or no equity</td>
<td></td>
</tr>
<tr>
<td>▪ Likelihood of conflicts between home-owner and financier ‘partner’ —over maintenance, renovation, etc. How are conflicts to be resolved?</td>
<td></td>
</tr>
<tr>
<td>▪ Banks unlikely to invest, constrained by capital adequacy requirements</td>
<td></td>
</tr>
</tbody>
</table>
### Macquarie Bank retail investors model

- Could aggregate large volume of small savings
- Could provide a growing stream of finance for well-organised and professionally run community housing organisations (CHOs)
- Provides equity-like investment opportunities akin to commercial property trusts in the residential sector (diversification benefits to investors)

<table>
<thead>
<tr>
<th>Macquarie Bank alternative model (taxation exemptions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Trades on existing ‘cottage industry’ nature of the rental sector</td>
</tr>
<tr>
<td>- Could be facilitated by states granting targeted land tax and stamp duty concessions to investor-landlords</td>
</tr>
<tr>
<td>- Provides a long-term basis for secure leases (tenure) and cost savings on maintenance, etc.</td>
</tr>
<tr>
<td>- Could encourage downward ‘filtering’ of higher rent stock to affordable segment</td>
</tr>
</tbody>
</table>

| - Numbers don’t stack up: requires substantial subsidies to work, hence very costly for govt. —i.e. limited leverage of govt. funds |
| - Current shortage of suitable CHOs |
| - Not targeted at households below $30,000 income |

<table>
<thead>
<tr>
<th>Woods Tax Credit model</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Trades on existing ‘cottage industry’ nature of the rental sector</td>
</tr>
<tr>
<td>- Total tax subsidy can be capped (as in the U.S.)</td>
</tr>
<tr>
<td>- Could be facilitated by states granting targeted land tax and stamp duty concessions to investor-landlords</td>
</tr>
<tr>
<td>- Provides a long-term basis for secure leases (tenure) and cost savings on maintenance, etc.</td>
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<tr>
<td>- Could encourage downward ‘filtering’ of higher rent stock to affordable segment</td>
</tr>
</tbody>
</table>

| - Difficulty in quarantining tax benefits to affordable stock—large ‘deadweight cost’ |
| - ‘Distorts’ market outcomes and reduces efficiency |
| - Possibility of fraud via benefits claimed on stock not rented at affordable rents |
| - High surveillance costs to ensure compliance with rules |
| - Current shortage of suitable CHOs |
| - Politically infeasible, contradicting existing fiscal philosophy of govt. central agencies winding back special tax concessions |

### Going forward

Recent research from AHURI and elsewhere has clearly outlined the emergence of a housing affordability crisis in Australia. Current policy is not dealing with the problem. New approaches are needed. This paper outlines several ways, each vitally dependent on appropriate government action, that large volumes of private investment could be leveraged into expanding the stock of affordable housing. Each involves packaging adequate levels of government subsidy or guarantees.

Other models are possible. Berry (2002) discusses two such models:
- a stock exchange listed company vehicle with Commonwealth equity
- one based on the non-profit housing company recently launched by the Queensland Housing Department and Brisbane City Council.

Furthermore, ‘linkage’ or inclusionary zoning levers can be introduced through the land-use planning system, as recent developments in NSW attest (Williams, 2000). However, the four approaches outlined in the preceding section are those currently generating interest.
The detailed research carried out for the Affordable Housing National Research Consortium concluded that the Consortium bond model offers the most cost effective way for government to ensure a rapid, targeted increase in affordable housing. The balance of advantages to disadvantages presented in the above Table underscores this point. In particular:

- The other approaches are more costly and less closely targeted on households suffering serious housing stress.
- They are also less directly pointed at the supply side of the market and are more likely to stimulate housing demand without a corresponding increase in supply, especially at the low rent end of the market.
- Those approaches that rely on subsidies delivered through the tax system fail the test of political feasibility. Central agencies at both federal and state levels are focused on the task of reducing special taxation benefits to particular investment areas. Policy advocacy in favour of creating new recipients of targeted tax relief is likely to get short shrift.

The Consortium bond model is very likely to generate maximum private sector leverage in situations where dwelling price appreciation is positive in real terms and interest rates are at low to moderate levels. This approach is, as argued earlier, complementary to the existing twin policies of rent assistance and CSHA capital funding. Unless subsidy levels are very high, the consortium model does not deliver affordable rents for the very low income earner (e.g. the single unemployed person on benefit). It is, however, a very efficient and effective way of providing affordable housing to households in the second bottom income quintile, especially those with incomes in the $20,000 to $30,000 range. This group is currently caught between households in the bottom income quintile who are more likely to access available public housing and households with higher incomes able to afford ruling rents and mortgage costs.

Finally, it should be repeated, the Consortium bond model offers governments the opportunity to mix it with existing housing assistance policies in different proportions across the different housing markets and jurisdictions, in order to minimise the average subsidy cost per tenant and stretch available government funding to the maximum. This makes obvious sense in a world of constrained public expenditure and growing social need.
References


Colebatch, T. (2002b) "Investors defy Reserve and buy up", *The Age*, 9 September.


