

Better housing futures

Stimulating private investment in affordable housing

Report to the Affordable Housing Forum by

The Allen Consulting Group

2004



**Brotherhood
of St Laurence**

Working for an Australia free of poverty



CEDA
Committee for Economic Development of Australia

VicUrban



**Melbourne
Affordable
Housing**

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Executive summary

Introduction

A shortage of affordable rental housing represents a major barrier to the economic and social participation of individuals and families, and an increasingly visible constraint on economic growth.

This shortage impacts directly not only on low-income households, but increasingly also on households on moderate incomes.

A shortage of affordable rental housing has implications not only for the individuals and families directly affected, but also for the efficiency of the labour market and the broader economy.

Addressing this shortage will require investment from the public, private and community sectors. The scale of the challenge implies that private sector finance to expand the housing stock will be an important element of any long-term solution.

This report highlights that meeting this challenge involves a relatively modest financial cost, but generates substantial economic and social benefits.

The shortage of affordable housing

There is a serious shortage of affordable housing in Australia. In particular, the demand for *low-cost rental housing* exceeds the supply of such accommodation. It is estimated that in 1999, 742 000 low-income households were in 'housing stress': their housing costs were so great that they were not left with a sufficient income to meet other basic needs. The majority of these households – more than 400 000 – were renting privately from a landlord.

Why should governments be concerned?

Government assistance to address the shortage of affordable housing may be justified on three grounds:

- Affordable, appropriate and secure housing is a basic need that is not sufficiently provided in the private market;
- Housing is a critical determinant of household well-being, labour market efficiency and social cohesion; and
- The housing market is riddled with examples of conventional market failure.

Existing policy approaches are inadequate

There are several government initiatives that seek to improve Australians' access to affordable housing. These include the provision of public housing, rent assistance, the first home owners scheme and tax incentives.

Previous research has demonstrated that housing policy in Australia is poorly designed, poorly targeted and poorly integrated with other policy objectives. The bulk of housing assistance – which is in the form of indirect tax incentives – flows to households that do not need it. Housing assistance flowing to those in housing need – primarily through public housing and rent assistance – is modest in comparison.

This report argues that much of the nation's housing affordability problem can be overcome if government can stimulate institutional investment in affordable rental housing. Furthermore, where affordable rental housing is supplied, it needs to be occupied by low and moderate-income households.

In this context, target households are broadly considered to be those in the bottom 40 per cent of the income distribution, after adjusting for household composition. In particular, such a scheme would be targeted at households:

- in more expensive private rental accommodation;
- in share accommodation, where this is considered inappropriate;
- seeking to make the transition from public housing to the private rental market; and
- for whom affordable and appropriate housing would provide a significant boost to potential workforce participation or reduce key worker shortages.

The essential policy challenge is to give institutional investors a reasonable return for their perceived risks. This requires government to reconcile two core objectives:

- an appropriate risk-adjusted rate of return for investors; and
- an affordable rental level for low and moderate-income households.

In this context, the key risks applying to affordable housing relate to changes in the capital value of dwellings and changes in rental yields. If investors are to assume market risks, they will demand to be compensated for them through a higher expected rate of return. This will imply a higher government subsidy. If government chooses to absorb this market risk itself, there is a reduction in the budget cost for government, but not the true cost.

In addition to systematic (market) risks, investors in residential property may demand a premium to offset the poor quality of market information.

An important task for policy design is to allocate risks to those who can best manage them. In the context of affordable rental housing, it is argued that this would imply allocating rental price risk to tenants themselves. In practical terms, this eliminates rental price risk from a cost to government perspective, as neither governments nor private investors need to be compensated for it. For tenants, this is valued positively, as it translates into stable rents.

Policy options

This report considers three options to increase private sector investment in affordable housing. Each of these approaches is dependent on government subsidies that seek to leverage large volumes of private finance to expand the supply of affordable housing. The three options considered are:

- the Bonds Model – government investment in affordable housing financed by government bonds, supplemented by a recurrent government subsidy;
- the Partnerships Model – private sector investment in affordable housing financed by private equity and/or debt investment, supplemented by a flexible government capital grant or recurrent subsidy; and
- the Tax Credits Model – private sector investment in affordable housing financed by private equity and/or debt investment, supplemented by a fixed recurrent subsidy delivered through a tax credit.

Each of the models examined has advantages and disadvantages. For example, while a bond instrument is clearly the lowest cost option, it is not clear that this is politically feasible. What is evident from an overview of strengths and weaknesses – see Table A.1 below – is that no single model is likely to produce the best outcome on all criteria.

Table A.1

SUMMARY OF THREE OPTIONS

| OPTION | Allocative Efficiency | Dynamic Efficiency | Investor Interest | Political Feasibility |
|--------------------|-----------------------|--------------------|-------------------|-----------------------|
| Bonds Model | ✓✓✓ | ✓✓ | ✓✓✓ | ✓✓ |
| Partnerships Model | ✓✓ | ✓✓✓ | ✓ | ✓✓✓ |
| Tax Credits Model | ✓✓ | ✓✓ | ✓✓✓ | ✓✓ |

Source: The Allen Consulting Group

Estimating cost effectiveness

A stylised economic model is used to capture the essential relationships between affordable housing finance and investment. There are three distinct aspects to the operation of this model:

- Risk allocations, borrowing costs, transaction costs and baseline parameters are used to estimate the gross financing gap.
- Taxation revenue clawbacks and displacement effects are considered to arrive at an estimate of net government impact.
- The impacts of additional investment on the economy and the housing market are considered.

All cash flows and risks are converted into equivalent annual value terms. This ensures consistent valuation of discrete and recurring cash flows and risks, and the three policy options are each assessed on the assumption of a 10-year investment horizon.

Estimates of the cost-effectiveness of the three policy options considered are fundamentally driven by differences in the cost of capital. In this respect, the essential differences are outlined in Box A.1 below.

Box A.1

WHAT ARE THE ESSENTIAL FEATURES OF COST ESTIMATES?

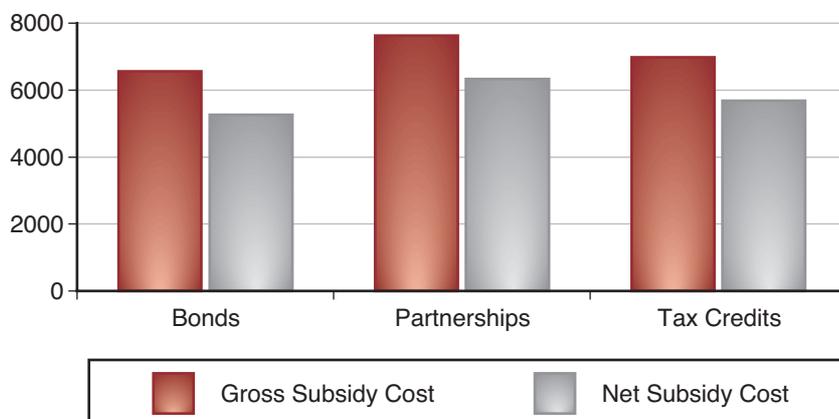
- A number of basic design features drive the estimates of cost effectiveness:
- All three models incorporate the full value of capital price risk, regardless of whether market risk is borne by government or the private sector.
 - All three models involve the allocation of rental price risk to tenants, although this is something that tenants value positively as it translates into stable rents.
 - All three models involve management and tenancy risk being managed by affordable housing associations.
 - The Bonds Model involves a lower cost of borrowing as governments can borrow at cheaper rates than the private sector.
 - The Partnerships Model involves higher transaction costs associated with negotiating and agreeing on arrangements with the private sector.

Source: The Allen Consulting Group

Figure A.1 below reports the outcomes for the three models in terms of government subsidies required.

Figure A.1

GROSS AND NET SUBSIDY COST (\$ PER HOUSEHOLD ASSISTED PER ANNUM)



Source: The Allen Consulting Group

A significant finding is that all three models involve broadly comparable subsidy costs, suggesting that other considerations will be important in choosing the best option.

All of the options considered involve a relatively modest financial cost. The lowest gross subsidy cost per household assisted is for the government bonds model, at around \$6 560 per annum. This could be reduced by around \$1 300 per annum as a result of taxation clawbacks. Further, it is noted that the reported budget cost would be reduced further as a result of government budgetary practices that do not explicitly price risk.

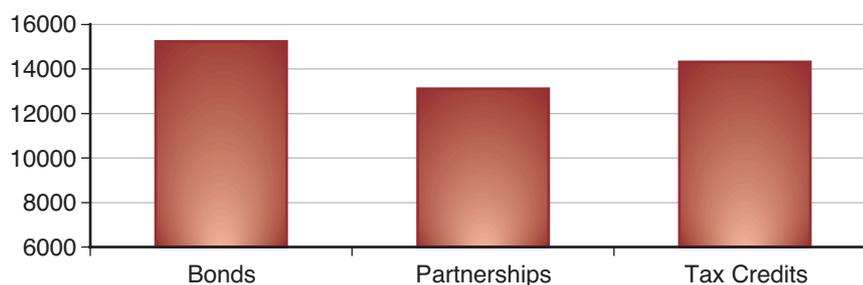
These costs compare favourably with the subsidy of over \$9 000 per household per annum for the wealthiest owner-occupiers.

A program with an initial cost to government of \$100 million per annum, growing by \$100 million per annum to \$1 billion per annum and then stabilising at that level, has the potential to assist over 150 000 households at its peak.

This would generate new housing investment of around \$2.67 billion per annum. Figure A.2 shows the number of additional households that would be assisted each year. Such a program would ultimately assist up to 150,000 households per annum and make a significant dent in the affordable housing shortage.

Figure A.2

INCREMENTAL HOUSEHOLDS ASSISTED PER ANNUM



Source: The Allen Consulting Group

At an average dwelling price of \$175 000, \$2.67 billion of new investment in the first year would directly assist around 15 200 households, growing by this number in each of the first ten years.

An investment with high economic and social dividends

Alongside a relatively modest cost, and more effective targeting than existing programs, the payoff from an investment in affordable rental housing would be substantial. The economic and social dividends would include:

- a major economic impetus, which could be tailored to the appropriate stage of the economic cycle;
- the alleviation of housing stress (and in many cases poverty) for a significant number of low and moderate-income families under financial pressure;
- the reduced economic, social and personal costs of family breakdown, crime, ill-health and low educational attainment;
- more efficient labour markets and increased workforce participation; and
- a pattern of urban and regional development that is conducive to economic prosperity, environmental sustainability and liveable communities.

A shared responsibility

The shortage of affordable rental housing – and the impact this has on Australian households – is a shared responsibility. Accordingly, this report calls for a new national partnership – one that draws on the resources and expertise of the three levels of government, the private sector and the community sector. The initiative of State and Territory Governments in establishing the National Affordable Housing Project may offer the best opportunity for some time for such a partnership to emerge.

To be effective, however, responsibilities and risks need to be allocated to those best equipped to manage them. This report has argued that:

- The role of the Commonwealth should be to provide a base subsidy and establish core program objectives, including transparent reporting requirements and sharing of good practice.
- State and Territory Governments would have primary responsibility for administration of housing support and, in the case of the Bonds Model, housing development.
- A network of affordable housing managers would have responsibility for property management and tenancy issues, subject to guidelines.
- Market rental risk would be eliminated through the use of fixed price contracts between renters, government and investors.
- Other market risks would be borne by State and Territory Governments (in the Bonds Model) or private investors (in the Partnerships and Tax Credits Models).

An important feature of any national program should be to encourage governments, affordable housing managers and the private sector to experiment with a variety of approaches to finance, design, management and policy. In this context, a strong emphasis on project evaluation, combined with a mechanism to share the lessons of these experiences, would help to enshrine a learning process in policy development.

Conclusion

For some years now, the evidence has suggested that the lack of affordable rental housing generates major economic and social costs. It has also suggested that it is a policy challenge that is not beyond us.

This report has shown that the financial cost associated with such a commitment is modest and has argued that the economic and social benefits would be substantial. Achieving the objective of affordable, appropriate and secure housing for Australians, however, will take a stronger policy commitment than governments have thus far demonstrated.

Chapter 1

Introduction

1.1 Introduction

A shortage of affordable rental housing represents a major barrier to the economic and social participation of individuals and families, and an increasingly visible constraint on economic growth.

It impacts directly on not only low-income households, but increasingly also households on moderate incomes. Indirectly, it impacts on individuals and families across the entire income distribution as it affects public, private and community services.

Addressing the policy challenge requires an appreciation of the basic financial principles that motivate private investment in rental housing and the barriers that must be overcome to increase that investment.

This report seeks to examine these issues by considering three specific policy options to address them.

1.2 Scope of the report

The purpose of this report is to compare options to increase the supply of affordable rental housing and thereby reduce the shortage of affordable rental housing.

The report does not explicitly consider the important interaction between home ownership and rental housing. It is noted, however, that while support for home ownership will ease pressures in the private rental market, evidence suggests that these benefits are unlikely to flow to those who most need support.

The report assumes that existing housing policies are unchanged. In particular, it is considered that current programs under the Commonwealth State Housing Agreement (CSHA) and Commonwealth Rent Assistance – despite their shortcomings – are considered essential in helping to alleviate the pressures confronting households in acute need.

Finally, the design of a scheme to increase the supply of affordable rental housing will inevitably be complex. The report does not seek to answer all program design questions, but attempts to raise relevant concerns that would need to be considered in more detail by governments.

1.3 Structure of the report

The remainder of the report is organised as follows:

- Chapter Two documents the affordable housing shortage in Australia, its costs and the rationale for policy intervention.
- Chapter Three considers the current suite of housing policies and their effects on housing affordability.
- Chapter Four examines issues relevant to stimulating private sector investment in affordable housing, including basic issues of risk and return.

- Chapter Five explains and assesses three policy options to increase the supply of affordable rental housing;
- Chapter Six examines the impact of these options in terms of the costs and benefits facing governments and society more broadly; and
- Chapter Seven concludes with a consideration of policy implications.

Chapter 2

The shortage of affordable housing

2.1 Introduction

This chapter documents the scale of the affordable housing shortage in Australia and the costs this imposes on individuals, families and society. The chapter also considers the rationale for government intervention to expand the supply of affordable rental housing.

2.2 Affordable housing in Australia

The majority of Australian households either own or are buying their own home. In 2000-01, there were about 7.3 million households in Australia. Of these:

- 38 per cent owned their own home;
- 32 per cent were buying a home; and
- 27 per cent were renting.¹

Of the estimated 2 million renting households, 82 per cent were renting from a private landlord. The remaining 18 per cent were renting public housing from a state or territory housing authority.

The focus of this report is on how to improve Australians' access to *affordable* housing. While measures to improve access to housing that is appropriate and secure are not explicitly considered, considerations of affordability cannot be sensibly separated from the appropriateness and security of tenure of the housing in question. As will be discussed, the 'affordability problem' facing many households in Australia is their inability to access housing that is both affordable and appropriate to their family situation, for reasons such as size and location.

Housing affordability and housing stress

A judgment of whether a household's housing situation is affordable is usually based on the proportion of income that is taken up in housing costs. Housing becomes unaffordable if it takes up too much of a household's budget, such that not enough money is left for spending on other things. This approach was encapsulated by the National Housing Strategy (NHS), which defined affordable housing as a situation where:²

housing costs ... leave households with a sufficient income to meet other basic needs such as food, clothing, transport, medical care and education.

Given this definition, housing affordability is considered to be a problem among low-income households. High-income households who spend a lot on housing are not considered to have an affordability problem because they still have sufficient income to meet other basic needs.

¹ ABS 2003, *Household income and income distribution, Australia, 2000-01*. cat. no. 6523.0. A further 2 per cent of households were classified as having 'other tenure type'. Percentages do not add to 100 due to rounding.

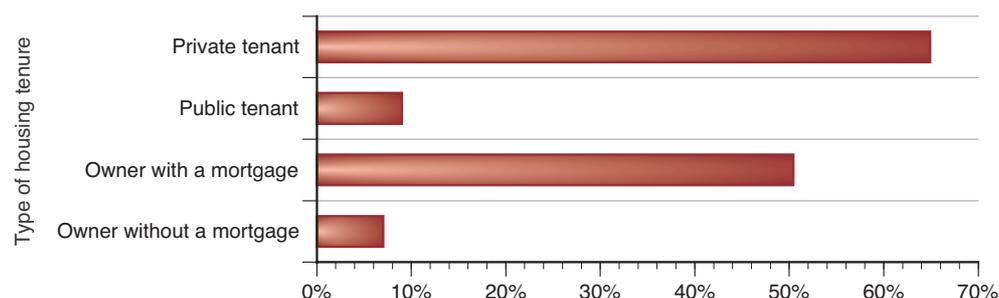
² National Housing Strategy 1991, *The affordability of Australian housing*, Issues Paper No. 2, AGPS, Canberra.

The NHS defined households in the lowest 40 per cent of the income distribution who spend more than 25 per cent of income on housing costs (mortgage payments or rent) as being in *housing stress*. The NHS also indicated that a more conservative benchmark would be 30 per cent of income. This latter benchmark coincides with the minimum acceptable mortgage repayment limits set by institutional mortgage providers.³ The 30 per cent of gross income benchmark has become widely used as the measure of whether a low-income household is facing housing affordability problems.

The most recent ABS housing survey found that, in 1999, households renting from a private landlord were the most likely to experience housing stress. Among the lowest 40 per cent of the income distribution, about 65 per cent of private tenants were paying more than 30 per cent of income in housing costs. In comparison, housing stress was experienced by 50 per cent of people buying their home, 7 per cent of outright home owners and 9 per cent of public tenants (figure 2.1).⁴ In total, 742 000 households were found to be in housing stress, of whom more than 400 000 were private tenants.

Figure 2.1

PROPORTION OF LOW INCOME HOUSEHOLDS PAYING MORE THAN 30 PER CENT OF GROSS CASH INCOME IN HOUSING COSTS, 1999



Notes: 'Low-income' households are those in the lowest 40 per cent of the income distribution. Housing costs include: mortgage or loan repayments where the purpose of the loan is to buy or build, add to or alter the dwelling; rental payments; water and general council rates; land tax payments; body corporate or strata title payments; and expenditure on repairs and maintenance for the dwelling. Source: ABS 2000, *Australian housing survey: Housing characteristics, costs and conditions*, cat. no. 4182.0, AusInfo, Canberra.

³ M. Berry and J. Hall 2001, *Policy options for stimulating private sector investment in affordable housing across Australia: Stage 1*, Report prepared for the Affordable Housing National Research Consortium.

⁴ ABS 2000, *Australian housing survey: Housing characteristics, costs and conditions*, cat. no. 4182.0, AusInfo, Canberra.

Berry and Hall (2001) analysed the affordability of housing in Sydney, Melbourne and Adelaide in June 2000.⁵ They found that low-income tenants had extremely limited affordable housing choices in all three cities. For many households, housing that was both affordable and appropriate was even more limited. For example:

- Fewer than 10 per cent of low-income households in each city could afford to rent a three bedroom house – and then only in outer metropolitan locations;
- Only a very small proportion of households could afford to rent a one bedroom unit in inner Sydney or Melbourne, with almost 40 per cent able to in Melbourne;
- No low-income household could afford to purchase a three bedroom house anywhere in Sydney, Melbourne or Adelaide; and
- No low-income households could afford to purchase a dwelling of any type anywhere in Sydney.

The authors also argued that this trend would continue to increase in the years ahead:

On present trends, the number of households in housing stress in Australian capital cities will double in 15 years and will reach one million in 20 years. This analysis ignores the growth in stressed households in regional Australia where research by Yates and Wulff suggests that effective shortages of low cost rental dwellings are more intense, where incomes at the bottom end have fallen significantly. (p.65)

The recent evidence thus suggests that a large and growing proportion of Australian households are suffering housing stress. There is a considerable shortage of housing that is affordable and appropriate for low-income households.

This is no longer an issue simply for those on very low incomes or reliant on government benefits. Housing stress is now extending to moderate-income households that are not eligible for assistance under existing housing programs.

Yates and Wulff (2000) highlighted the growth in the shortage of low-cost rental housing in the decade to 1996. They estimated the shortfall of low-cost rental stock to be almost 50 000 dwellings in 1996. Further, they showed that more than 100 000 low-cost rental dwellings were occupied by higher income households paying relatively low proportions of their incomes in rent. A similar pattern characterised the low-moderate income segment.⁶

Such ‘under consumption’ of housing by higher income earners contributes directly to the shortage of affordable housing for low-income households. Allowing for this fact, Yates and Wulff estimated the national shortage of low-cost rental dwellings to be around 150 000 in 1996. More recently, the ABS has estimated that more than 400 000 rental households are in housing stress – suggesting that the shortage of affordable housing for low-income households has since increased further.

⁵ M. Berry and J. Hall 2001, *Policy options for stimulating private sector investment in affordable housing across Australia: Stage 1*, Report prepared for the Affordable Housing National Research Consortium.

⁶ J. Yates and M Wulff, ‘W(h)ither low cost private rental housing?’ *Urban Policy and Research*, 18 (1), 45-64.

The Productivity Commission has recently noted that:⁷

Increasing investor activity in rental markets appears to have contributed to a rise in vacancy rates for rental properties and a decline in gross yields (the ratio of median rent to the median price of a dwelling). According to the RBA, the gross rental yield on houses in Australia declined from just under 5.5 per cent in March 1994 to around 3.4 per cent in June 2003. For flats, yields declined from around 6 per cent to just over 4 per cent over the same period.

It is important not to misinterpret such statements as implying that the shortage of affordable rental housing is moderating, as:

- Alongside increased rental supply, there is an increase in the number of households renting.
- The private rental market is highly segmented by location. For example, despite rents falling slightly in high-value locations in New South Wales in 2001-02, rents in low-cost areas remained stable or increased slightly.⁸
- Declining rental yields – measuring rents as a proportion of asset values – are as likely to be a function of rising asset values as falling rents.
- Falling aggregate rental levels do not automatically relieve housing stress, as this also depends on whether it is low and moderate-income households that benefit.

For these reasons, evidence of falling aggregate rental yields provides little support for the proposition that housing stress is easing significantly.

2.3 Why should governments be concerned?

While most people's housing needs are catered for by the private market, many households rely on government assistance to access affordable, appropriate and secure housing.

Government assistance may be justified on three grounds:

- Affordable, appropriate and secure housing is a basic need that is not sufficiently provided in the private market;
- Housing is a critical determinant of household well-being, labour market efficiency and social cohesion; and
- The housing market is riddled with examples of conventional market failure.

Appropriate, affordable and secure housing for all

Government intervention in the provision of housing services is typically justified on the grounds that people's basic need for appropriate housing is not met by the market.

⁷ Productivity Commission 2003, *First home ownership: Issues paper*, AusInfo, Canberra, p.10.

⁸ NSW Cabinet Office 2003, Submission to the PC Inquiry into First Home Ownership, p.43.

Governments in Australia have long recognised this need as a basis for intervention in the housing market. Since 1945, the primary mechanism by which governments have sought to assist households gain appropriate housing has been the Commonwealth State Housing Agreement (CSHA). The 2003–08 CSHA states that:⁹

In entering into this Agreement the Commonwealth and the States recognise that the provision of housing assistance to people requiring access to affordable and appropriate housing is essential to reduce poverty and its effects on individuals and the community as a whole. The aim of this Agreement is therefore to provide appropriate, affordable and secure housing assistance for those who most need it, for the duration of their need.

In other words, the Commonwealth and the States agree that their role is to assist households access housing that is *appropriate, affordable* and *secure* – with priority given to those with the greatest need.¹⁰ This role is based on the failure of the market to deliver efficient and effective housing outcomes.

Housing affects well-being

Housing and household well-being

Australians' housing arrangements are of great importance to their quality of life. Housing has considerable social and symbolic meaning to people, above and beyond its use as a source of shelter. The National Housing Strategy (NHS) quotes Kendig and Paris with Anderton:¹¹

The home is ... the place where people spend more time than anywhere else. It is the centre of recreation and social activity as well as shelter. Its location determines access to a wide range of services and facilities, and it is an important symbol to the world of ourselves and our social position.

Further, in economic terms, housing is the most significant item of expenditure over the lifetime of most Australians. Housing costs can have a significant impact on the ability of households to meet other basic needs. In addition, the house is the most valuable asset of most homeowners. Changes in the value of housing can be an important determinant of households' long-term financial security.

A lack of affordable housing can present severe problems for individuals and families, including:

- *housing-related financial hardship* – Australian research has consistently found a positive relationship between poverty and housing costs, especially for households in the private rental sector. Households paying more than 30 per cent of their income on housing are likely to suffer severe financial difficulties in meeting non-housing expenses;¹²

⁹ 2003 Commonwealth State Housing Agreement, Department of Family and Community Services, AusInfo, Canberra, Recital C.

¹⁰ The types of assistance provided under the CSHA are discussed in section 3.2.

¹¹ H. L. Kendig and C. Paris with N. A. Anderton 1987, *Towards fair shares in Australian housing*, National Committee of Non-government Organisations, IYSH, Canberra.

¹² AHURI and The Allen Consulting Group 2001, *Policy options for stimulating private sector investment in affordable housing across Australia: Stage 3 Report*, report for the Affordable Housing National Research Consortium.

- *family instability and breakdown* – inadequate housing and related financial stress can contribute to family breakdown, as well as resulting from it. Without secure tenure over housing of a reasonable basic standard which is large enough to meet the minimum requirements for shelter of a household, given its size and composition, normal ‘family life’ is extremely difficult to support;¹³
- *diminished labour market opportunities* – the geographic concentration of lower cost housing in areas of low employment prospects can markedly reduce the job prospects of households forced by lack of resources to live in such areas. Poor job prospects reduce lifetime earnings and the capacity to meet long-term housing costs;
- *health problems* – there is a large body of evidence linking poor housing to a range of health problems for household members.¹⁴ Geddes (1993) finds that low socio-economic status residents in public housing in Adelaide had better health outcomes than similar households in the private rental market;¹⁵
- *crime* – the links between crime and inadequate housing are complex. Providing housing that is both appropriate and affordable is one of a number of strategies necessary for dealing with the problems criminal activity imposes on victims and the broader community; and
- *low levels of educational attainment* – children living in temporary, overcrowded or otherwise inadequate housing may suffer educational disadvantage. Insecurity of tenure and frequent forced moves can disrupt a child’s schooling and encourage truancy.¹⁶

Housing and labour market efficiency

A shortage of affordable housing affects labour market efficiency in two important respects:

- Employers find it hard to fill job vacancies.
- Potential employees cannot access affordable, appropriate and secure housing within reasonable proximity to job opportunities.

A number of groups of workers are likely to be affected:

- potential employees who are seeking to make the transition from welfare to work but cannot afford to live in areas of employment growth;
- ‘key workers’ who provide essential community services – for example, nurses, teachers, police officers and public transport workers; and
- workers in service industries such as entertainment, hospitality and tourism.

¹³ J. McCaughey 1992, *Where now? A study of homeless families in the 1990s*, Background Paper No. 8, Australian Institute of Family Studies, Melbourne.

¹⁴ See, for example, The National Health Strategy 1992, *Enough to make you sick: how income and environment affect your health*, Research Paper No. 1, Canberra; B. Cass 1991, *The housing needs of women and children*, Discussion paper prepared for the National Housing Strategy; and H. Clough, *Somewhere that’s home*, Compass Accommodation Support Service, Melbourne.

¹⁵ E. Geddes 1993, *The impact of socio-economic and locational disadvantage of health outcomes and cost*, The Centre for South Australian Economic Studies, Adelaide.

¹⁶ C.Bridge, J.Cockburn-Campbell, P.Flatau, S.Whelan, G.Wood and J.Yates 2003, *Housing assistance and non-shelter outcomes*, Australian Housing and Urban Research Institute.

While these problems already exist, a tightening labour market will make them an increasingly visible constraint on economic growth. Employers will be unable to operate efficiently if they are unable to hire the types of labour they require. They will be required to increase wages to attract workers or delay expansion. The former would create wage pressures and place further pressure on interest rates, while the latter would stifle growth in economic activity and employment.

The ongoing debate on welfare reform in Australia has emphasised the importance of maximising opportunities for economic and social participation. A lack of affordable housing in strong labour markets is a clear barrier to people taking advantage of employment opportunities.

Furthermore, highly skilled workers are not insulated against the effects of a lack of affordable local housing. The location choices of highly skilled workers are influenced by factors such as community safety, access to quality education, health and community services, and a range of lifestyle opportunities. These are services that require a ready supply of key workers and service industry workers.

Housing and social cohesion

In a special 1998 issue of the US journal *Housing Policy Debate*, a number of papers focused on the general links between social capital formation and adequate housing. The availability of affordable, appropriate and secure housing is related to higher levels of social capital. Neighbourhood stability reinforces social networks and provides a secure residential environment in which people can securely plan their lives.¹⁷

Attempts to improve social cohesion must inevitably explore the links between poor housing and community disadvantage. A major report by Jesuit Social Services in 1999 demonstrated that the most disadvantaged communities in Australia have remained disadvantaged for a number of decades.¹⁸ There is significant debate as to whether housing policy efforts to address neighbourhoods of entrenched disadvantage should be focused on facilitating mobility, community renewal or a combination of the two.

On the one hand, there is evidence that greater mobility weakens family and community support, and trust – which may also have implications for crime.¹⁹ On the other hand, housing programs in the United States have found substantial improvements in material living conditions and employment prospects from programs that actively facilitate mobility.²⁰

¹⁷ K. Temkin and W. Rohe 1998, 'Social capital and neighbourhood stability: an empirical investigation', *Housing Policy Debate* 9 (1).

¹⁸ T. Vinson 1999, *Unequal in life. The distribution of social disadvantage in Victoria and New South Wales.*, Melbourne: The Ignatius Centre for Social Policy and Research, Jesuit Social Services. See also R. Fincher and M. Wulff 2001, 'Moving in and out of disadvantage: population mobility and Australian places' in R. Fincher and P. Saunders, (eds), *Creating unequal futures? Rethinking poverty, inequality and disadvantage*. Crows Nest: Allen & Unwin. pp.194-229.

¹⁹ There is an extensive literature on these points. See E.L. Glaeser and D. DiPasquale 1999, 'Incentives and social capital: are homeowners better citizens?', *Journal of Urban Economics*, 45 (2), pp.354-384.
D. Halpern 2001, 'Moral values, social trust and inequality', *British Journal of Criminology*, 41, pp.236-251.

²⁰ Under the Moving to Opportunity program, families use housing vouchers and housing counselling to move from public housing in very poor communities to communities with lower poverty and better employment prospects. Participants have experienced significantly improved housing and labour market outcomes.
E.Rosenbaum and L.Harris 2001, 'Residential mobility and opportunities: early impacts of the Moving to Opportunity Demonstration Program', *Housing Policy Debate*, 12 (2); and J. Ludwig,

The significance of affordable housing in addressing disadvantage has been a recurring theme in reviews of poverty.²¹ For example, when a consortium of economic, community and environmental peak bodies developed a comprehensive agenda for ‘liveable communities’, their principal action item under the objective of ‘closing the gap between the advantaged and disadvantaged’ was:²²

The Commonwealth–State Housing Agreement should be reinforced and updated to incorporate new development and financing opportunities for affordable housing on a national basis.

Market imperfections

While not the principal rationale for intervention, housing also has numerous characteristics that create the potential for conventional definitions of market failure.²³ Many of these involve failures in the provision of credit. Flannery (1993) identified information failures as the most pervasive source of market failure in the provision of housing finance.²⁴ Asymmetric information can result in incomplete markets. Credit markets fail due to the effects of adverse selection and to the presence of unpredictable or systemic risks. Barr (1992) also discusses how the state can improve efficiency by intervening in housing to ameliorate ‘a series of principal-agent problems’.²⁵

Smith, Rosen and Fallis (1988) pointed to the following other sources of market failure:²⁶

- the durability of housing;
- slow adjustment to equilibrium because of credit rationing, land use controls and non-market clearing prices resulting from incomplete information;
- the dual nature of housing as both a consumer good and an investment;
- the symbiosis of housing and location choice; and
- high transaction costs exacerbated by the heterogeneous nature of housing as a commodity.

G. Duncan and J. Pinkston 2000, ‘Neighborhood effects on economic self-sufficiency: Evidence from a randomized housing-mobility experiment’, unpublished draft, January, Center on Budget and Policy Priorities, Washington DC.

²¹ This is evident from a range of submissions received by the Senate Community Affairs Committee Inquiry into Poverty and Financial Hardship. See http://www.aph.gov.au/senate/committee/clac_ctte/poverty/submissions/sublist.htm

²² Liveable Communities Communique, November 2001.

²³ Much of this discussion of market failure in housing is derived from J. Yates 1994, ‘Private finance for social housing in Australia’, *Housing Policy Debate* 5 (2).

²⁴ M. Flannery 1993, ‘Government risk-bearing in the financing sector of a capitalist economy’ in M. Sniderman (ed.), *Government risk-bearing*, Kluwer, Boston, pp. 71-100.

²⁵ N. Barr 1992, ‘Economic theory and the welfare state: a survey and interpretation’, *Journal of Economic Literature*, 30 (2), pp. 741-803.

²⁶ L. Smith, K. Rosen, and G. Fallis 1988, ‘Recent developments in economic models of housing markets’, *Journal of Economic Literature*, 26 (1), pp. 29-64.

Chapter 3

Affordable housing: the policy context

3.1 Introduction

This chapter examines the range of existing housing policy initiatives, their effectiveness and their impacts on housing investors and consumers.

3.2 Housing policies

The shortage of affordable housing described in chapter 2 exists despite a large amount of government expenditure on housing programs. This section reviews the major government programs that aim to improve housing affordability before explaining why many households remain in housing stress.²⁷

Commonwealth State Housing Agreement

The focus of the CSHA is on the provision of public housing to people with very low income or special needs, such as people with a disability. Public housing rents are generally set at market levels and rebates are granted to low-income earners such that tenants pay no more than 25 per cent of their assessable income in rent.

The CSHA also provides funding for community housing, Indigenous housing, crisis accommodation, home purchase assistance and private rental assistance. Home purchase assistance is provided to moderate-income households to help with first home purchases or mortgage repayments. Private rental assistance is provided to low-income households experiencing difficulty in securing or maintaining private rental accommodation. However, the scale of such assistance is limited.

On average, the Commonwealth provides about two-thirds of total funding for the CSHA, with the remainder provided by the States and Territories. In 2003-04, the Commonwealth, State and Territory Governments will provide an estimated \$1.3 billion to CSHA programs, of which the Commonwealth will contribute \$930 million.²⁸

Total funding under the CSHA has declined by 20 per cent in real terms over the past decade.

Rent assistance

In addition to the assistance provided through the CSHA, the Commonwealth also fully funds the provision of rent assistance to low-income households in the private rental market. Assistance is in the form of a non-taxable income supplement paid to recipients of income support payments or people who receive more than the minimum family payment.

²⁷ For the purposes of the analysis presented in this report, it is assumed that these policies continue on a business-as-usual basis.

²⁸ Shelter Australia and Australian Council of Social Service 2003, *Rent assistance: does it deliver affordability?*, Sydney.

Rent assistance is paid at the rate of 75 cents for every dollar of rent paid above a specified minimum rent threshold until a maximum rate is reached. The maximum rates and thresholds vary according to family circumstances. For singles without children, the maximum rate also varies according to whether or not accommodation is shared with others. Rent thresholds and maximum rates are indexed in March and September each year to reflect increases in the consumer price index.²⁹

In 2002, about 940 000 Australians were receiving rent assistance. The Commonwealth estimates it will provide \$1.9 billion in rent assistance in 2003-04.³⁰

Total funding for rent assistance has increased by almost 30 per cent in real terms over the past decade, reflecting the increased reliance of low-income households on the private rental market.

First home owners grant scheme

In July 2000, the Commonwealth introduced a first home owner grant of \$7000 to compensate first home buyers for increases in building and housing costs associated with the implementation of the GST. The scheme is administered by States and Territory Governments. The grant is available to households who purchase a home to be their principal place of residence and who have not previously owned a residential property.

In March 2001 the FHOG was increased to \$14 000 for first home owners who build their home, or purchase a newly constructed home. From January 2002 until June 2002 the FHOG was scaled back to \$10 000. Since July 2002 the grant has been wound back to its initial \$7000 value. Notably, the grant is not means tested.

Since its introduction, more than 480 000 households have received a first home owner grant, at a cost to the Commonwealth of more than \$3.8 billion. In 2002-03, about 150 000 households received the grant, at a cost of about \$1.1 billion.

Tax incentives

The most significant form of housing assistance is the indirect assistance provided through the taxation system. Investors in rental properties can expense some costs against income, including unrelated income ('negative gearing'), and include others in the property's capital base and depreciate them over time (such as air conditioning, light fittings and carpets).³¹ Further, the Building Write Off Allowance provides for 2.5 per cent per annum of the value of initial construction to be written off over 40 years, with this allowance being conditional on the property being rented or available for rent. The annual deduction can be written off against pre-tax income, although its benefit is partly offset as it reduces the initial capital base for the purposes of calculating capital gains tax.

²⁹ Department of Family and Community Services 2003, *Rent Assistance and Centrepay*, <http://www.facs.gov.au/internet/facsinternet.nsf/aboutfacs/programs/house-rentassist.htm>, accessed on 15 October 2003.

³⁰ Shelter Australia and Australian Council of Social Service 2003, *Rent assistance: does it deliver affordability?*, Sydney.

³¹ The cost to government of negative gearing is believed to be in the order of \$2 billion per annum. See <http://www.onlineopinion.com.au/view.asp?article=767>

Investments in rental properties are subject to capital gains tax (CGT). CGT is levied on realised capital gains accruing on designated assets acquired after September 1985. Initially, CGT was based on real capital gain achieved. Since 21 September 1999, however, an individual is allowed a discount of 50 per cent on the nominal capital gain achieved, provided the asset has been held for at least 12 months.

Despite some benefits, investors in rental property also appear to face a number of barriers relative to home ownership. Rental income on investment property is taxed as part of income, whereas the implicit value of rental services by owner-occupied housing is tax-free. It may be argued that this relative cost is mitigated by the non-deductibility of mortgage interest payments. Unlike rental housing, a taxpayer's main residence is not subject to CGT.

Yates (2002) estimated the cost of these tax incentives in 2001 at:

- \$13 billion arising from the non-taxation of capital gains from owner-occupied housing; and
- \$8 billion arising from the net effects of the non-taxation of imputed rents on owner-occupied housing.³²

Yates points out that the benefits of these tax arrangements flow predominantly to high-income households. For example, she estimates that:

- High-income owners receive tax benefits of \$9 000 per household assisted per annum; and
- Purchasers in the bottom 80 per cent of the income distribution receive tax benefits on average of less than \$500 per households assisted per annum.³³

Investors in new rental property are also liable for stamp duty, which increases with the value of property.³⁴ This is also taken into account in the calculation of the initial capital base for the purposes of calculating capital gains tax.

A number of features of the taxation treatment of investments in rental housing favour investors with higher marginal tax rates – for example, they derive greater benefit from negative gearing and the Building Write-Off Allowance, which provide a shelter against other taxable income. Progressive tax measures, such as land and property taxes, also discourage investors increasing the value of their property portfolio.

³² Yates estimates the non-taxation of imputed rents to be worth \$13 billion, but discounts this by \$5 billion which is the cost of non-deductibility of mortgage interest costs. She argues this provides the most appropriate estimate. See J. Yates 2002, *A distributional analysis of the impact of direct and indirect housing assistance*, AHURI.

³³ Yates, J. 2002, *A distributional analysis of the impact of direct and indirect housing assistance*, AHURI.

³⁴ Land and property taxes imposed by State and Local governments also have the feature of increasing with the total value of property, discouraging larger holdings.

3.3 Recent developments in housing policy

Commonwealth State Housing Agreement (CSHA)

The existing Commonwealth State Housing Agreement (CSHA) provides the foundation on which Australian housing policy is built. The CSHA is an agreement between the Commonwealth and the States and Territories, the purpose of which is to provide funding to assist those whose needs for appropriate housing cannot be met by the private market.

The principles guiding the Commonwealth and the States in the development of the 2003 CSHA include:

- to maintain a core social housing sector to assist people unable to access alternative suitable housing options;
- to promote innovative approaches to leverage additional resources into social housing, through community, private sector and other partnerships;
- to adopt a cooperative partnership approach between levels of government towards creating a sustainable and more certain future for housing assistance; and
- to promote a national, strategic, integrated and long-term vision for affordable housing in Australia through a comprehensive approach by all levels of government.

The Commonwealth and each State will negotiate and enter into a bilateral agreement that states how they will involve the private sector, community and local government in the provision of social housing. Measures may include:

- exploring the use of private, community and local government investment capital or other mechanisms to direct investment to affordable housing, and
- changes to fiscal measures including the use of State and Territory government charges such as stamp duty and land tax to develop affordable housing opportunities.

Prime Ministerial Task Force on Housing Ownership

In September 2002, the Prime Minister commissioned the Menzies Research Centre (MRC) to report on possible policy interventions to support home ownership in Australia. The MRC produced a three-volume report³⁵:

- the first volume suggested that a shared equity scheme could have a positive impact on home ownership;
- the second volume suggested that a temporary loans scheme could help ameliorate the housing effects of short-term variations in income (such as job loss); and
- the third volume suggested that improved education and tax incentives could encourage investment in home ownership.

Reflecting the broader public debate, the principal focus of this work was on home ownership.

³⁵ Menzies Research Centre 2003, *Summary of findings for the Prime Ministerial Task Force on Home Ownership Vol. 1, 2 & 3*, see <http://www.mrcld.org.au/secure/SNAPSummary%20of%20Findings.pdf>

Productivity Commission Inquiry into First Home Ownership

On 2 August 2003, the Treasurer formally requested that the Productivity Commission inquire into the affordability and availability of housing for individuals and families wishing to purchase their first home.

The Productivity Commission has been asked to:

- identify and analyse all components of the cost and price of housing, including new and existing housing for those endeavouring to become first home buyers;
- identify mechanisms to improve the efficiency of the supply of housing and associated infrastructure; and
- identify any impediments to first home ownership, and assess the feasibility and implications of reducing or removing such impediments.

In September 2003, the Productivity Commission released a First Home Ownership Issues Paper, providing the background to the inquiry and the matters about which the Commission is seeking input.

National Affordable Housing Project

State and Territory Governments have thus far been more interested than Commonwealth Governments in promoting affordable rental housing – as opposed to home ownership. In the past, this has involved a variety of attempts to attract private sector investment in affordable housing – including the use of large-scale demonstration projects.³⁶

The National Affordable Housing Project (NAHP) is a group recently established by State Governments to promote a national, strategic, integrated and long-term vision for affordable housing in Australia – one of the guiding principles of the 2003–08 CSHA.

The Victorian Government's submission to the PC Inquiry identifies the following priorities for coordinated action on affordable housing:

- increase the supply of affordable housing;
- increase access to housing that is affordable;
- enhance delivery arrangements for social and affordable housing; and
- review market efficiency and effectiveness.

The explicit goal is to increase opportunities for low and moderate-income households to access affordable and appropriate housing in diverse, cohesive and sustainable communities. Importantly, the NAHP will model scenarios in nominated case study areas across jurisdictions to demonstrate how adjusting a combination of policy levers could facilitate the development of more affordable housing in these areas.

The Commonwealth has indicated that it will be unable to contribute to the NAHP while the Productivity Commission Inquiry into First Home Ownership is progressing.

³⁶ Yates provides an overview of previous NSW experience with Residential Property Trusts, the Public Equity Partnership Scheme (PEP1) and the Private Equity Partnership Scheme (PEP2). J. Yates 1994, 'Private finance for social housing in Australia', *Housing Policy Debate* 5 (2).

3.4 More is needed to reduce housing stress

The low rate of housing stress among tenants of public housing suggests that *CSHA programs* effectively provide the vast majority of their recipients with access to affordable housing. However because public housing is expensive to provide, it is appropriate that it be targeted toward households with the most acute housing needs. The potential capital and ongoing costs of extending public housing to all households experiencing housing stress are prohibitive.

Rent assistance makes housing more affordable for low-income households, and successfully moves many households out of housing stress. But it is not effective in alleviating housing affordability problems for many other households.

National Shelter and the Australian Council of Social Service (2003) have found that in 2001-02, 35 per cent of rent assistance recipients – or about 330 000 people – were paying more than 30 per cent of income on rent.³⁷ About 9 per cent were paying more than 50 per cent of income on rent. Rent assistance recipients living in the inner parts of mainland capital cities were generally the most likely to suffer housing stress. This research indicates that one of the reasons that many rent assistance recipients are in housing stress is that the maximum rate of rent assistance does not vary to account for the significant geographical disparities in the rents paid.

This finding is consistent with the work of Berry and Hall (2001), who found that rent assistance provides no substantial alleviation of housing stress for single people and couples without children living in Sydney and Melbourne. Rent assistance does improve the ability of single parents and couples with one or two children to access affordable housing in Sydney and Melbourne, but only in a minority of metropolitan locations.

The \$1.3 billion to be provided under the *CSHA* in 2003-04 and the \$1.9 billion to be provided under Commonwealth Rent Assistance are dwarfed by the estimated \$21 billion provided in tax incentives that primarily benefit high income earners.

The *first home owners grant* may assist some households to reach the deposit level they wish to attain before purchasing a house. As a one-off payment, however, the grant will have only limited effect on the ongoing cost of mortgage repayments. As mortgage repayments on a given house are greater than the rent paid on a house of similar value, it is not clear how the first home owners grant could assist low-income households move out of housing stress. In fact, it is likely that the availability of the grant causes house prices to rise to some degree, which could increase the number of households with a mortgage who experience housing stress.

The missing link in housing policy

While housing policy in Australia provides targeted support for those in most need, through support for homelessness programs, the provision of public housing and rent assistance, the financial pressures of the housing market are now extending up the income distribution. This is limiting the opportunity for workforce participation and social mobility for those who are seeking to make these transitions.

The missing link in Australian housing policy is a strategy that reduces the shortage of affordable rental housing for those in housing stress.

³⁷ The affordability benchmark used here is net rent (gross rent less rent assistance) as a proportion of net income (gross income less rent assistance). Shelter Australia and Australian Council of Social Service 2003, *Rent assistance: does it deliver affordability?*, Sydney.

Given the scale of housing stress in Australia, support is likely to be needed for the development of new stock of multi-dwelling, affordable rental housing. While variations could be tailored for the conversion of existing stock, or for individual properties, a long-term solution to the shortage of affordable rental housing would appear to require a significant expansion of stock. In this context, it is likely that economies of scale can be achieved by focusing on multi-dwelling developments.

It is envisaged that such projects would be supported on the basis of a competitive process. While affordable housing would be the principal objective, assessment criteria should also promote designs that involve a reasonable housing mix, functionality, sustainability and community safety. The location of supported housing should be consistent with the objectives of government infrastructure, planning and population policies – with adequate access to employment opportunities and community services.

State and Territory Governments would have responsibility for administration of funding, including project selection, but would be required to meet reporting standards outlined by the Commonwealth Government. Allowing States and Territories the flexibility to develop their own criteria for assessment – subject to core guidelines – would give them the opportunity to meet particular regional and local housing needs.

Target households

As discussed in chapter 2, merely expanding the supply of rental housing does not ensure that it is made available at affordable rents and for those households that need it.

In this context, target households are broadly considered to be those in the bottom 40 per cent of the income distribution, after adjusting for household composition. It is anticipated that such a scheme would be targeted at households:

- in more expensive private rental accommodation;
- in share accommodation, where this is considered inappropriate;
- seeking to make the transition from public housing to the private rental market; and
- for whom affordable and appropriate housing would provide a significant boost to potential workforce participation or reduce key worker shortages.

Tenant eligibility would not affect eligibility for other government benefits, including rent assistance. That is, the benefit provided would be additional to any rent discount received via rent assistance. Arrangements would be needed to ensure that changes in earnings and/or household composition did not diminish work incentives or cause undue housing disruption.

Chapter 4

Risk allocation and the financing gap

4.1 Introduction

This chapter considers the supply side of the private rental market and the challenges that need to be addressed if private investment in affordable rental housing is to be increased.

4.2 The investors in rental housing

Private rental housing is provided by a diverse group of property owners ranging from householders to non-profit institutions, employers and corporations. The largest group of property owners is private household investors who provide rental housing for around 60 per cent of households who rent in the private market.

Individual landlord investors

In June 1997, there were 584 000 income units with rental investment property, representing 6.5 per cent of all Australian households.³⁸ More than three-quarters of private household investors owned only one rental property. The majority literally appear to be ‘mum and dad’ investors: couple families represented 75 per cent of all household investors.

As a group, household investors in rental housing appear to be less responsive to market forces than other investors. Yates (1996) noted there is a significant incidence of ‘accidental landlordism’.³⁹ About one-quarter of household investors are renting out a house they previously lived in themselves as an owner-occupier. Others had inherited their dwellings and were not necessarily long-term landlords.

The most common reason for investing in residential property is that it provides a secure long-term investment. In 1998, two-thirds of household investors stated this as one of their main reasons for investing. Other reasons tended to vary with age. Younger investors were more likely to want to reduce tax through negative gearing, while rental income was more important for older investors.

Berry and Hall (2001) described the overall picture of the private rental sector as ‘a disparate and fragmented “cottage industry”, with low barriers to entry and frequent movement’ of investors and dwellings around a more stable core of long-term investors.⁴⁰ They concluded that ‘not all investors in rental property will respond “rationally” to market signals’ and that ‘substantial numbers’ of household investors will earn less than full commercial rates of return on their rental investment. For example, some will be biased towards the perceived economic security provided by ‘bricks and mortar’, while others’ emotional attachment to dwellings will override careful calculations of returns and costs.

³⁸ ABS 1999, *Household investors in rental dwellings, Australia, June 1998*, cat. no. 8711.0, AusInfo, Canberra.

³⁹ J. Yates 1996, ‘Toward a reassessment of the private rental market’, *Housing Studies*, 11 (1).

⁴⁰ M. Berry and J. Hall 2001, *Policy options for stimulating private sector investment in affordable housing across Australia: Stage 1*, Report prepared for the Affordable Housing National Research Consortium.

Barriers to institutional investment

As discussed above, a feature of the Australian residential property market is the lack of institutional investment. Given the scale of the affordable housing shortage, institutional investment is likely to be an essential part of any endeavour to expand the supply of affordable housing.

The investor perspective on investment in rental housing may be summarised⁴¹:

- Risk adjusted return is the overwhelming concern;
- Most investors have a preference for an income stream rather than capital growth;
- Investors are typically seeking a low-risk, low-return product rather than a high-risk, high-return product;
- To attract investor interest, there is a need for either larger projects or investment vehicles;
- Policy commitment and consistency will be needed to convince investors to make the effort to take a long-term interest in this sector;
- Given limited reliable information and data on market performance, the immaturity of the market (from an institutional investor perspective) and the illiquidity of the investment, a premium would initially be required; and
- Some investors are prepared to accept market risk – but they will demand a return for this risk.

4.3 The financing gap

The key barrier to attracting investment in affordable rental housing is that the rents required to deliver investors an acceptable rate of return are not affordable to low and moderate-income households.

The essential policy challenge is therefore to reconcile two core objectives:

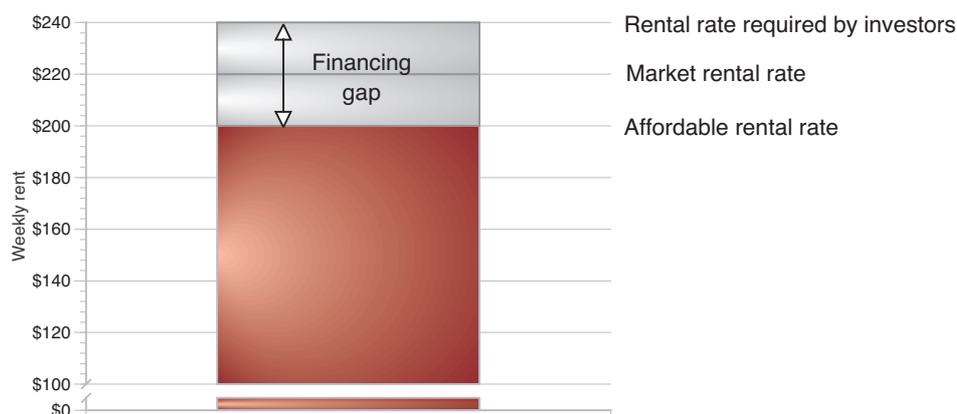
- an appropriate risk-adjusted rate of return for investors; and
- an affordable rental level for low and moderate-income households.

Figure 4.1 provides an illustration of the financing gap for a rental property with a market weekly rent of \$220. For simplicity, we suppose here that an affordable weekly rent for a moderate-income household is \$200 – \$20 less than the market rate. We also assume that for an institution to invest in the property, it would require a return of \$240 per week – \$20 more than the market rate.

This gap of \$40 is referred to as the ‘financing gap’ and represents the government subsidy required for investors to supply rental housing at affordable rental levels.

⁴¹ N. Youren, Global Head of Property Finance and Investment with the National Australia Bank, presented to the Brisbane Housing Summit in November 2002; AHURI and The Allen Consulting Group 2001, *Policy options for stimulating private sector investment in affordable housing across Australia, Stage 2 Report: Identifying and evaluating the policy options*.

Figure 4.1

FINANCING GAP FOR A PROPERTY WITH MARKET WEEKLY RENT OF \$220

Source: The Allen Consulting Group

4.4 Risk and return

The key policy challenge is to deliver a subsidy that provides investors with a risk-adjusted return that is sufficient to motivate investment in affordable rental housing.

The required rate of return for such an investor will reflect an opportunity cost of capital. This involves the estimation of the cost of capital associated with activities of comparable risk and is a rate set by the market as a whole, not by individual investors or governments.

An investor's required rate of return depends on the 'risk' of the investment, typically measured as the variability in the cash flows generated by the investment.

There are two types of risks that investors confront – systematic risks that arise from economy-wide shocks that affect the returns to all assets, and non-systematic risks that are specific to the particular investment.

Investors can use diversification – the act of combining assets into a portfolio in order to reduce the volatility of overall returns – to reduce non-systematic risk. When extended across all assets, holding a well-diversified portfolio of assets can eliminate all of this non-systematic risk. It follows that, in a competitive capital market, an investor should not be able to receive compensation for bearing non-systematic risk.

The intuition behind this is that if the returns to an asset reflected the risk borne by an investor who only held that one asset, then investors with a portfolio of assets would perceive that asset to have a lower risk (and therefore a higher value). The latter investors could then bid up the price of the asset until its value was consistent with only providing compensation for systematic risk.

Application to residential property investment

The main systematic risks related to residential property investment fall into two categories. First, macroeconomic variables critical to housing include inflation and interest rates. Second, variables specific to the housing sector are also important: these include as dwelling price growth, rental returns and construction and management costs.

Capital return risk

Capital return risk refers to the variability in dwelling prices over time. In general, the risks must lie with either government or the private sector – although the allocation of these risks varies with policy design.

Rental return risk

Rental return risk refers to the variability in rental prices and vacancy rates over time. Rental price risk can be managed through appropriate program design, as will be discussed.

‘Head leasing’ agreements can be used to transfer vacancy and default risk to a State Housing Agency, a social housing association or a private agent. In some cases, investors may prefer to receive a guaranteed return (below market rents) in return for protection against rental risk, vacancy risk and default risk.

Cost escalation risk

Cost escalation risk refers to the variability in construction, management and administrative costs due to economy-wide factors. If costs increase by more than rents, the return to the investor is reduced. While these risks can be partly mitigated through contracting arrangements, increases due to economy-wide factors are typically passed through to some extent.

In general, property development will involve a higher cost escalation risk than property investment, due to the additional risk inherent in the construction lag. Whereas property development is seen as a high-risk, high-return sector, property investment is seen as a low-risk, low-return investment. Given that we are considering new developments, it is likely that at least some allocation of systematic risk is required.

Developers tend to start new projects during favouring conditions. Involvement in real estate development will lead to greater exposure to the economic cycle, thereby increasing systematic risk.⁴²

Market imperfections

Aside from investors who appear not to always act rationally – as discussed in chapter 3 – a number of market conditions limit the applicability of finance theory to residential real estate. Burke (2001) identifies the following as the most relevant:

- Estimating the return required to compensate for systematic risk requires a time series of data that does not exist;
- Actual returns in residential real estate are strongly driven by non-systematic risks, particularly location;
- Returns to residential property do not follow a normal distribution, as a result of transaction costs associated with construction, purchase and sale; and
- The residential real estate market is characterised by limited information of varying quality.

Market data for the residential real estate sector is imperfect for most if not all investors. While sales data is reported by suburb in various State Valuers Generals’ Annual Reports, the data are highly aggregated, split only by houses and flats.

⁴² D. Brounen and P. Eichholtz 2002, Combining property investment and development: What creates value?, see http://www1.fee.uva.nl/fm/PAPERS/Brounen/Development_synergie.pdf.

Given the view that poor quality information is a barrier to institutional investment, consideration should also be given to strategies to improve the transparency, availability and quality of market information. To date, policy efforts in this area have been limited.

Given the scale of market imperfections, investors are likely to seek to reduce this uncertainty by demanding a risk premium on the rate of return.

Capital structure, investor classes and taxation

Affordable housing developments will generally be financed by a combination of debt and equity, with part of the returns that accrue to the project flowing to debt providers and part to equity holders. The term weighted average cost of capital (WACC) is often used to refer to the market-determined cost of capital for a particular project – reflecting the fact that the overall return to an asset comprises a return to both lenders and equity holders.

Whether private finance is advanced in the form of debt, equity or a combination of both, it is the risk-adjusted return that affects private investment. A common assumption in finance is that the cost of capital is invariant to capital structure. That is, as gearing increases, so too does the cost of equity – such that the cost of capital does not change. This, however, applies to a simplified world with no taxation.

In practice, investors are concerned in their after-tax returns. The ‘tax wedge’ measures the gap between pre- and post-tax investor returns. Taxes create further distortions in residential property investment as:

- Rental incomes are treated differently to capital gains.
- Debt and equity investments are treated differently for taxation purposes.
- Different classes of investors are treated differently for taxation purposes.

As a result of these complexities, capital structure and taxation are important in practice.⁴³ For example, Wood (2001) argues that there are strong ‘clienteles’ effects in the supply of rental housing, due to different taxation treatment of rental income and capital gains. He argues that higher gross rental yields coincide with higher investor costs of capital for low tax bracket investors.

While these taxation matters are not considered in detail here, it is important that governments carefully consider the implications of incentives to promote private sector investment for different categories of investment and investor.

⁴³ These effects are further complicated by dividend imputation.

4.5 Risk allocation

Risks allocated to Government

As discussed in chapter 3, the key challenge for policy is to meet the financing gap required to meet an investor's required rate of return. As the central determinant of investment is risk-adjusted returns, this may involve either:

- increasing the expected value of returns to investors; or
- reducing the variability (risk) of those returns.

One option is for government to assume some of the risks involved with the project – thereby reducing the investor's required rate of return. As discussed, however, an implication of finance theory is that the risk-adjusted return required on a project is a function of the characteristics of the investment rather than the investor. As such, the government's required rate of return on equity investment should be the same as that of the private sector. When the government assumes risks, this does not diminish the required rate of return for the project as a whole.

Under present public sector accounting arrangements, these risks are not explicitly priced in the budget. Rather, they are recorded as a below-the-line contingent liability. The effect of this is to substantially reduce the budgetary cost to government – which may carry presentational benefits – but not the actual cost.

Box 4.1

COSTING RISKS ALLOCATED TO GOVERNMENT

The budgetary impact of a subsidy for affordable housing is not a true reflection of the true cost for government. The reason is that budgetary practice in Australia does not incorporate estimates of risk. Where such risks are borne by government, a premium should be added to the budgetary cost to derive an effective cost for government.

Source: The Allen Consulting Group

Rental price risk

The risks inherent in an investment may be borne by the private sector, governments or renters themselves. In the context of rental housing, it is assumed that renters, governments and investors all prefer a steady payment stream to an uncertain payment stream – whether it relates to rents, subsidies or incomes.⁴⁴

The use of fixed price contracts that predetermine rents payable can effectively remove rental price risk for both governments and investors. The direct effect of this is to reduce the investor's required rate of return on investment and the corresponding government subsidy needed. From the renter's perspective, an affordable rental level is guaranteed, irrespective of changes in market rents.⁴⁵

⁴⁴ Pre-set rents may also support greater use of longer-term leases, supporting tenure security.

⁴⁵ In practice, any such arrangement would set rents at the lower of (i) affordable rents and (ii) a small discount on market rents. This would prevent the program from ever being entirely ineffective – such as could happen if market rents available to target tenants fell below pre-agreed affordable rents.

The market rental risk in this case has not disappeared – rather, it is absorbed in the market value of the subsidy renters implicitly receive. That is, as market rents increase, so too does the implicit subsidy (given that rents charged are fixed). As they fall, so too does the implicit subsidy.⁴⁶

The distinguishing feature of such an arrangement is that the financing gap has been reduced – as neither the government nor the private sector needs to be compensated for rental risk. This is significant, as rental risk is likely to represent a significant element of systematic risk.

Box 4.2

ALLOCATING RENTAL PRICE RISK

A fixed price contract between the investor, government and renters can minimise the impact of market rental risk and reduce the financing gap. Market risk is then reflected in a variable implicit rent subsidy and the cost to government is reduced.

Source: The Allen Consulting Group

Management and tenancy risk

A condition of government support would be that affordable rental dwellings are managed by recognised affordable housing associations – such as State Housing Authorities or community housing organisations.

To ensure that affordable rental housing is made available to those who it is intended for, these managers would also be responsible for tenant selection and management. Given that rents would be at a discount to market rates, it is envisaged that vacancy rates could be kept very low.

Affordable housing associations would be contracted under head leasing arrangements⁴⁷, with requirements to meet specified tenancy and maintenance standards, and incentives to exceed them.

An explicit purpose of allocating management and tenancy risk to the affordable housing sector would be to develop the expertise and capabilities of the sector – which should help to reduce costs over time. At a minimum, this would appear to require greater transparency of service agreements and performance, and specific efforts to share good practice.

⁴⁶ The risk (variability of cash flows) in this case has been transferred to renters – in the form of a variable implicit benefit. From a renter viewpoint, however, this variable benefit is valued positively as it translates into stable rents.

⁴⁷ Head leasing refers to a situation where a community organization leases properties in the private rental market and then sub-lets them to groups targeted for support.

Chapter 5

The options compared

5.1 Introduction

This chapter considers a limited range of options to increase private sector investment in affordable housing.

Each of these approaches is dependent on government funding to leverage private finance to expand the supply of affordable housing. The three options examined here are those generating the most interest and informing the discussion of preferred instruments to expand investment in affordable housing.

This analysis is based on the premise that through appropriate structures and coordination, governments can influence incentives for investment in affordable housing by appropriately allocating risks and thereby minimising the gap between market rental yields and investors' required (risk-adjusted) returns. The three models considered are:

- the Bonds Model – government investment in affordable housing financed by government bonds, with rental income supplemented by a recurrent government subsidy;
- the Partnerships Model – private sector investment in affordable housing financed by private equity and/or debt investment, supplemented by a variable capital grant or recurrent subsidy; and
- the Tax Credits Model – private sector investment in affordable housing financed by private equity and/or debt investment, supplemented by a fixed value tax credit.

These models are described below and considered against the criteria of:

- allocative efficiency;
- dynamic efficiency;
- investor interest; and
- political feasibility.

5.2 The Bonds Model

The model

The model assessed is an adaptation of models proposed by the National Affordable Housing Research Consortium in its examination of similar issues in 2001 and by Yates (1994)⁴⁸. The basic design features of this model are as follows:

- State Governments issue inflation-indexed bonds, the proceeds of which are used by State Housing Authorities or other housing providers to develop affordable rental housing⁴⁹.
- These bonds are Commonwealth Government guaranteed, although financial risk ultimately lies with State Governments as a result of bilateral agreements.
- Bond coupon payments would be met by a combination of net rental returns and government subsidies (in the form of direct outlays).⁵⁰
- Commonwealth support – through underwriting and an additional subsidy – would be conditional on State Governments at least matching the value of the Commonwealth contribution.
- State Governments would be responsible for all implementation issues, such as administration, construction, management and letting, and would be required to minimise these risks through performance-based contracting.
- The entities responsible for affordable housing developments are assumed to face the same taxation treatment as the private sector.

Allocative efficiency

In practice, there is a variety of bond-based funding models – with varying allocations of risk between investors and government.

As discussed in section 4.2, the premium required for government to assume asset risk is the same as that for the private sector, despite the fact that this is often not reflected as a budgetary cost.

Government bond financing is nonetheless cheaper than private sector borrowing – as government can take advantage of larger debt issues, an established and liquid market and higher credit ratings.⁵¹ Commonwealth Government borrowing is the cheapest available, followed by State Treasuries, State Authorities and high-grade corporate ratings.

⁴⁸ Yates' proposal, referred to as 'equity bonds', suggested a number of refinements to the bonds model – such as linking coupon payments to inflation or earnings to reduce the variability of government payments, and indexing bonds to property values to reduce capital value risk. While there is merit in these proposals from a risk allocation perspective, they may also present as a riskier and more complex product for investors. See J.Yates 1994, 'Private finance for social housing in Australia', *Housing Policy Debate*, 5 (2).

⁴⁹ One option would be for all such bonds to be issued through a single entity – such as a National Housing Finance Corporation. It has been estimated that the scale generated would facilitate 30 to 40 per cent more volume than the proposed structure (Yates 1994 see note 46). The political feasibility of such an approach, however, is not clear.

⁵⁰ Government subsidies could be provided as either direct outlays or tax concessions relating to the bond income. Direct outlays are preferred for their transparency.

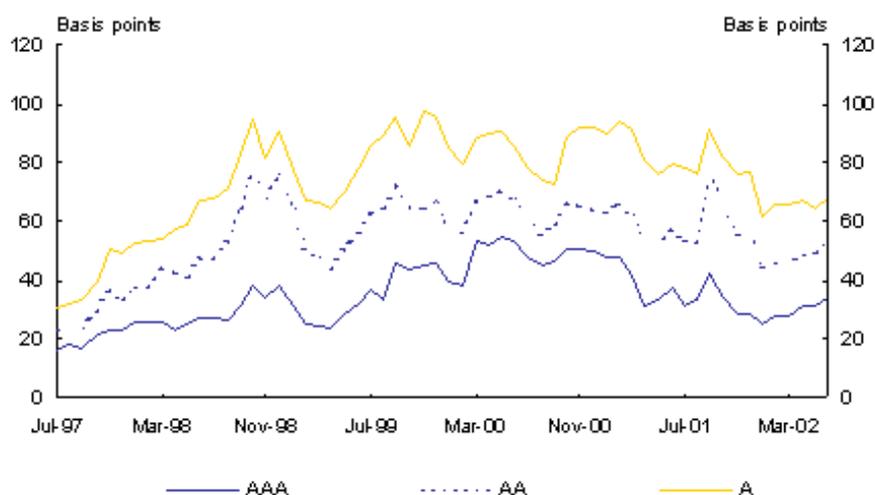
⁵¹ In the case of the Commonwealth Government, default risk is virtually zero as a result of its ultimate recourse to taxation.

There is limited information about the different interest rates that the market extracts for sovereign debt with different ratings. It has previously been estimated that a one-step change in the rating may change interest rates on new bonds by 20 basis points.⁵²

Data collected by the Reserve Bank for recent years also suggest that there is currently a margin of about 30 basis points between Commonwealth Treasury bonds and AAA-rated bonds, and 20 basis points between debt with AAA, AA and A ratings – see the figure below.

Figure 5.1

SPREAD OF CORPORATE BONDS TO TREASURY BONDS



Note: Bonds with three years to maturity.

Source: Reserve Bank of Australia 2002, Bulletin Statistical Tables.

The credit ratings provided by Standard and Poor's for NSW, Victoria and Queensland are all at AAA level.

Importantly, underwriting can virtually eliminate the differentials between borrowing rates. Bilateral agreements that involved the Commonwealth Government underwriting the borrowings of States and Territories could minimise finance costs, while ensuring that State and Territory Governments are allocated the risk. The Commonwealth has significant leverage – in the form of annual payments to States – to ensure that any risk is actually borne by State Governments.

Dynamic efficiency

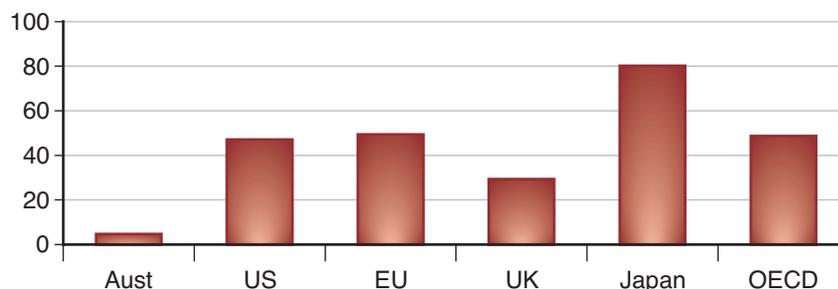
Australian governments enjoy a very low level of public debt, relative to governments in other nations. Public debt becomes a concern when it affects the cost of borrowing or the perceived risk of investment. A low level of public debt also provides flexibility to be able to respond to downturns in economic conditions.

⁵² See J. Quiggin, 2003, 'Being AAA is not the top', *Australian Financial Review*, 27 February. A discussion about the relationship between debt reduction, the credit rating and public debt interest costs in NSW is also provided in B. Walker and C. Walker 2000, *Privatisation, sell off or sell out?: The Australian experience*, ABC Books, p.59.

However, the public debt of Australian governments – at around 6 per cent of GDP – is lower than prudence would appear to require.

Figure 5.2

PUBLIC DEBT (% OF GDP)



Source: *OECD Economic Outlook 2003*

It is worth noting in this respect that the Australian preoccupation with low public debt is not commonly adopted by other nations – including nations that are supported by strong credit ratings. For example:

- In the United States, Congress has passed legislation that limits the level of government debt – to close to 60 per cent of GDP.
- In the United Kingdom, Chancellor Brown boasts of having one of the lowest public debt/GDP ratios in the developed world – at around 30 per cent.
- In Ireland, the Government has created a National Development Finance Agency with the capacity to borrow up to an additional 5 billion Euro to finance priority infrastructure projects where that is considered the optimal financing arrangement.

Debt, credit ratings and interest rates

It is often claimed that an increase in general government borrowing would increase interest rates. In practice, interest rates on general government debt reflect a wide range of factors including global interest rates, inflation, the exchange rate and a view about the risk attached to the government's capacity to service its debt obligations.

Some also argue that government borrowing 'crowds out' private sector borrowing and hence restricts economic activity. While there is an element of truth in this, the sums being considered in this context are minor and any such effect would depend on the extent to which borrowing is from domestic or global capital markets.

Views about the capacity of governments to manage their debt obligations are reflected in the ratings awarded by credit rating agencies. These ratings are assessments about the relative likelihood that a borrower will default on its obligations. While there is much debate about the veracity of ratings and their significance in the market place (especially from sources that have recently been downgraded) independent evaluations of the ratings agencies indicates that their ratings effectively summarise and supplement the information content of macro-economic indicators in the pricing of sovereign risk (i.e., they work).⁵³

⁵³ R. Cantor and F. Packer 1996, *Determinants and impacts of sovereign credit ratings*, Federal Reserve Bank of New York, Research Paper No. 9608.

The strong credit rating performance for Australian Governments has reflected a conscientious and determined approach to fiscal consolidation over several years.

Some states (including Queensland and Victoria) have specifically factored in flexibility to preserve room to borrow for investment purposes. Queensland's medium-term goals, for example, note that:

Borrowings or other financial arrangements will only be undertaken for capital investments and only where these can be serviced within the operating surplus consistent with maintaining an 'AAA' rating.⁵⁴

While the continued application of sound medium-term fiscal policies is considered essential, there appears to be significant scope for a greater use of debt financing for important economic and social investment. The objective of medium-term fiscal strategy is to obtain flexibility to meet needs as they arise while preserving confidence in fiscal management. It may be better in the long run to delay the rapid elimination of public debt – from which Australia gains little in the current context – in order to address a housing affordability problem that puts many families under severe financial pressure and constrains economic growth in other ways.

Despite it being the stated goal of Commonwealth and State Governments, there is no basis in economics for zero public debt – particularly in the context of public sector budgeting practices that:

- do not adequately differentiate between capital and current spending (at least at the Commonwealth level);
- fail to account for risks; and
- do not explicitly value benefits derived from expenditure.

A strong fiscal foundation and a modest impact on global capital markets suggest that Australian governments would be able to raise debt prudently and without the prospect of adverse implications such as a credit downgrade and increased interest rates.

The view that it is reprehensible for governments to finance new investments with debt contrasts starkly with the practice of successful companies. If a company has a low debt-to-equity ratio and has sound investment opportunities available to it, it would be considered irrational not to borrow to finance investment.

In addition to public debt concerns, which have been shown to be unfounded, it is relevant to consider whether the equity risks involved in affordable rental housing are best managed by government. That is, should governments hold a portfolio of housing assets, as the Bonds Model would imply?

Investor interest

Bonds offer a standardised investment product that is well understood by investors. It is also a product that is much in demand, particularly as liquidity in the Commonwealth Securities Market has diminished.

Bonds satisfy the market's desire for a low-risk, low-return investment product and would generate a substantial volume of institutional investment.

⁵⁴ See Standard and Poor's, 2003, *Local & Regional Governments*, March 2003, p.85.

Political feasibility

Commonwealth and State Governments

In recent years, Commonwealth and State Governments have adopted a conservative approach to debt financing. The Federal Treasurer has stated that he wishes to eliminate public debt through asset sales and budget surpluses. In this context, it is noted that since 1995-96, the vast bulk of public debt reduction has come from asset sales rather than fiscal prudence.

State Governments have adopted a similar approach to debt. Box 5.1 below provides an example of the NSW State Government's approach to public debt. A similar approach is adopted in other States.

Box 5.1

NSW FISCAL STRATEGY

Infrastructure planning and provision takes place within the NSW Government's fiscal strategy framework. The framework is set by the *General Government Debt Elimination Act 1995*, which specifies:

- a timetable for eliminating General Government debt (a target of a sustainable level of net debt by 2005, and zero net debt by 2020), thereby securing the State's AAA credit rating;
- maintaining the Government sector's net worth in real terms from year to year; and
- restraining Government spending and taxation to strengthen the State's competitiveness and attract business investment.

Consistent with this strategy the Government intends to maintain the acquisition of infrastructure and other assets at a constant rate in real per capital terms while continuing to achieve its fiscal strategy objectives.

Source: NSW Government 2002, *State Infrastructure Strategic Plan 2002*, December.

Local Governments

A differentiating characteristic of municipal level financing overseas, relative to Australia, is the opportunity for municipal bonds to finance affordable housing development. For example, it is estimated that around 10 per cent of new rental dwellings in the US are funded through tax-advantaged bonds.

The potential for the use of municipal bonds in Australia is fundamentally limited – by a lack of taxing power and the small scale of local government. The development of a local equivalent of US municipal bonds would involve high transaction costs in setting up and regulating/enforcing a market. It is likely that distinct debt instruments for separate Australian local government bodies with distinctive credit risks would result in limited liquidity that would make debt management prohibitively expensive. It is also not clear that an Australian municipal bond system would offer any offsetting advantages over the alternative of 'piggy-backing' local government borrowing on the existing general borrowing capacity of Commonwealth and State Governments (without extra establishment costs and added liquidity). On this prospect, the Local Government Association of Queensland has noted:⁵⁵

With Local Government in Queensland being able to access funds through the Queensland Treasury Corporation, the lowest cost of capital available on the market is already being fully obtained.

⁵⁵ LGAQ, 2002, *Public inquiry on mechanisms to fund Queensland's roads and transport infrastructure. Final Report*, May, Local Government Association of Queensland, Brisbane.

While the discussion above suggests that the political feasibility of bond financing may be limited, government attitudes to debt instruments can be quite different where there is a revenue stream attached to the finance. In the case of affordable rental housing, rental incomes provide this revenue stream.

Further, an increasing number of respected commentators are questioning the wisdom of prevailing attitudes to public debt.

5.3 The Partnerships Model

A second option to finance investment in affordable housing is through a public private partnership (PPP). Under this model, a special purpose vehicle – which could be a listed company or a property trust – could raise either equity or debt finance to fund an affordable housing development.

The model

The essential feature of a PPP for the purpose of this report is the allocation of risk to the private sector. In practice, PPPs may involve governments and the private sector sharing a project's risk.

It is assumed that projects supported under the Partnerships Model consist of 50 per cent equity investment and 50 per cent debt finance.

It is noted that a number of design considerations that affect the viability of the Partnerships Model are ignored in this stylised analysis. The most important of these relate to the tax advantages that benefit a listed company over a property trust structure and the relative tax treatment of equity and debt finance.⁵⁶

Allocative efficiency

Where the private sector accepts market risk, investors will demand to be compensated for this risk. This, however, should not imply a higher cost of capital than the public sector – for reasons outlined in Chapter 4.

One genuine source of difference in the cost of capital relates to the higher borrowing costs confronting the private sector relative to government – as was discussed in section 5.2.

Partnerships also typically involve high transaction costs, with these costs increasing where significant risk sharing is involved. In such cases, detailed contracts have to be negotiated and formalised, and the legal and financial advice associated with this process is expensive. As a percentage of deal value, these costs tend to increase with the complexity of the agreement and decrease with the scale of a project.

One of the primary objectives of PPPs is to encourage the private sector to innovate, through identifying and exploiting synergies across the various facets of a project and achieving operational efficiencies.

⁵⁶ While both would receive the advantages of being treated as an equity investment, SPV would receive more favourable tax treatment, as the trust would have to discount initial capital by the amount of government subsidy. As a result, capital gains tax liability would be higher.

The essential efficiency trade-off – relative to government assuming risk – is therefore one of higher borrowing and transactions costs against greater potential for innovation. The evidence available on these matters is far from conclusive.⁵⁷

A major benefit of PPPs is that they can ensure that valuable investment proceeds in cases where governments face recurrent budget pressures and are not prepared to consider increasing public debt. Where these investments generate positive significant social returns – as is suggested in the case of affordable rental housing – this makes a direct contribution to economic efficiency, properly measured.

Dynamic efficiency

A feature of well-designed PPP frameworks is that their costs fall and their benefits increase over time:

- Costs fall as the public sector develops its expertise in negotiating and contracting with the private sector, reducing both transaction and deadweight costs.
- Benefits increase as innovations in delivery become known to the market, fostering improved practices and efficiency.

A critical aspect of PPPs relates to the transparency of deals, the details of which are often regarded as commercial-in-confidence. This issue is about more than political accountability and monitoring difficulties – it is equally about the capacity to disseminate information about strategies that work and those that do not. This is particularly important in the context of developing the capacity of a sector that cuts across the three levels of government, the private sector and the community sector.

As with bond financing, PPPs allocate the costs of investments over time – providing benefits in terms of both dynamic efficiency and intergenerational equity.

Investor interest

While there has been strong interest in the potential for PPPs for specific developments, it is questionable whether there is a widespread market appetite for PPPs in affordable housing. The lack of success of residential property trusts in the past may have fuelled a general scepticism of rental property investment among institutional investors. Against this, the experience of other nations suggests that this lack of institutional investor interest in affordable rental housing is most likely to be a function of the policy environment.

PPPs appear to be well suited to projects where governments have particular objectives related to the specific circumstances of the development. For example, it may be that Key Worker Housing and low-income, inner-city housing can be most effectively addressed through PPPs.⁵⁸

⁵⁷ It is noted that more variable outcomes under PPPs are not considered a cost to government under conventional public sector budgeting, because such budgeting does not explicitly consider the benefits achieved by government expenditures.

⁵⁸ Nelson (2002) suggests that tailored solutions are required to address low-income housing needs in high cost areas. See K. Nelson 2002, 'Housing needs and effective policies in high-tech metropolitan economies', *Housing Policy Debate*, 13 (2).

PPPs appear to offer an opportunity for innovative responses to particular project needs, but are unlikely to generate a scale of investment sufficient to address the affordable housing shortage. To address the broader challenge, it is likely that a standardised investment product would be needed.

Political feasibility

Commonwealth Government

PPPs are not new to Australia. In fact, Australia was pioneering in this area throughout the 1980s and 1990s, even if in an ad hoc manner.

In 2001, the Commonwealth Treasurer asked the State and Territory Heads of Treasury to consider policy options in the PPP area. A Private Finance Unit was established in the Department of Finance and Administration and a set of 'Private Financing Principles' has since been released. While there has been significant interest in PPPs across departments, most notably defence, immigration and transport, there appears limited Commonwealth commitment to this approach. In part, this may reflect the fact that State Governments assume greater responsibility for relevant areas of infrastructure and service delivery.

State Governments

Australian State and Territory governments are increasingly looking to the private sector to assist in the delivery of public infrastructure – see Box 5.2 below.

Box 5.2

STATE GOVERNMENT FRAMEWORKS FOR PUBLIC PRIVATE PARTNERSHIPS

Victoria was the first State to release a policy on PPPs, *Partnerships Victoria*. Partnerships Victoria is widely considered to be best practice in terms of PPP policies.

New South Wales released its *Working with Government* (WWG) policy in November 2001, along with a potential project list, available at www.nsw.gov.au/wwg. While there have been some differences in processes, NSW has tried to remain as consistent with Victoria as possible.

Queensland released a PPP policy in late 2001. Queensland have recently followed up with detailed PPP guidance documents.

Western Australia has a PPP policy under consideration. WA has previous experience in PPP-type project delivery, particularly in the hospital area.

South Australia's policy, *Partnerships SA*, was released in mid-2002. A PPP unit in the SA Treasury was established in November 2000.

Tasmania has a private investment in infrastructure policy, released in July 2000, and are currently not looking to update it using PPP methodology.

Source: Australian Council for Infrastructure Development

In developing PPP guidelines, jurisdictions have adopted a number of common themes, including:

- clear specification of project outputs, which encourage innovation;
- assessment, identification, measurement and allocation of risk to the partner best able to manage it;
- preparation of a public sector comparator (PSC) setting out whole-of-life costs if the project is delivered by traditional public sector processes;
- preparation of a business case analysing alternative private sector delivery models and benchmarking against the PSC; and
- specification of procedures/process (to be competitive and transparent with an emphasis on reducing transaction costs).⁵⁹

While the public sector's capacity to deliver PPPs is rapidly developing, political attitudes still appear lukewarm. Despite their growing popularity with State Governments – which is driven by a combination of necessity and good public accounting – PPPs invariably involve not only financial but political risk.

Politicians are acutely aware that PPPs have a mixed history. Political risk is a real impediment to PPPs. This political risk is often a function of financial risks assumed by the private sector – despite this risk allocation being an explicit objective of PPPs.

For example, when PPP projects are successful, the private sector often makes a significant profit – giving rise to the accusation that government is subsidising large private sector profits. Conversely, when PPP projects are not successful, it is often portrayed as the failure of a government-supported project. Sometimes the pressure is so significant that government is forced to assume control of the project at greater cost.

While governments can adopt contracting strategies to set bounds on both of these risks, such as through sharing of 'super-profits' and step-in terms, this comes at a financial cost and political risks can rarely be eliminated.

In the context of affordable rental housing, however, such risks are not likely to be significant. The bulk of rental housing is already delivered by the private sector and discounted rental housing (beyond rent assistance measures) is not considered as a core public service along the lines of education and health services.

5.4 The Tax Credits Model

Tax incentives could target a class of investment or individual projects. As discussed, a number of tax incentives already exist for investors in rental housing, through measures such as negative gearing and the building write-off allowance.

The Tax Credits Model, however, examines a particular form of tax concession, based on the US Low Income Housing Tax Credit (LIHTC).

⁵⁹ Australian Procurement and Construction Council, *Discussion paper: Key issues in procurement through public private partnerships*, November 2002.

US Low Income Housing Tax Credit

Box 5.3 describes the operation of the US Low Income Housing Tax Credit and the flow of funds under this scheme is outlined in Figure 5.3.

Box 5.3

US LOW INCOME HOUSING TAX CREDIT

The Federal Government allocates a fixed level of tax credits to State Governments (US\$1.75 per capita). Projects submit bids for the tax credits, in return for their commitment to offer affordable rental housing. Bids are on the basis of the quality of the development and take into account a range of criteria beyond affordability. Despite being subject to basic guidelines, States have considerable flexibility in program criteria.

New projects or those involving substantial rehabilitation involve a tax credit of 9 per cent of initial development costs for 10 years, equating to around 70 per cent of the total value of the project. Projects that benefit from other government concessions receive a tax credit of 4 per cent of initial development costs for 10 years, equating to around 30 per cent of the total value of the project.

If a project is awarded tax credits, the developer sells these credits to bidding private investors - who can use them to offset their other tax liabilities. The proceeds provide an up-front equity injection into the project – in a similar way to bonds. This both reduces the need to raise further finance and reduces the required rate of return on the project. This allows the developer to offer discounted rents.

Under the scheme, low-income occupancy must be maintained for 30 years. This must involve either 20 per cent of dwellings being occupied by households with incomes less than 50 per cent of the local median or 40 per cent of dwellings being occupied by households with incomes less than 60 per cent of the local median. Rent levels must be less than 30 per cent of local median incomes.

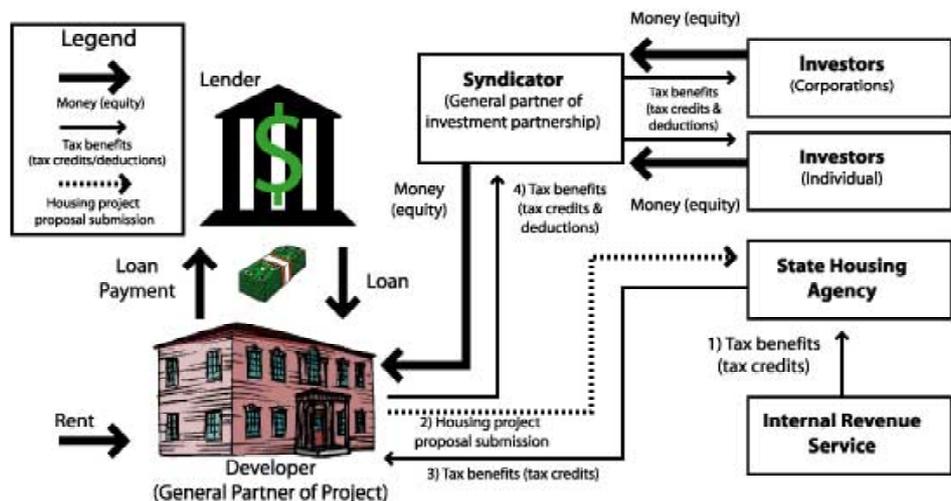
The scheme has now been operating for over 15 years. While it involves significant compliance costs and complex ‘packaging’, some projects are exceeding minimum standards and offering approaches that are increasingly integrated with other aspects of social policy, such as community development, employment programs and crime prevention.

The networks of sharing experience in the various jurisdictions are also strong – ensuring that successful approaches are rapidly emulated. Of the 225,000 new rental dwellings produced per annum in the US, around one-quarter are provided with LIHTC.

Source: Various

Figure 5.3

FLOW OF FUNDS UNDER US LOW INCOME HOUSING TAX CREDIT



Source: <http://www.danter.com/taxcredit/lihtccht.htm>

The model

Key features of the Tax Credits Model are:

- Commonwealth tax credits are made available to State and Territory Governments on the basis of agreed criteria.⁶⁰
- State and Territory governments allocate these tax credits to projects on the basis of providing affordable rental housing at a minimum, with any additional criteria at the discretion of the governments.
- The developer for successful projects on-sells the right to these tax credits to investors. The equity raised is then treated as a capital gift to the affordable housing development, subsidising the returns of other investors. This allows the project to offer rents at discounted levels.

Allocative efficiency

Like the Partnership Model, the Tax Credit Model assumes that the private sector accepts market risk.

A notable feature of the Tax Credits Model is the cooperation between the three levels of government. The Commonwealth Government's contribution is capped, with State and Territory Governments administering housing policy. In the US, strong competition for government support has resulted in local governments working cooperatively with the private sector to produce high quality proposals. Such a design feature seems well suited to Australia's governance framework.

Unlike other tax concessions, the LIHTC is applied on a dollar rather than income offset basis. By implication, it benefits different classes of investors equally, whereas an income offset favours investors with the highest marginal tax rate.⁶¹

As the level of tax credits is fixed, support is awarded on the basis of quality alone. This avoids many of the transaction costs incurred under the Partnerships Model.

Tax Credit projects seek to maximise benefits for a predetermined cost. This contrasts with PPPs, in which competition is on the basis of a combination of benefits (quality) and costs (subsidy). This implies that Tax Credits have less flexibility to meet a range of development circumstances. For example, a criticism of the Tax Credits approach to emerge in the United States is that projects are concentrated in poorer neighbourhoods, undermining the desire to achieve social mix.⁶²

As with the Partnerships Model, the borrowing costs under the Tax Credits Model – involving private financiers – are slightly higher than under the Bonds Model.

⁶⁰ While tax credits are allocated to States on a per capita basis in the US, such an approach would be inappropriate in Australia given the differences in affordable housing challenges facing different States and Territories.

⁶¹ For a comparison of the Building Write Off Allowance and a LIHTC, see P.Flatau, R.Watson and G.Wood 2002, *The incentive to invest in residential rental housing: The role of alternative supply-side policies*, School of Economics, Murdoch University, Working Paper 185.

⁶² McClure, K. 2000, 'The low income housing tax credit as aid to housing finance: How has it worked?', *Housing Policy Debate*, 11 (1), 91-114; J.Cummings and D.DiPasquale 1999, 'The low income housing tax credit: An analysis of the first ten years', *Housing Policy Debate*, 10 (2), 251-307.

A general concern with the use of tax concessions is that their face value is not always their real economic value. That is, beneficiaries can manipulate financial structures to leverage additional taxation benefits from a given tax concession. Where this occurs, additional finance may be generated for affordable housing, but this benefit is ultimately at the expense of government. In the design of the tax credit outlined, however, this risk should be minimal as the tax credit is fixed in dollar terms regardless of the investor.

Dynamic efficiency

Tax credits spread over the life of a project are similar in principle to the stream of subsidy payments under the Bonds Model. In both cases, a stream of future payments is capitalised, providing an up-front contribution to a development.

A program of Tax Credits should be able to achieve similar efficiency benefits over time as the Partnerships Model. This was the experience with the LIHTC in the US, where efficiencies – in terms of both cost savings and innovative approaches – took some time to emerge.

Investor interest

Tax concessions enjoy significant support in the investment community. This is often related to not just their direct value, but also to opportunities for tax minimisation. Even without such opportunities, tax incentives are likely to effectively motivate private sector finance.

A significant advantage over the Partnerships Model is that the investment product is standardised – with the implication that investors are more likely to make the effort to understand it.

While previous experience with infrastructure bonds suggests that investors may be wary of political risk, the overall investor attitude to tax credits is likely to be positive.

Political feasibility

The Commonwealth government has previously expressed a preference for providing assistance through outlays rather than tax concessions.

The 1996-97 Budget papers described the problems with tax concessions that were identified by the National Commission of Audit:

The NCA argued that tax expenditures were less visible than outlay programmes and therefore less likely to be critically assessed and reviewed than outlay programmes. They also noted that tax concessions are generally uncapped, open-ended and are susceptible to cost blowouts.

Commonwealth Government 1997, Budget Statements 1996-97, Budget Paper No.1, AGPS, Canberra

Many of these concerns relate to general tax concessions, but are not applicable to targeted tax credits. For example, in the model considered here, tax concessions are capped and their value is in dollar terms rather than income offset terms.

While the Commonwealth Government may see the provision of subsidies as a responsibility of lower levels of government, bilateral agreements can be used to ensure that subsidy burdens rest with State and Territory Governments if that is desired.

5.5 The options compared

As has been discussed, each of the three models examined has advantages and disadvantages. For example, while a bond instrument is clearly the lowest cost option, it is not clear that this is politically feasible. What is evident from an overview of strengths and weaknesses – see Table 5.1 below – is that no single model is likely to produce the best outcome on all criteria.

Table 5.1

SUMMARY OF THREE OPTIONS

| OPTION | Allocative Efficiency | Dynamic Efficiency | Investor Interest | Political Feasibility |
|--------------------|-----------------------|--------------------|-------------------|-----------------------|
| Bonds Model | ✓✓✓ | ✓✓ | ✓✓✓ | ✓✓ |
| Partnerships Model | ✓✓ | ✓✓✓ | ✓ | ✓✓✓ |
| Tax Credits Model | ✓✓ | ✓✓ | ✓✓✓ | ✓✓ |

Source: The Allen Consulting Group

Chapter 6

Estimating cost-effectiveness

6.1 Introduction

This chapter examines the cost effectiveness of the three options, in light of the discussion in the previous chapter. This involves use of modelling that establishes a common basis of comparison and reflects actual market conditions.

The case for an investment in affordable rental housing should include an assessment of the wider economic and social effects of an increased supply of affordable rental housing. In practice, the cost to government provides the substantial hurdle in government decision-making. Given this, much of this chapter focuses on the cost to government of the three options.

6.2 Affordable Housing Investment Model

The Allen Consulting Group developed a stylised model to estimate the impact of the additional housing investment generated under the three policy options – on the cost to government, and on a range of economic and housing outcomes.

The model captures the essential relationships between affordable housing finance and investment. There are three distinct aspects to the operation of the model:

- Risk allocations, borrowing costs, transaction costs and baseline parameters are used to estimate the gross financing gap.
- Taxation revenue clawbacks and displacement effects are considered to arrive at an estimate of net government impact.
- The impacts of additional investment on the economy and the housing market are considered.

6.3 Establishing a basis for comparison

All options considered in this report require a government subsidy. As has been discussed, however, this subsidy can be delivered in a number of forms:

- a financial contribution, made available on an up-front or recurring basis⁶³;
- a non-financial contribution, such as through a land or property contributions⁶⁴;
- an absorption or re-allocation of risk.

⁶³ This could be in the form of either an outlay or a tax concession/exemption.

⁶⁴ Governments own significant tracts of valuable land and property, including in highly valued growth areas. Making such land available for affordable housing development – at discounted rates – is another option of government support. A similar principle applies to governments' existing stocks of housing assets. In other nations, the contribution of government land or property has been used as the effective subsidy to private sector development of affordable housing. Similarly, linkage fees, developer charges or inclusionary zoning could be used to the same effect.

While these subsidies differ in their transparency and budgetary impacts, they all represent a cost to government. A meaningful assessment of the alternatives requires that the various subsidies be converted into a consistent basis for comparison purposes.

All subsidies are therefore converted into equivalent annual value terms – which ensures consistent valuation of discrete and recurring cash flows and risks. Estimates reflect the true cost to government, as opposed to direct budget costs. Only considering direct budget impacts would be misleading because:

- different forms of subsidy are not treated consistently in government budgets and non-financial contributions (including risk absorption) are often not valued at all; and
- the timing of budget costs can mislead about the true cost of assistance.

The selection of an appropriate investment horizon is a further consideration. From a purely financial perspective, a longer investment horizon would reduce the direct cost of the government subsidy required.⁶⁵ A longer investment horizon may also increase the security of tenure in some cases.

An appropriate investment horizon, however, should also consider the desire of governments to actively manage supported housing stock over time to ensure that it meets the evolving design and locational requirements of the target population.⁶⁶

For the purposes of this report, a 10-year investment horizon is assumed. Where the government has an equity position in affordable rental housing, this implies that the stock would be sold at the end of the 10-year period, with the proceeds rolled forward into new developments. Where the private sector is supported, the duration of the subsidy support would also be 10 years. Of course, existing arrangements could simply be rolled forward if that is considered appropriate.

Baseline parameters

The baseline parameters adopted for modelling purposes are those assumed to apply to a sufficient pool of investors to expand the supply of affordable housing. The modelling makes no attempt to address the diversity of housing situations. Rather, it provides a representative case, the implications of which are robust.

In relation to taxation, no attempt is made to identify individual investors. Taxes payable are modelled directly, on the assumption that investors face an effective tax rate of 30 per cent for other investments. In all models, the government subsidy provided is considered to be tax-exempt.

Table 6.1 below outlines the parameters that underpin the modelling reported.

⁶⁵ M. Berry and J. Hall 2003, *Risk management and efficient housing assistance provision: A new methodology*, AHURI, and P. Flatau, R. Watson and G. Wood 2002, *The incentive to invest in residential rental housing: The role of alternative supply-side policies*, School of Economics, Murdoch University, Working Paper 185, both show that a longer holding period reduces the subsidy costs.

⁶⁶ A shorter investment horizon also helps government to avoid holding a large stock of housing concentrated in areas where job opportunities are limited, as has been the experience with public housing.

Table 6.1

BASELINE PARAMETERS

| Parameter | Estimate |
|---|---------------------|
| * Affordable Rental Levels | 5% |
| Maintenance, Letting and Administration Costs | 2% pa |
| Capital Gains | 3% pa |
| Effective Tax Rate | 30% |
| Stamp Duty | 3% of capital value |
| Land and Property Taxes | 1% pa |
| Property Value | \$175,000 |
| Investment Horizon | 10 years |
| Commonwealth Bond Rate | 6% pa |
| Risk Premium for Residential Property | 2% pa |
| PPP Transaction Costs | 4% of capital value |

* Affordable rental levels will vary with household income and composition

6.4 Estimates of cost-effectiveness

Estimates of the cost-effectiveness of the three policy options considered are fundamentally driven by differences in the cost of capital. In this respect, the essential differences are outlined in Box 6.1 below.

Box 6.1

WHAT ARE THE ESSENTIAL FEATURES OF COST ESTIMATES?

A number of basic design features drive the estimates of cost effectiveness:

- All three models incorporate the full value of capital price risk, regardless of whether market risk is borne by government or the private sector.
- All three models involve the allocation of rental price risk to tenants, although this is something that tenants value positively as it translates into stable rents.
- All three models involve management and tenancy risk being managed by affordable housing associations.
- The Bonds Model involves a lower cost of borrowing as governments can borrow at cheaper rates than the private sector.
- The Partnerships Model involves higher transaction costs associated with negotiating and agreeing on arrangements with the private sector.

Source: The Allen Consulting Group

Based on the above features, it is intuitively the case that the Bonds Model is the lowest cost option, followed by the Tax Credits Model and the Partnerships Model.

The cost-effectiveness measures reported are:

- gross and net financing gap; and
- gross and net subsidy cost per assisted household.

As discussed in chapter 4, the financing gap represents the gap between the investor's required after-tax rate of return and the after-tax rate of return from investment in affordable rental housing.

Gross subsidy cost per household measures the direct government contribution that is required per household assisted. This differs from the budget cost only in the case of the Bonds Model – where the true cost to government is higher than that recorded in the budget for reasons discussed in chapter 4.

Net subsidy cost per household measures the overall cost to governments per household assisted, considering the incremental taxation revenue that governments receive. These estimates have been adjusted to take account of displacement effects.

As estimates of cost effectiveness, the estimates reported are conservative, in that they do not include the broader range of economic and social benefits. These include:

- the direct and indirect benefits of reduced housing stress;
- the economic impacts of housing investment;
- the benefits of increased workforce participation and a more efficient labour market; and
- the benefits of improved social mobility and cohesion.

Taxation 'clawbacks' and displacement

When investment in affordable rental housing proceeds, government taxation revenue is also generated. For example, the Commonwealth Government receives income tax and capital gains tax on disposal, State governments receive stamp duty and State and local governments benefit from land and property taxes.

These taxation 'clawbacks' mitigate the net cost to government of subsidies. In valuing these clawbacks, it is necessary to consider the degree to which the housing investment represents new investment – as opposed to investment displaced from other parts of the housing market or other sectors of the economy.

For the purposes of this analysis, it is assumed that:

- 25 per cent of the investment generated displaces investment elsewhere in the housing sector;⁶⁷
- 60 per cent of the investment displaces investment elsewhere in the economy; and
- 15 per cent of the investment is additional.

Displacement has important implications for estimating taxation clawbacks. For example:

- there will be little difference in income and capital gains tax revenue if investment is displacing other investment that would have been subject to similar tax treatment; and

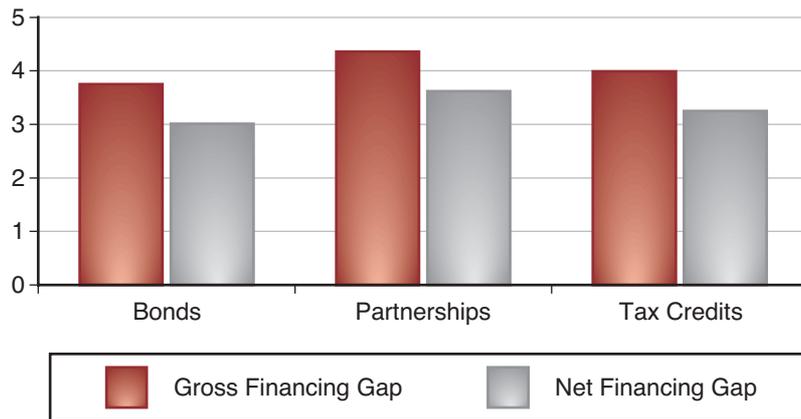
⁶⁷ While this may appear low, the subsidies are targeted at institutional investors – who currently have little involvement in the rental housing market.

- to the extent that housing investment is additional, government revenue from stamp duty⁶⁸, land taxes and property taxes will be incremental.

Figure 6.1 shows the gross and net financing gap – expressed as a percentage of property value – for the three options. It can be seen that the Bonds Model involves the lowest financing gap – ahead of the Tax Credits and Partnerships models.

Figure 6.1

GROSS AND NET FINANCING GAP (AS % OF PROPERTY VALUE)

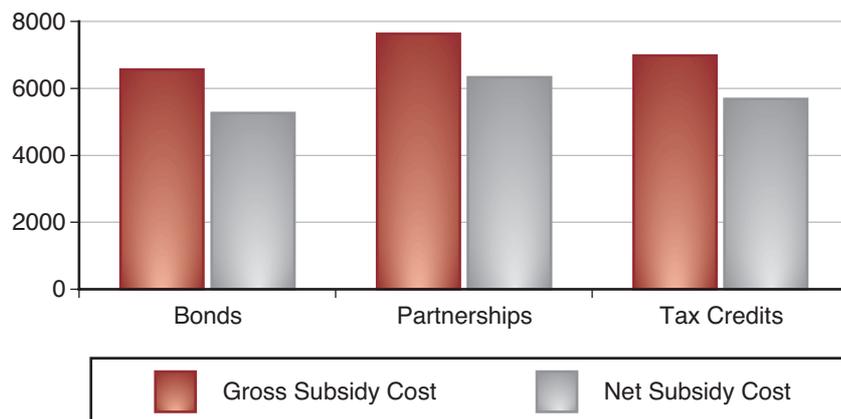


Source: The Allen Consulting Group

Figure 6.2 reports the outcomes for the three models in terms of government subsidies required.

Figure 6.2

GROSS AND NET SUBSIDY COST (\$ PER HOUSEHOLD ASSISTED PER ANNUM)



Source: The Allen Consulting Group

The three models involve broadly comparable subsidy costs, suggesting that the other considerations outlined in Chapter 5 will be important in choosing the best option.

⁶⁸ While stamp duty is payable by the purchaser, in practice its economic incidence will depend on demand and supply elasticities. For the purpose of modelling, it is assumed that the burden of stamp duty is on the developer.

The lowest gross subsidy cost per household assisted is for the government bonds model, at around \$6 560 per annum. This could be reduced by around \$1 300 per annum as a result of taxation clawbacks.

Further, it is noted that the reported budget cost would be reduced further as a result of government budgetary practices that do not explicitly price risk.

Broader economic impacts

Increased support for private sector investment in affordable housing will also have implications for the broader economy. While the affordable housing shortage is a matter of urgency, the timing of any housing assistance should consider the stage of the economic and housing market cycle. Recent experience has shown that housing assistance can have a heavy influence on macroeconomic outcomes.

Aside from its immediate contribution to economic activity, additional housing investment induces further production and consumption activity in the economy. The Australian Bureau of Statistics uses input-output multipliers to estimate the effects of additional housing investment of economic activity and employment. These impacts are summarised in Box 6.2 below.

Box 6.2

ABS MULTIPLIERS

Production-induced effect

The amount of input required from all industries in the economy to produce the initial output effect. In turn, this will require input from other sectors and so on. The combined effects of the initial effects plus all of the production-induced rounds of extra output are called simple multipliers.

Consumption-induced effect

As the household sector is paid for work done in the production process, more is also spent on goods and services. This requires the production of more goods and services in turn. This is referred to as the consumption-induced effect.

Total multipliers

The ABS calculates total multipliers that measure the immediate, production-induced and consumption-induced effects of an increase in investment on total economic activity.

Employment multipliers

Adopting similar methodology, the ABS also estimates the impact on employment in the economy, taking into account immediate effects, production-induced effects and consumption-induced effects.

Source: Australian Bureau of Statistics 2000, *Information Paper: Australian National Accounts: Introduction to input-output multipliers*, Cat.no. 5246.0

The ABS estimates that \$1 billion of additional investment in the construction sector generates a total of \$2.73 billion in economic activity and 28 000 jobs. This is before considering the impact of a significant boost to household consumption as a result of renters paying less rent and therefore having greater disposable income.⁶⁹

⁶⁹ The impact of housing investment on macroeconomic outcomes will also depend on the degree of displacement.

In addition to direct macroeconomic effects, significant economic benefits would flow from:

- more efficient labour markets;
- greater workforce participation;
- the reduced budget costs of dealing with the personal and social consequences of inadequate housing;
- increased social mobility; and
- increased social cohesion.

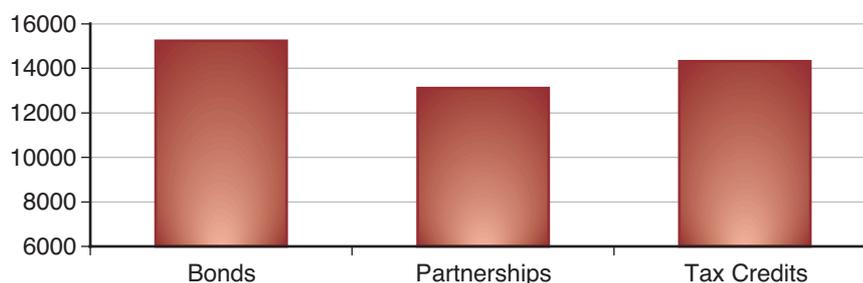
Impacts on housing outcomes

A program with an initial cost to government of \$100 million per annum, growing by \$100 million per annum to \$1 billion per annum and then stabilising at that level, has the potential to assist over 150 000 households at its peak.⁷⁰

This would generate new housing investment of around \$2.67 billion per annum. Figure 6.3 shows the number of additional households that would be assisted each year. Such a program would ultimately assist up to 150,000 households per annum and make a significant dent in the affordable housing shortage.

Figure 6.3

INCREMENTAL HOUSEHOLDS ASSISTED PER ANNUM



Source: The Allen Consulting Group

At an average dwelling price of \$175 000, \$2.67 billion of new investment in the first year would directly assist around 15 200 households, growing by this number in each of the first ten years.⁷¹

The impacts of the scheme on housing outcomes for specific groups will be a function of program design. As discussed, it is anticipated that the primary beneficiaries of the scheme would be:

- those in more expensive private rental accommodation;
- those in share accommodation, where this is considered inappropriate;

⁷⁰ For reasons outlined, this cost to government will not equate to the budget cost under the Bonds Model. The budget cost of such a program would be around 65 per cent of the true cost to government.

⁷¹ On the assumption that 25 per cent of new investment is substituting for investment in dwellings with an average price of \$350 000, there would be around \$670 million less invested in higher value dwellings, representing a loss of around 1900 rental or owner-occupied dwellings.

- those seeking to make the transition from public housing to the private rental market; and
- those for whom affordable and appropriate housing would provide a significant boost to potential workforce participation or reduce key worker shortages.

The net increase in supply of affordable rental housing should moderate rental prices more generally, creating new opportunities for other households at the low end of the private rental market.

It is anticipated that around 20 per cent of participants would come from public housing waiting lists, with a further 10 per cent supported in the transition from public housing and 10 per cent assisted out of homelessness.

The scheme's targeting will have important implications for the costs of existing government housing programs. In the case of rent assistance, the impact is ambiguous:

- Those beneficiaries of the scheme currently receiving rent assistance would receive lower rent assistance, as they would be paying lower rents.
- To the extent that beneficiaries become eligible for a higher rate of rent assistance (e.g. those who currently live with other family members or are in share accommodation), the costs of rent assistance will increase.

The cost of public housing support will not be affected, as outflows would be offset by inflows from long public housing waiting lists (which would decline). The cost of homelessness programs such as SAAP would also be reduced. In addition to the direct benefits of participants, US research has found that the rents of low-income housing are a significant determinant of the incidence of homelessness.⁷²

⁷² M.Honig and R.K.Filer 1993, 'Causes of intercity variation in homelessness', *American Economic Review*, vol.83, no.1, pp.248-55.

Chapter 7

Policy implications

7.1 Still a pressing need

In September 2001, the Affordable Housing National Research Consortium argued that the shortage of affordable rental housing represented ‘a pressing need’.⁷³ Two years later, this need appears to be approaching crisis point for many families. For an estimated 400 000 low and moderate-income families, paying the rent means going without basic needs.

Policy responses to this situation will ultimately reflect the choices that governments make about society’s priorities.

Previous research has demonstrated that housing policy in Australia is poorly designed, poorly targeted and poorly integrated with other policy objectives. The bulk of housing assistance – which is in the form of indirect tax incentives – flows to households that do not need it. Housing assistance flowing to those in housing need – primarily through public housing and rent assistance – is modest in comparison.

Traditionally, the perceived challenge of housing policy has been to alleviate acute need. However, years of economic, social and demographic change have extended the burden of housing stress further up the income distribution.

It has been argued that a long-term response to this problem must not only increase the supply of affordable rental housing, but also target this supply to those households that need assistance.

This report has examined three specific options to address this policy challenge. In considering which option or combination of options to pursue, governments should have regard both to the estimates of cost effectiveness and to considerations such as investor interest and political feasibility discussed in chapter 5.

The report suggests that all models considered have a relatively modest financial cost. For example, under the preferred Bonds Model:

- the cost to government would be \$6 560 per household assisted per annum;
- the budget cost would be \$4 110 per household assisted per annum; and
- these costs are reduced by a further \$1 300 per annum if the additional tax revenue generated is taken into account.

These costs compare favourably with the subsidy of \$8 800 per household per annum for the wealthiest owner-occupiers.⁷⁴

⁷³ Affordable Housing National Research Consortium 2001, *Affordable housing in Australia: Pressing need, effective solutions*.

⁷⁴ Australian Institute of Health and Welfare [forthcoming], Measuring the distribution of direct and indirect housing assistance, AIHW, Canberra, cited in *Australia’s welfare 2003*, Canberra, AIHW, p.179.

The program proposed – involving an initial cost to government of \$100 million per annum, growing by \$100 million per annum to \$1 billion per annum in the 10th year and then stabilising at that level, would assist over 150 000 households per annum at its peak. The scale of such a program is dwarfed by the \$21 billion that is provided to owner-occupied housing each year through the taxation system.

7.2 An investment with high economic and social dividends

Alongside a relatively modest cost, far more effective targeting than existing programs produces a substantial payoff. The economic and social dividends would include:

- a macroeconomic impetus, which could be tailored to the appropriate stage of the economic cycle;
- the alleviation of housing stress (and in many cases poverty) for a significant number of low and moderate-income families under financial pressure;
- the reduced economic, social and personal costs of family breakdown, crime, ill-health and low educational attainment;
- increased workforce participation and labour market efficiency; and
- support for a pattern of urban and regional development that is conducive to economic prosperity, environmental sustainability and liveable communities.

7.3 A shared responsibility

The shortage of affordable rental housing – and the impact this has on Australian households – is a shared responsibility. Accordingly, this report calls for a new national partnership – one that draws on the resources and expertise of the three levels of government, the private sector and the community sector.

The initiative of State and Territory Governments in establishing the National Affordable Housing Project may offer the best opportunity for some time for such a partnership to emerge.

To be effective, however, responsibilities and risks need to be allocated to those best equipped to manage them. This report has argued that:

- The role of the Commonwealth should be to provide a base subsidy and establish core program objectives, including transparent reporting requirements and sharing of good practice.
- State and Territory Governments would have primary responsibility for administration of housing support and, in the case of the Bonds Model, housing development.
- A network of affordable housing managers would have responsibility for property management and tenancy issues, subject to guidelines.
- Market rental risk would be eliminated through the use of fixed price contracts between renters, government and investors.
- Other market risks would be borne by State and Territory Governments (in the Bonds Model) or private investors (in the Partnerships and Tax Credits Models).

7.4 A need for flexibility and learning

It is clear from previous efforts to reduce housing stress that policy-makers do not yet have all the answers. Berry and Hall (2003) examine whether the adoption of a number of policy options together could actually minimise costs to government. Their essential argument is that due to the differing effectiveness of the various forms of housing assistance under different economic circumstances, overall risk may best be managed with a mixed approach.⁷⁵

Given this, an important feature of any national program should be to encourage governments, affordable housing managers and the private sector to experiment with a variety of approaches to finance, design, management and policy.

In this context, a strong emphasis on project evaluation, combined with a mechanism to share the lessons of these experiences, would help to enshrine a learning process in policy development.

7.5 Conclusion

The purpose of this report is to broaden the public debate on housing policy, at a time when that debate has a more prominent role than at any other time in recent decades.

It is hoped that the current attention paid to housing policy in Australia – by both Commonwealth and State and Territory Governments – is reflected in the recognition that households in the private rental sector are those most likely to face the financial pressures of housing stress.

For some years now, the evidence has suggested that the lack of affordable rental housing generates major economic and social costs. It has also suggested that it is a policy challenge that is not beyond us.

This report has shown that the financial cost associated with such a commitment is modest and has argued that the economic and social benefits would be substantial. Achieving the objective of affordable, appropriate and secure housing for Australians, however, will take a stronger policy commitment than governments have thus far demonstrated.

⁷⁵ Berry and Hall look at measures to increase the supply of affordable rental housing as complements to programs such as public housing and rent assistance. See M.Berry and J.Hall 2003, *Risk management and efficient housing assistance provision: A new methodology*, AHURI.