

E4. Housing affordability

Key points

Access to affordable housing is a key policy issue for the Australian community that is only likely to grow in importance. Policies of Australian governments have traditionally treated owner-occupied housing as the preferred housing tenure. This approach reflects the desire of most Australians to own their home. It also recognises the benefits ownership can bring both the community and homeowners, such as greater security in retirement. The approach in this Report is consistent with this policy goal, while recognising that home ownership will not be realistically available, or the right solution, for all households.

Measures of housing affordability emphasise different aspects of the issue, but all reflect the cost of housing and people's ability to pay for it. For renters, reforms to housing assistance would improve the ability of low-income earners to afford rental housing. For purchasers, affordability is constrained by prices that remain high relative to average income levels. While high prices or rents may result from increases in housing demand, they can only be sustained at high levels when supply is not responsive. Evidence suggests that the current supply of housing is insufficient, placing ongoing pressure on house prices.

Reforms to stamp duties and land tax would reduce current impediments to housing supply generated by the tax system. However, as taxation is not the major source of supply constraints in the Australian housing market, housing affordability would be best promoted through wider reforms that facilitate housing supply.

Housing supply can be restricted through a range of policies, such as planning and zoning regulations, as well as the approvals processes that govern them. However, such policies are designed to achieve a range of policy objectives, against which their impact on the price of housing should be assessed. The use of infrastructure charges has the potential to improve the allocation of infrastructure. However, where they are not set appropriately, infrastructure charges can reduce the supply of new housing, which can increase overall house prices.

This is not a straightforward area of policy because while reforms to increase supply may promote housing affordability, they can also reduce existing home values and change the shape of Australian cities in ways that many existing residents do not desire. This suggests a serious community dialogue is needed on the distribution and quality of housing across Australia. As a first step, the Council of Australian Governments should review building and land use policies and infrastructure charges to ensure they do not unnecessarily restrict the supply of housing.

E4–1 The role of housing in Australia

In its myriad forms, housing provides shelter, security and a savings vehicle to millions of Australians. Adequate shelter is fundamental not only in meeting basic human needs, but also in providing a base from which to develop individual capabilities, to raise a family and to participate in the community and the workforce.

The value of housing derives from more than the day-to-day shelter it provides. More than two-thirds of Australians enjoy the benefits of owning their own home. Whether they are a first homeowner with little equity or a retiree whose mortgage has been paid off, the security of tenure associated with home ownership provides an additional benefit over and above physical shelter. In many areas, a stable base of home ownership underpins social integration. Home ownership can benefit not only homeowners, but their communities too.

As well as providing vital services to individuals and communities, housing also forms a large share of Australia's savings. Houses are built to last — many people work hard to pay off their house during middle age, in order to ensure they have access to accommodation with no cash payment obligations when they are old. As a form of savings, housing has additional benefits over other savings vehicles because it not only acts as a store of value, but also reduces exposure to fluctuations in rental costs. In particular, those on fixed incomes are insulated from housing cost fluctuations, ensuring that other necessities like food or energy are affordable and they are protected from the risk of poverty.

Australia currently has one of the highest rates of home ownership in the OECD. In total, 68 per cent of Australians own or are buying the home they live in, compared to an OECD weighted average of 63 per cent. For those aged over 65 years old, the rate is 82 per cent, which is among the highest in developed countries (Bradbury 2008). These high levels of home ownership often reflect strong personal preferences for home ownership over other forms of housing tenure, as well as deliberate government policies to enable owner-occupied housing.

The Review's recommendations are intended to support this policy goal. There is a strong case for continuing Australia's approach of ensuring that owning their own home is within the reach of ordinary families. The role of owner-occupied housing as the key source of voluntary retirement savings is a major reason for continuing to exempt it from income taxation (see Section A1 Personal income tax). Further, owner-occupied housing plays a particularly important role in providing financial security for the large majority of Age Pension recipients who own their own home. Continuing the means test exemption for owner-occupied housing, up to an indexed threshold to ensure fairness of the test, will support this objective (see Section F2 Means testing).

However, home ownership will not be realistically available, or the right solution, for all households at all times. Ensuring access to appropriate rental housing is an integral part of Australia's transfer system. The reforms to housing assistance recommended in this report would mean that the transfer system is better placed to address housing affordability by ensuring access to affordable housing at the rents available in the market (see Section F5 Housing assistance).

In framing its terms of reference, the Australian Government requested that the Review pay particular attention to Australians' access to affordable housing. The affordability of housing,

in light of high housing price rises and increasing rents, is a fundamental challenge facing all Australian governments.

E4–2 What is housing affordability?

At its most basic level, housing affordability means ensuring that low-income households can access an adequate standard of housing without unduly compromising their other spending needs. Concern over housing affordability extends beyond this to whether people across a range of incomes can purchase housing without facing undue financial stress.

Studies of housing affordability do not settle on a single definition or way of measuring housing affordability (for example, Robinson et al. 2006; Gabriel et al. 2005). Different measures often reflect different conceptions of what is the most important aspect of housing affordability. Concern may focus on low-income earners' access to housing (often as renters), the degree of home purchase capability enjoyed by moderate-income or first home buyers, or the ongoing cost of sustaining a mortgage for those on average incomes (see Box E4-1). However, what is common through all of these benchmarks is a measure of the price of housing and a household's means to pay for it.

Box E4–1: Different measures of housing affordability

Several measures of housing affordability focus on low-income earners.

'Residual' measures of affordability record the remaining income available to households after deducting the cost of a level of housing (for example, see Harding & Szukalska 2000; Burke & Ralston 2003). This approach can indicate whether households enter housing poverty through rising housing costs or falling income.

'Ratio' measures of affordability compare the costs of housing to household income (for example, see ABS 2002; Harding, Phillips & Kelly 2004). Under this approach, housing is agreed to be unaffordable when housing costs exceed 30 per cent of income for households with incomes in the bottom 40 per cent of the income distribution (for example, see the National Housing Strategy 1991).

The affordability of housing for wider groups in society can be measured in other ways.

A simple measure that reflects the cost of purchasing a dwelling is the ratio of median house prices to average household income.

Several measures assess the ongoing costs of home purchase of a dwelling through a mortgage. The Reserve Bank of Australia compares the cost of repaying a mortgage – based on 80 per cent of the prevailing median house price at the prevailing variable mortgage rate – with average household income (see Richards 2008).

HIA-Commonwealth Bank applies a similar approach to the median house purchase price for first-home buyers (see HIA 2009). While there is no single view of when housing is affordable using such measures, affordability is often interpreted as being at low levels when repayments exceed 30 per cent of income.

Box E4–1: Different measures of housing affordability (continued)

Other measures of purchase affordability reflect the up-front cash required for a deposit on a mortgage and are often used to describe the degree of first home buyers' access to the market. For example, the 'deposit gap' records the difference between typical house prices and the maximum mortgage available on a typical household income (Yates and Milligan 2007).

Developments in housing affordability in Australia

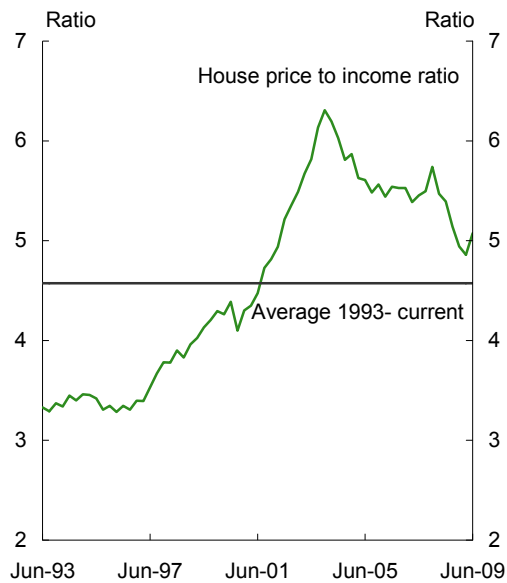
Current measures of housing affordability indicate that Australia faces significant challenges in providing sufficient affordable housing.

Median house prices have risen from around three times average household earnings in the early 1990s to around five times today (see Chart E4–1 Panel A). Higher prices affect access to housing in a range of ways. Under the Reserve Bank of Australia's measure, loan repayments are only just under 30 per cent of income (see Chart E4–1 Panel B). Houses are more affordable now than during 2007, but the recent improvement reflects interest rates falling to 'emergency lows' to combat the global financial crisis. These low rates are likely to be unwound as the economy recovers. Higher housing prices also meant that the deposit needed by first home buyers reached record highs during 2007 (Richards 2008). Higher house prices may also delay access to home ownership by younger Australians. The proportion of Australians under 35 who own their own home declined from 44 per cent in 2001 to 38 per cent in 2008. Similarly, higher house prices may mean fewer people own properties outright. The proportion of Australians aged 55 to 64 with mortgages has increased from 13 per cent in 1996–97 to 30 per cent in 2007–08. The National Housing Supply Council (2009) also noted that there is a spatial dimension to the affordability of dwellings; 27 per cent of dwellings in different population centres were found to be 'unaffordable' in 2006, while none were in 2001.¹⁵

15 This is based on the UDIA/Matusik Affordability Measure (2008), which characterised an area as 'unaffordable' when a household spending 30 per cent of the average income in that region on repayments (and with a 10 per cent deposit) could purchase less than 15 per cent of the houses in the region.

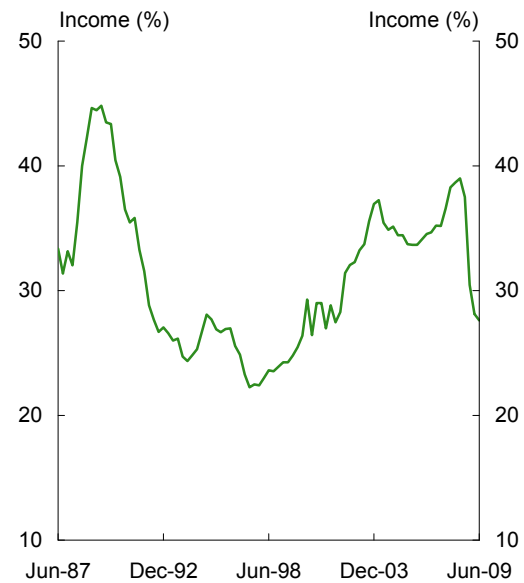
Chart E4–1: Housing affordability for owners

Panel A: Median house price to disposable household income



Source: REIA 2009, ABS (2009a) and Treasury estimates.

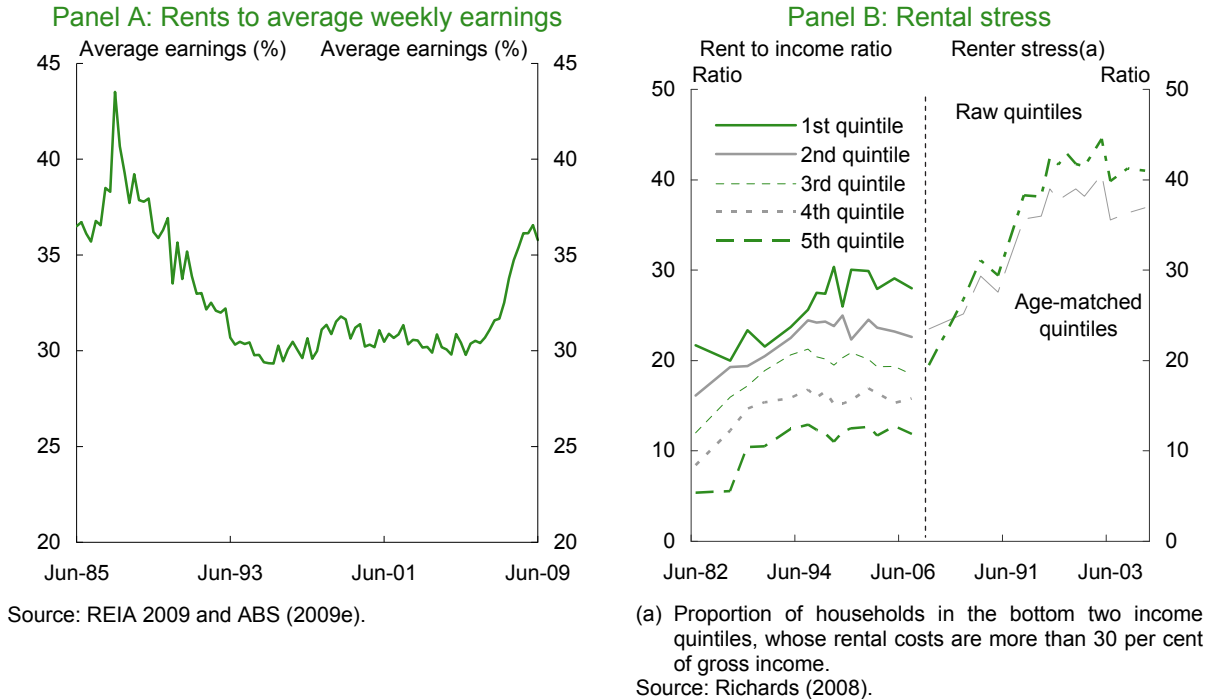
Panel B: Housing Loan Repayments



Source: RBA unpublished.

Importantly for many low-income earners, or transfer recipients, higher house prices reduce rental affordability, as rents need to increase if investors are to maintain their rental yield. The ratio of rents to average weekly earnings has risen to its highest level since the late 1980s (see Chart E4–2 Panel A). As at 5 June 2009 there were 418,000 individuals and families paying more than 30 per cent of their income in rent even after receiving Rent Assistance; 129,000 of these were paying more than 50 per cent of their income. Many of these people, especially age pensioners and disability support pensioners (who make up around one-quarter of Rent Assistance recipients) are likely to have limited capacity to increase their incomes. The number of Rent Assistance households paying more than 30 per cent of their income in rent is at its highest level since 2000.

Chart E4–2: Housing affordability for renters



The price level of any market good or service is set by its demand and supply. The Productivity Commission (2004) and Reserve Bank of Australia (2003) attribute the increase in house prices around the start of the decade primarily to strong growth in demand. This demand reflected a range of factors, including growth in average household incomes, increased credit availability and relatively low interest rates. In the short term, when housing supply is relatively fixed, price increases are an inevitable response to strong demand.

A persistent gap between housing supply and underlying demand (or the ‘need’ for housing based on population growth and trends in household formation) indicates that there are problems on the supply side of the housing market. Strong population growth in recent years has led to relatively strong underlying demand for housing. However, the supply response has not been able to keep pace. Over the past five years, the population grew on average 1.7 per cent a year, while housing completions fell on average 2.0 per cent a year.

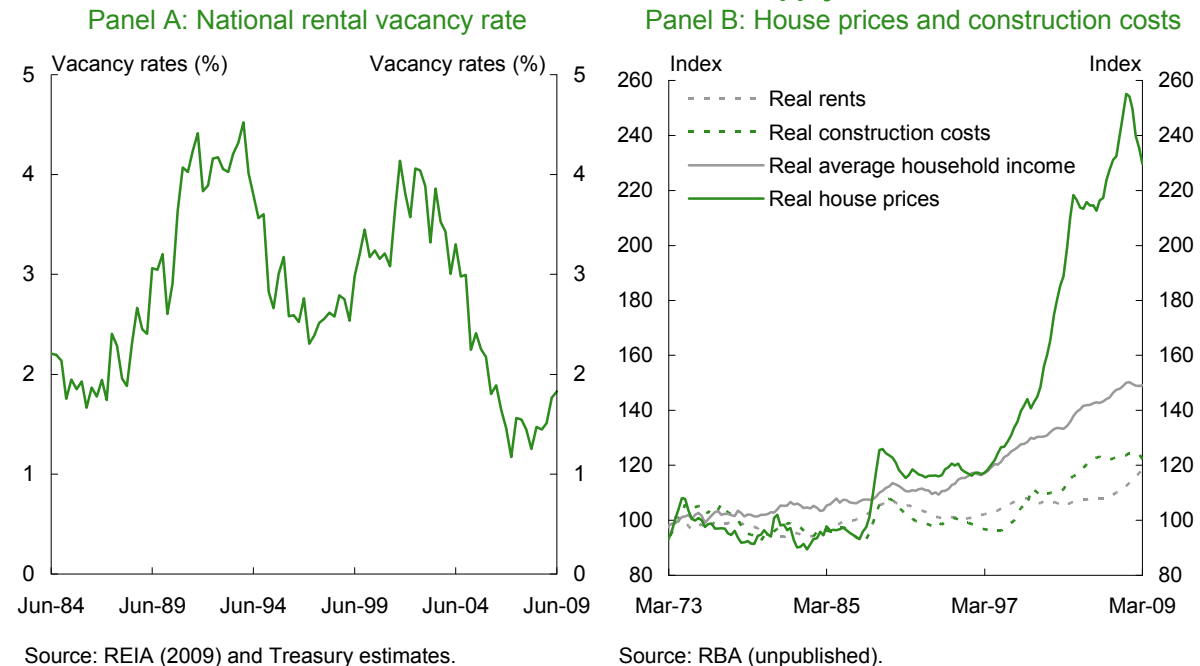
Thus sustained high levels and strong growth of housing prices are only possible when housing supply cannot increase to meet movements in demand.

There are a range of indicators of tight supply in the current housing market. Rental vacancy rates are currently around the record lows experienced during 2008 (see Chart E4–3). The National Housing Supply Council estimated that there is a substantial shortage of housing in Australia, with an unmet need of 85,000 dwellings in 2008, and construction levels falling short by around 20,000 to 30,000 a year. If the Council’s medium growth estimate of underlying demand and medium supply projection were met, there would be a cumulative gap by 2028 of 431,000 dwellings. Annually, the gap would increase by around 23,000 dwellings until 2016, when the annual shortfall would decrease consistent with an ageing population.

Of course, in markets demand always equals supply so long as prices can adjust. The Council's projections should be seen as an indication of the degree of likely price pressures and the subsequent challenges facing the community.

The growth in house prices largely reflects increasing prices of existing houses, rather than growing costs of construction (see Chart E4-3 Panel B). Land has made up a growing share of house prices, increasing from 53 per cent to 61 per cent in the 15 years to 30 June 2009.

Chart E4-3: Constrained supply



The responsiveness of housing supply is influenced by a range of factors. Even in ideal conditions, dwellings take a long time to plan and construct, which will mean that the supply of housing is unlikely to be as responsive as supply in other markets. Currently, difficulties in securing finance for the development of multi-unit developments are a consequence of lending practices changing in response to the global financial crisis. There are, however, many public policy choices that can have a long-term impact on housing supply and housing affordability. As well as tax settings, housing supply and prices are influenced by planning and zoning laws, building regulations, environmental regulations, infrastructure provision and pricing, the availability of skilled labour in residential construction, and even transport policy. As a consequence of achieving other public policy objectives, these policies may affect housing prices.

E4-3 The effect of the tax system on housing affordability

Many taxes influence the housing market. The personal tax system affects the affordability of rental housing through the assessment of income from investment in residential rental properties, offsetting expenses (such as interest costs) and capital gains. The housing market is also affected by the exemption of owner-occupied housing from the personal income tax and the capital gains tax system, stamp duties on housing transactions, GST on the price of supplying new housing, council rates and land taxes.

Prices send a signal to direct resources within an economy. Resources are directed to where they are most valuable when price signals reflect real preferences and resource constraints rather than tax policy settings, which of themselves contain no information about the type or location of dwellings Australians want to live in. Where taxes add to the volatility of demand or restrict the supply of housing, they reduce the efficient operation of the housing market. The general efficiency principle of tax policy, involves minimising its impact on economic activity. Similarly, when the tax system affects housing prices it can also affect fairness, for example, if the tax system makes it difficult for disadvantaged groups to afford housing.

However, other public policy objectives are of relevance for the taxation of housing. The role of housing as a lifetime savings vehicle that provides security in retirement means the income from owner-occupied housing should not be taxed. However, the Review is proposing to tax rental properties in a way that is more consistent with other forms of investment, reducing biases in housing investment and savings portfolios. As a result, these different tax treatments will affect the cost of housing for renters compared to homeowners.

Effect of proposed reforms on supply and demand for housing

Outlined below are a number of proposed reforms to the tax system that would reduce the impact of the tax system on house prices. These reforms are described in more detail in Sections C2 (Land tax and conveyance stamp duty) and A1 (Personal income tax). In concert with other reforms to improve housing supply, they should improve housing affordability by making housing supply more responsive to demand.

Removing stamp duty

Removing stamp duties would improve the supply of housing, as well as reducing a range of other adverse impacts on the housing market.

By suppressing the number of transactions undertaken in the housing market, stamp duties reduce the effective supply of housing.¹⁶ More transactions means a better matching of people to housing, which in turn means a given housing stock can effectively house more people. By adding to the cost of moving to a larger house, stamp duty encourages people to renovate rather than re-locate. This means that more investment is channelled into making existing housing larger than into more affordable and newer housing. These impacts on the supply of housing are on top of the personal costs of stamp duty, which arise when people live in houses that are ill-suited to their needs.

As a turnover tax, stamp duties can also discourage the development of new housing stock. Stamp duties are paid twice in the supply chain of new housing construction: when the developer buys the property from its initial owners and when the final owner buys the land. Stamp duties impose their highest effective tax rate when a property is held for a short period (see Section C2 Land tax and conveyance stamp duty). As a result, they fall heavily on people who hold property over short time periods while it is developed (or redeveloped) into housing. As the liability from a land tax is independent of holding periods, replacing stamp duty would support new housing supply.

¹⁶ For example, Leigh (2009) estimates that a 10 per cent increase in stamp duty costs reduces the total number of transactions by 4 to 5 per cent if the increase is sustained over a three year period.

As well as taxing turnover, stamp duties are also a tax on the buildings (or improved value) including in housing. Compared to a tax on land only, stamp duties discourage the construction of new dwellings, which is likely to reduce supply and increase cost of housing.

Land tax

Using the size of holdings and the use of land to determine land tax liabilities has adverse impacts on the housing market. Reforms to levy land tax on all land, based on its value, should reduce these effects.

Apart from the ACT, all States that levy land tax calculate it on the basis of aggregate land holdings. In combination with progressive rate scales, this approach creates a significant bias against large-scale land holdings. In combination with the negative gearing tax advantage available to individual investors, this is a major reason for the residential property market being dominated by small-scale investors.

Policies that discourage large-scale investors from participating in the housing market are likely to have adverse effects on the supply of rental housing and its affordability for tenants. By favouring small investors, housing investment forgoes the potential for lower costs from economies of scale in housing supply. For example, small landlords effectively share the services of tenancy management by purchasing them from property agents. Large scale housing investors may be able to bring the supervision of tenancy arrangements 'in house', reducing their cost and the cost of housing overall. Further, large-scale investors are more likely to invest over longer time horizons, as they are less likely to face cash-flow problems or the need for portfolio diversification that can force sales by small-scale investors. For long-term investors, longer leases would also reduce negotiation costs and provide certainty of income. Such arrangements would be particularly beneficial to some tenants who currently face high costs from insecure tenure, such as many elderly people and low-income families. The security of tenure provided by longer leases would have positive effects for tenants' social integration and for high levels of social capital within communities.

Improvements to housing investment arising from the removal of the aggregation basis for land tax would likely develop over a reasonably long time period in light of the range of other factors affecting housing supply.

The current exemptions from land tax mean that the tax is unlikely to be fully capitalised into land values (see Section C2 Land tax and conveyance stamp duty). This results in the burden of the tax falling on the users of land, greatly reducing the efficiency of the tax. This is particularly relevant for the housing market. When developers purchase land that was exempt because it was used in primary production and will become exempt in the future (as owner-occupied property), little of the tax will be reflected in lower land values. The exemption is likely to add to holding costs of supplying new housing. Similarly, the burden of the current land tax on investment property is likely to fall predominantly on renters through higher rent. Broadening the land tax would therefore improve housing affordability.

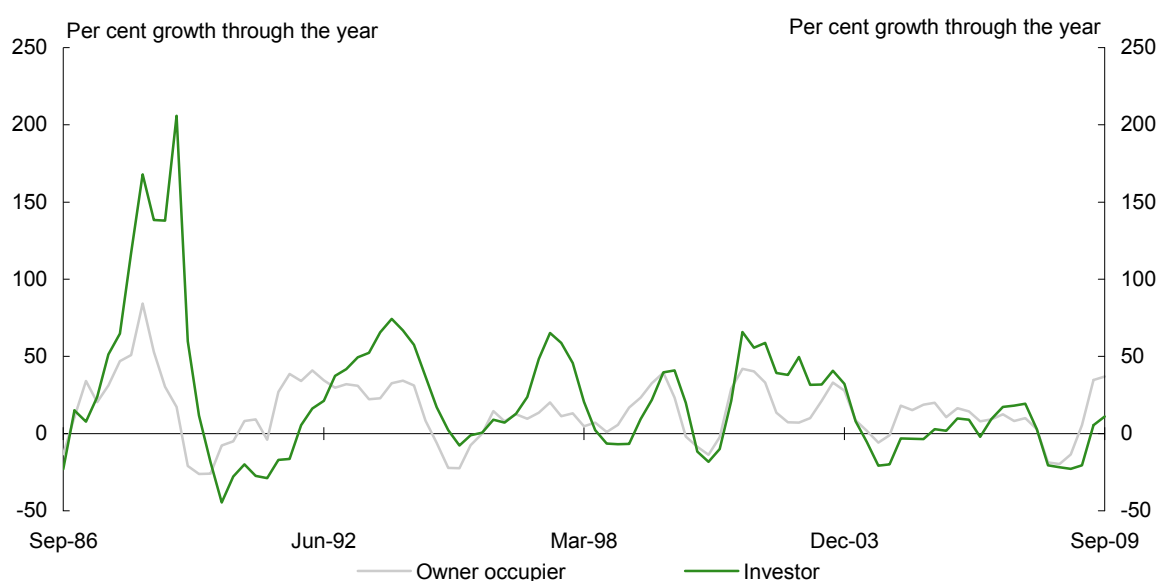
Changes to the taxation of investment properties

The current personal income tax system favourably treats capital gains and amplifies this benefit when investments are geared. By discounting net rental income at the same rate as capital gains, the tax treatment of investor housing will be less responsive to gearing levels

and capital gains, creating a more neutral treatment of different forms of savings (see A1 Personal income tax).

The proposed reforms would reduce the bias in favour of the capital gain generated in rental properties by treating it more neutrally compared to rental yield. Over the long term, this is likely to change investor demand toward housing with higher rental yields and longer investment horizons. This may also result in a more stable housing market, as the current incentive for investors to chase large capital gains in housing would be reduced. Finance for investment in rental property appears to be more volatile than that for owner-occupiers (see Chart E4-4). The Productivity Commission (2004) and Reserve Bank of Australia (2003) have suggested that favourable taxation settings can contribute to volatility of the housing market.

Chart E4-4: Volatility of housing finance from investors and owner-occupiers



Source: ABS(2009j).

However, changing the taxation of investment properties could have an adverse impact in the short to medium term on the housing market. Investment returns in the Australian residential housing market are likely driven by capital gains rather than by rental yield. As such, reducing net rental losses and capital gains tax concessions may in the short term reduce residential property investment. In a market facing supply constraints, these reforms could place further pressure on the availability of affordable rental accommodation within the private rental market. These reforms therefore should only be adopted following reforms to the supply of housing and reforms to housing assistance (see Section F5 Housing assistance). The design of these reforms differs from the previous amendment to taxation of rental properties, see Box E4-2.

Box E4–1: Changes to tax treatment of negative gearing, 1985 and recommended

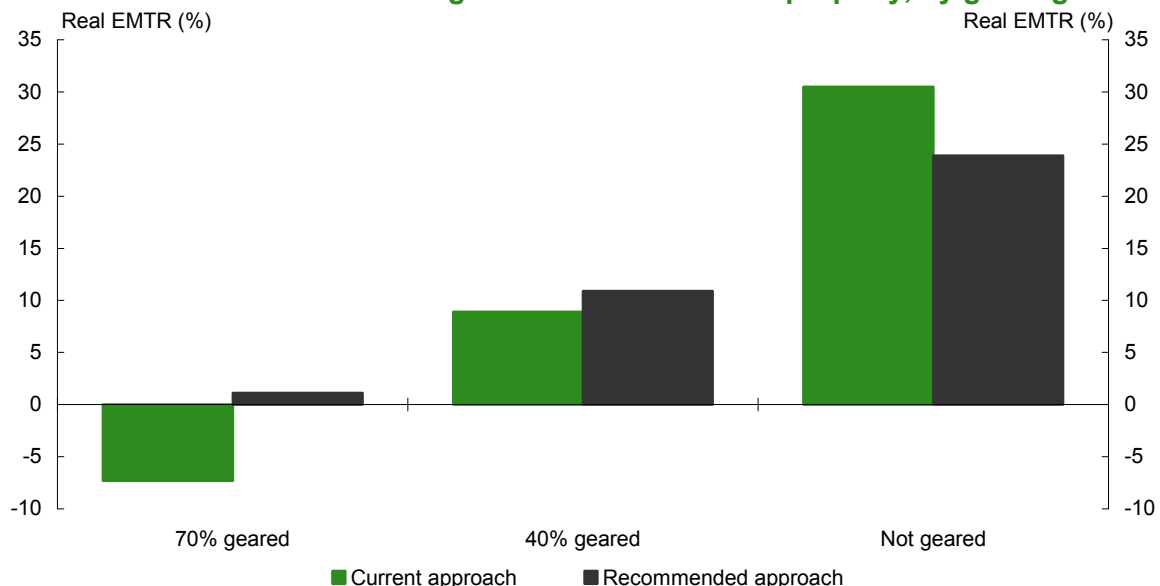
The effect of applying the recommended savings income discount to net rental income would be that a negatively geared investor would still be able to offset net rental losses against other income, including labour income. While the extent of the offset would be reduced, negatively geared investors would continue to access ongoing deductions that they might value for cash flow reasons.

Under the savings income discount, there would also be a generally better outcome for rental property investors that finance out of equity. The more neutral treatment would reduce the crowding out of other potential investors in rental housing by those undertaking negative gearing, and improve the long-term stability of the housing market.

Accordingly, this is quite a different approach to that adopted in 1985 (and reversed in 1987). In 1985 the tax benefits of negative gearing became restricted through the introduction of quarantining measures for excess deductions. As such, negatively geared investors could not access the entire net rental loss in the income year it was incurred, rather, excess interest in any year was carried forward and offset against future rental income or any gains taxable under capital gains tax from the sale of such investments.

In terms of rent setting, a more neutral taxation of investment housing would reduce the tax on some investors, while increase it for highly geared investors (see Chart E4–5). The long-term impact on rents would depend on how these different investors respond and their relative prominence in the rental housing market. Currently, investors with no or low levels of gearing form the minority of the market, so the current tax advantages available to highly geared investment can operate as a subsidy to renters by placing downward pressure on rents.

Chart E4–5: Real effective marginal tax rates on rental property, by gearing ratio



Assumptions: Individual on 31.5 per cent marginal tax rate. 6 per cent nominal return, 2.5 per cent inflation. For rental property, 50 per cent of the return is attributable to capital gain, 50 per cent attributable to rental income and the rental property is held for seven years then sold. Tax on debt provider disregarded.

Source: Treasury estimates.

This implicit subsidy is sometimes cited as a reason to sustain a non-neutral tax treatment. However, while some benefit may accrue to renters through lower rents, the tax advantage is neither transparent nor well-targeted to improve affordability for low-income renters. Further, providing assistance through subsidised geared investment can have other impacts on the availability of rental housing that may not be in the best interests of tenants. Recent work by Wood and Ong (2009) found that negatively geared investors were around half as likely to hold their property after five years as investors who were not negatively geared. For tenants, having landlords who are more likely to sell reduces the security of their tenure. In contrast to negative gearing, the proposed reforms to housing assistance are targeted to those who need assistance, making them a more effective and equitable means of subsidising low-income renters.

Overall impact on the housing market

While these reforms will address significant biases that the tax system introduces into the housing market, the overall impact on housing affordability depends on other factors, such as interest rates and land release policies. A range of other policies are likely to have a more significant impact on housing supply than tax settings.

The tax system is unlikely to be an effective instrument to move housing prices toward a particular desired level and the tax system is not the appropriate tool for addressing the impact of other policies on housing affordability.

Finding

Though the Review's proposed reforms to taxes, in particular stamp duty and land tax, could play significant roles in addressing housing affordability, other policies are likely to have a more pronounced impact on the responsiveness of housing supply.

E4–4 The effect of non-tax policies on housing supply

A range of policies restrict the supply of new housing, whether in new 'greenfield' areas or in infill projects.

Planning and zoning, approvals and building regulations

Features of the planning system intend to enhance the efficiency of land use in two ways: by managing or preventing perceived negative spillovers from development activities that may extend beyond the site of the development itself; and by facilitating positive spillovers through the provision of public goods (National Housing Supply Council 2009). However, planning can also add costs, such as where the regulations are not well-targeted and lengthy development assessment processes are involved. The key question is whether the benefits outweigh the costs.

The zoning process is one aspect of the planning system that controls the manner in which land can be used and regulates the supply of land for new housing. Zoning can have many rationales. It can be used to manage land use to protect the property rights of neighbouring land owners. Zoning can reduce spillover costs by congregating spillovers (such as noise pollution) in common areas (such as industrial zones). Some forms of infrastructure may also be provided at lower cost if they are specific to some forms of land use. Zoning is therefore

one mechanism for coordinating different uses of land and reducing spillover costs between owners.

Zoning and planning also can reflect other public policy objectives. A number of Australian cities employ boundaries or growth corridors that aim to limit the expansion of urban land. Limiting the expansion of cities can reduce the need for additional infrastructure, which tends to be more costly to deliver further from urban centres. These limits can be used to contain urban sprawl. The desire to contain sprawl can be motivated by cost considerations, such as reducing costs caused by congestion that results from longer commuting times. Objections to urban sprawl often reflect a range of values, such as a preference for non-urban land to be preserved or a concern that more distant communities may be socially isolated, particularly if the communities do not have access to public transport.

The use of zoning and local interpretation of zoning settings, however, restricts the supply of land for housing and necessarily increases its price. While land values for different types of rural land can be in the range of \$50 to \$5000 per hectare, the value of land on urban fringes can be substantially higher. For example, the value of land can increase by \$300,000 to \$400,000 per hectare when zoned for residential purposes (Department of Sustainability Victoria 2005). Such a significant increase will largely reflect the value that results from restricting supply.

Land already zoned for residential use is still subject to a range of constraints on its use. This may include preventing the construction of higher-density dwellings (such as dual occupancy or multi-story dwellings) in certain parts of a city. These restrictions may be motivated by similar reasons to those that underlie zoning itself. For example, a new higher-density residential development may impose social costs on existing residents by lowering the amenity of an area or congesting infrastructure. Another type of spillover is a 'pecuniary' spillover where increasing supply reduces the value of existing homes. Existing owners may therefore oppose the removal of restrictions on the supply of housing that maintain house prices at high levels. Limitations on higher density in existing urban areas may harm housing affordability more than restrictions at the fringe. This is because it would be cheaper to house people in areas close to services, transport, workplaces or places of natural beauty. The higher land and house values in inner-urban areas also reflects the fact that these areas are where more people want to live.

The removal of such building restrictions is not justified simply because it would reduce housing prices. Concerns for housing affordability need to be balanced against other policy objectives. Further, potential exists for some of these objectives to be addressed more effectively through price mechanisms. For example, moves toward more effective road pricing and congestion charging would reduce the need to use a growth boundary as an indirect way of reducing congestion costs. For many of the other policy motivations, however, there are clear trade-offs that need to balance concerns of competing groups who can benefit or be harmed by the maintenance of housing restrictions.

One such trade-off is reflected in the governance issues that affect development. In general, State governments are responsible for determining the plans for a city, as these require coordination across a number of local councils and the provision of large-scale infrastructure, for which they are responsible. Local governments often control the zoning or approvals that put broader plans into effect, such as by allowing higher-density housing in the areas designated by the plan. This can result in tension between the wider objectives, which can

often include objectives for higher-density housing, and the decisions of local government, which reflect the concerns of their citizens who are most strongly affected by change. It can therefore be difficult for State governments to implement urban infill strategies. There appears to be scope for reforms to planning governance to achieve greater clarity in the roles of institutional policy-setting and decision-making between levels of government (National Housing Supply Council 2009).

Regulations on the use of land need to be governed by approval processes to ensure they are enacted in a transparent and fair manner. These processes require consultation with affected stakeholders and assessment against a range of criteria, such as environmental requirements managed by Australian government legislation. Where these processes are slow, they add to costs of house building and the risk of developing land, thereby reducing the supply of housing. There is some evidence that delays have increased and that approval times can be 50 per cent longer in inner-urban areas than at the fringe (Productivity Commission 2004). Where approval processes are streamlined, they are likely to result in supply being more responsive to changing conditions.

While much of the recent increase in house prices reflects increasing costs of land, higher building costs can also affect housing affordability. National building codes mandate a minimum quality standard of construction. These standards ensure a minimum quality standard to ensure safety, promote environmental outcomes or improve the energy efficiency of buildings. Standards may be imposed to correct perceived market failures, particularly information asymmetry between home buyers and builders and spillover costs to the community that parties to the transaction may ignore. Improving the quality of housing raises its cost. These higher costs need to be balanced against the social and private benefits they deliver.

Findings

Higher house prices are likely to result from restrictions on the supply of housing that result from zoning, lengthy approvals processes and building code and other standards imposed on building quality. Housing affordability needs to be considered against the other policy objectives that motivate these regulations.

Scope for reform

Recommendation 69:

COAG should place priority on a review of institutional arrangements (including administration) to ensure zoning and planning do not unnecessarily inhibit housing supply and housing affordability.

Australia is likely to benefit from greater emphasis on housing supply in a range of policy areas. In particular, there appears to be scope for reforms to planning and approvals processes to enable more responsive supply of housing in greenfield and infill developments. However, the Review has not considered these mechanisms and is not in a position to identify those regulations that may prevent or delay viable developments.

Reforms that could promote the more responsive supply of housing will present serious choices for both the Australian people and their governments. Most starkly, 'improving'

housing affordability for purchasers involves policies that cause house prices to be lower or grow more slowly than the community would otherwise expect. While this will benefit those who gain access to housing, it will affect the wealth of the majority of home owning Australians.

Increased housing supply may also change the shape of Australian cities and towns in ways that many existing residents may not desire. How different tiers of government balance their concerns against those of potential new residents is an important question of governance. This suggests that a serious community dialogue is needed on the distribution and quality of housing across Australia. As a first step, the COAG should review the administration of land use policies by local councils and planning authorities, with a view to facilitating greenfield and infill developments.

E4–5 Infrastructure charges

Infrastructure charges (sometimes called ‘developer charges’ or ‘developer contributions’) are fees levied on developers to compensate governments for providing facilities necessary for land development. The charges are often associated with basic infrastructure (such as local roads and water mains), but more recently this has sometimes been extended to include major headworks (arterial roads and pumping stations) and social infrastructure (parks and libraries).

Infrastructure charges are widely used by local government as well as some State governments, and are increasingly prevalent in other developed countries. There is limited information and few aggregate statistics relating to infrastructure charges in Australia. Chan et al. (2009) reported that in 2005–06, New South Wales councils collected \$232 million and Victorian councils collected \$454 million in charges.

What is the potential role for infrastructure charges?

In Australia, the practice of governments charging for infrastructure has been becoming more prevalent since the 1980s. This reflects increasing demand for infrastructure and fiscal constraints on local governments, but also a policy shift towards using economic instruments to allocate infrastructure and influence development decisions (Chan et al. 2009).

In principle, efficient provision of infrastructure would be encouraged where its users pay for the construction of infrastructure that would be avoidable (that is, not needed) if the development did not proceed. By levying infrastructure charges that reflect these costs, State and local governments provide signals to develop housing in ways and places of greatest value. The cost of infrastructure increases directly with distance from essential headworks and inversely with the density of development (Slack 2002). To the extent that a developer can respond to these costs, for example, by choosing to build closer to an existing development or by increasing the density of housing, charging the developer can improve housing supply.

Indeed, in the absence of pricing, developers build without regard to such costs, and governments are more likely to rely on other policy instruments, such as planning regulations, to limit the budget costs of infrastructure associated with housing