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The great Australian nightmare

How expensive housing sits at the heart of some of Australia's most pressing policy challenges

by **Brendan Coates**

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Upstream from the Great Australian Nightmare of worsening housing affordability – and all the downstream consequences it is creating in our society – sits our longstanding intellectual neglect of the economics of land.

For most of the 20th century, the neglect of land was of little consequence. For economies powered by manufacturing, who owned land, where it was, and how it was used, was of secondary importance to the amount of capital invested and the pace of technological innovation.

But as the advanced economies of the world have transitioned again – from manufacturing to services – land is back. Economies powered by intangible capital strive or stagnate based on the ability of individuals to come together and combine their knowledge and skills. It is, as any real estate agent would tell you, all about 'location, location, location'.

Grattan Institute work shows that cities are the economic engines of the modern economy. Eighty per cent of the value of all goods and services produced in Australia is generated on just 0.2 per cent of the land. Economic activity is concentrated in CBDs, with those of Sydney

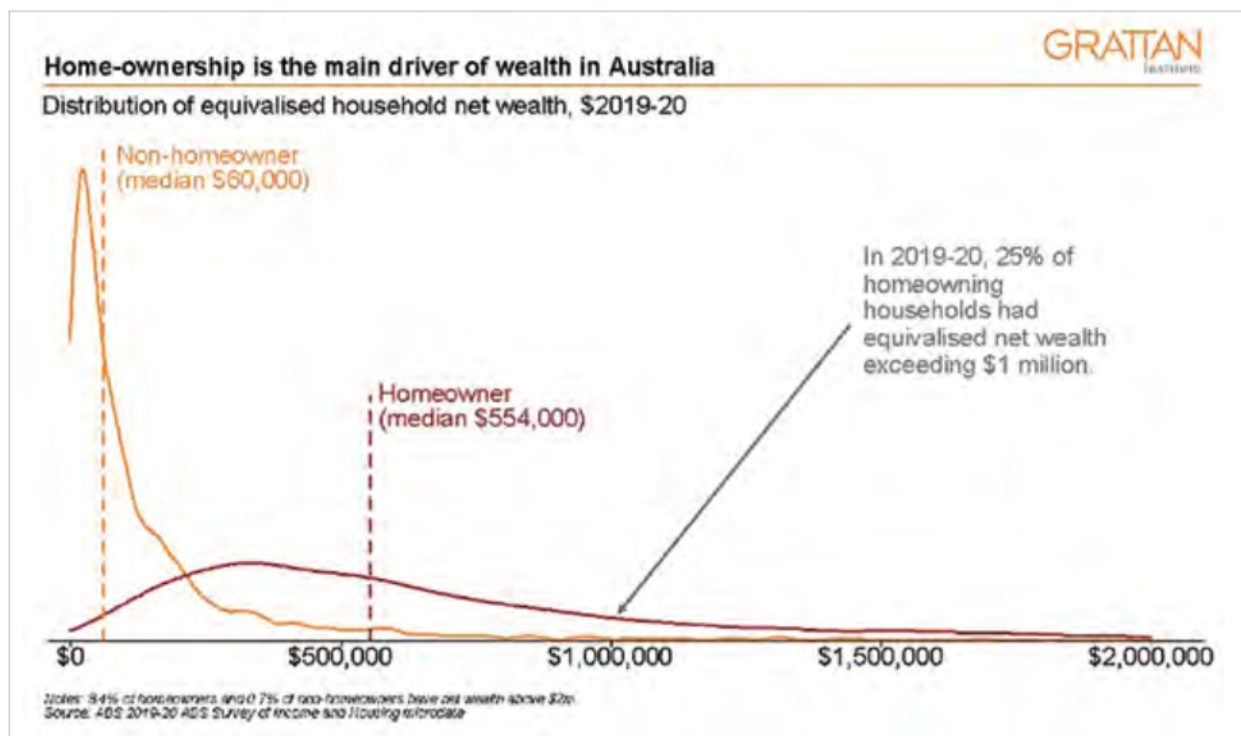
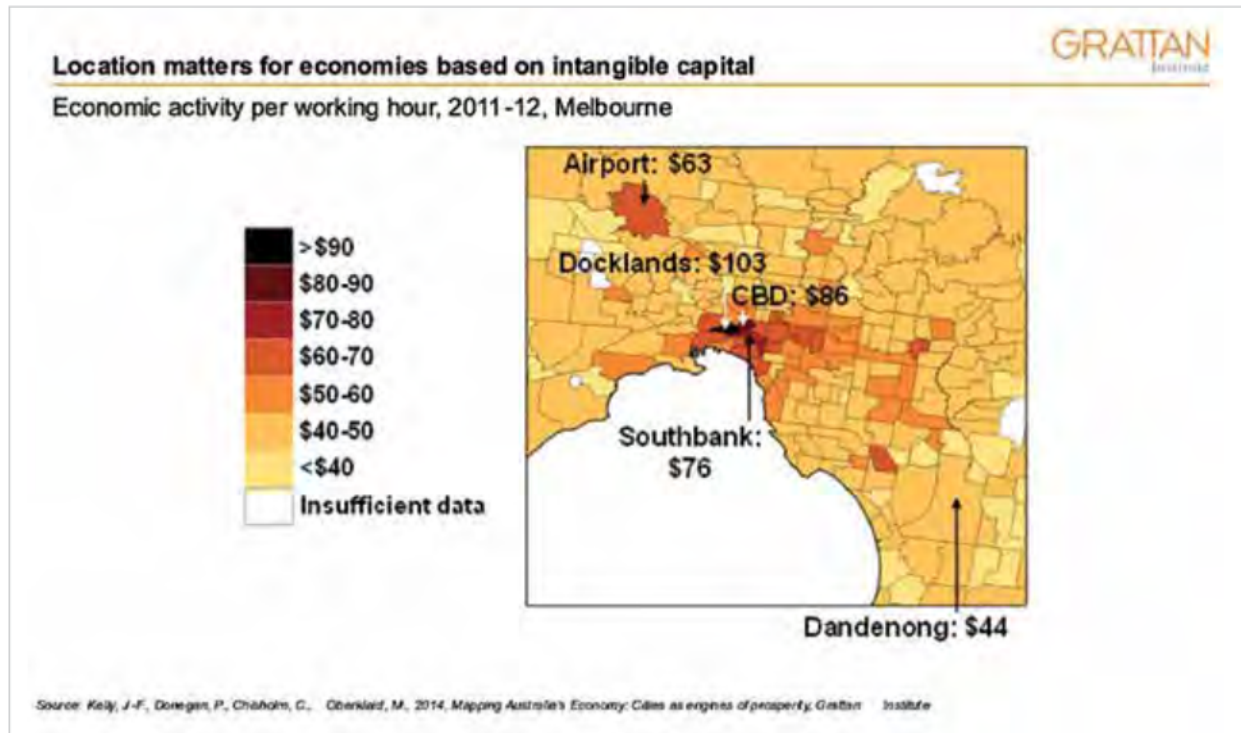
and Melbourne accounting for 10 per cent of all economic activity in Australia – more than three times the contribution of the entire agricultural sector.¹

This concentration reflects the rise in knowledge-intensive services, clustered together at the hearts of our major cities. The fact that businesses are willing to pay high rents to locate in the CBDs of our major cities shows the value of having access to high-skilled workers and proximity to suppliers, customers, and partners in those scarce locations.

And the willingness of Australian workers to pay much higher house prices for homes located close to those employment centres shows that Australians also see value in these connections.

Economists Josh Ryan-Collins and Cameron Murray estimate that prior to June 2019, in 16 of the previous 29 quarters the median Sydney home earned more than the median full-time

1 Kelly, J-F., Donegan, P., Chisholm, C., Oberklaid, M. (2014), Mapping Australia's Economy: Cities as engines of prosperity, Grattan Institute.



worker. How can it be that a relatively low risk, low effort investment can often provide greater returns than a year of hard work?²

And here we see how the fact that land was neglected in public discourse for so long has proven so costly as the Australian public, via their governments, have been among the smallest beneficiaries.

Australian governments derive far less revenue from property taxes as a share of GDP than they should. Australia's property tax take – at less than 1 per cent of GDP -- is far below that of some comparable countries. Land taxes do not distort decisions about land use, provided they apply in a way that the landowner can't avoid. Which is precisely why economists hold land taxes in such high regard.

2 Ryan-Collins, J. and Murray, C. (2020), When homes earn more than jobs: the rentierization of the Australian housing market, Housing Studies.

But at the same time, no country has succeeded in collecting a large share of land rents via land taxes, as Henry George demanded. Land taxes have in fact proved to be unpopular because they are highly salient – hitting the cash flows of households and businesses each year. In contrast stamp duties, which are almost universally denounced by economists because they impose large economic costs, have proven to be more palatable to the public.

Many countries were lucky enough to capture a good share of the rapid rise in land rents in recent decades because they owned a lot of land. In contrast Australian governments own relatively little land – just 6 per cent of total land value in Australia today. This means these growing returns to housing are captured privately, and our governments are limited in their ability to share these spoils with those that don't own housing and land in ways that other countries have done, such as Singapore.

The drivers of rising house (and land) values

But what's driven the enormous rise in house values since the Second World War?

It's a story of historically low interest rates, increased access to finance, tax and welfare

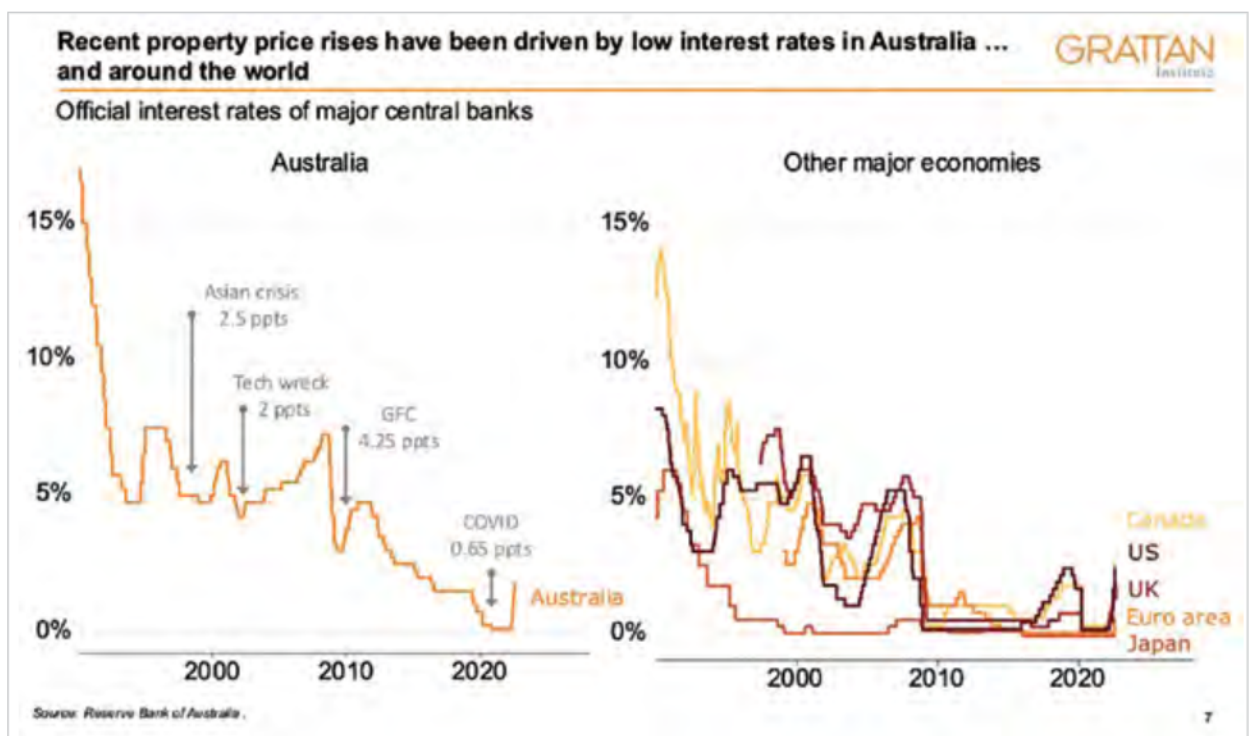
‘The politics of land-use planning – what gets built and where – favour those who oppose change.’

settings that favour investments in housing, and a boom in migration that's led to a chronic shortage of housing.

Nor, in my view, is the idea that there is a 'housing shortage' contradicted by the existence of more than one million vacant dwellings, as recorded by the 2021 Census, or by Prosper's work tracking vacant dwellings using data on homes' water usage.

Some states have sought to introduce vacant property taxes to encourage more vacant dwellings onto the market. But to date no vacant property tax has been successful, since they inevitably include exemptions for uses such as holiday homes, which make them easy to game.

Advertised rents are already surging, and many of Australia's most vulnerable are suffering as a result. Less than 1 per cent of rental properties are currently vacant – the lowest level on record.³ The typical asking rent on a new



3 Razaghi, T., Landlords hold upper hand, renters set for tough conditions over next 12 months, Domain.

property is up nearly 14 per cent nationally over the past year.⁴ The regions are not immune either, with the work-from-home revolution driving an exodus from the cities, pushing many in regional areas into acute rental stress and homelessness.⁵ And now that borders have reopened, population growth, and housing demand, is expected to rebound sharply.⁶

This is largely a failure of housing policy, not housing markets.

Australia's land-use planning rules are highly prescriptive and complex.

The prices of new homes, including apartments, exceed the cost of building more of them. Reserve Bank researchers estimated that restrictive land-use planning rules add up to 40 per cent to the price of houses in Sydney and Melbourne, up sharply from 15 years ago. More recent research suggests that planning rules have added substantially to the cost of apartments, where building height limits in and around the urban cores of our major cities prevent more construction.⁷

There are reasons to think of these estimates as upper-bound estimates of the size of the impact of land use planning.

But they are consistent with a growing international literature highlighting how land-use planning rules – including zoning, other regulations, and lengthy development approval processes – have reduced the ability of many housing markets to respond to growing demand, adding to both rent and house price growth in a number of countries.⁸ In many of these studies we see a clear correlation between the size of land rents and decent measures of land use planning stringency across US cities.⁹

The key problem is that many states and local governments restrict medium- and high-density developments to appease local residents concerned about road congestion, parking problems, and damage to neighbourhood character. The politics of land-use planning – what gets built and where – favour those who oppose change. The people who might live in new housing – were it to be built – don't get a say.

But studies assessing the local costs and benefits of current rules generally conclude that the negative externalities are much smaller than the costs of existing regulations.¹⁰

Heritage protection is a particular form of planning regulation that slows or stops development. Research from the US has identified an over-emphasis on heritage considerations as a significant barrier to development. While the precise magnitude of the barrier in Australian cities is unclear – no similar study has yet been undertaken – examples abound.

More recent work by Prosper and others has shown that land development is prone to cycles and strategic behaviour in greenfield areas.¹¹ The issue of land banking by developers warrants further investigation, but it does not, in my view, imply that there is a natural 'speed limit' on development independent of external constraints on housing supply.

Yet it remains clear cities offer too little medium-density housing in their inner and middle rings. Australian capital cities are more sparsely populated than cities of similar size in other developed economies.

This is not what most Australians want. It is a myth that all new first-home buyers want a quarter-acre block. Many would prefer

4 SQM Research, Weekly Rents.

5 Domain, June 2022 Rental Report.

6 Ellis, L. (2022), Housing in the Endemic Phase, Keynote Speech to the UDIA 2022 National Congress.

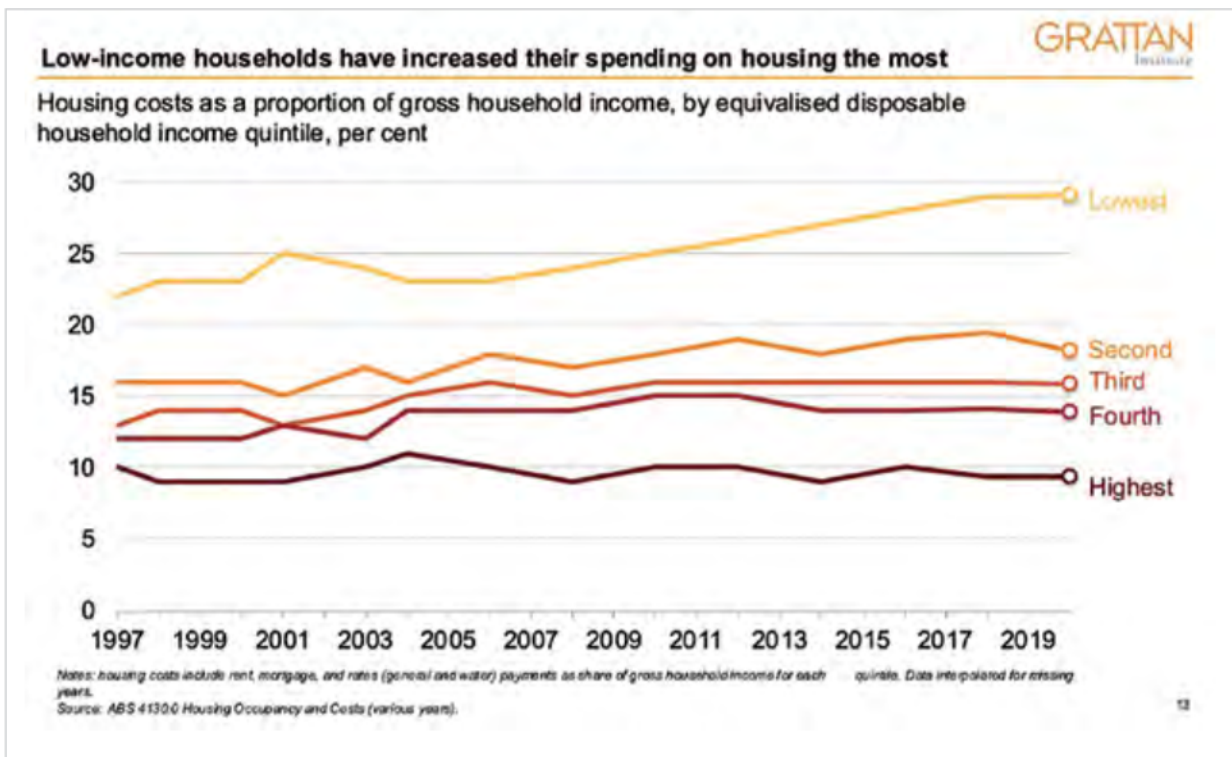
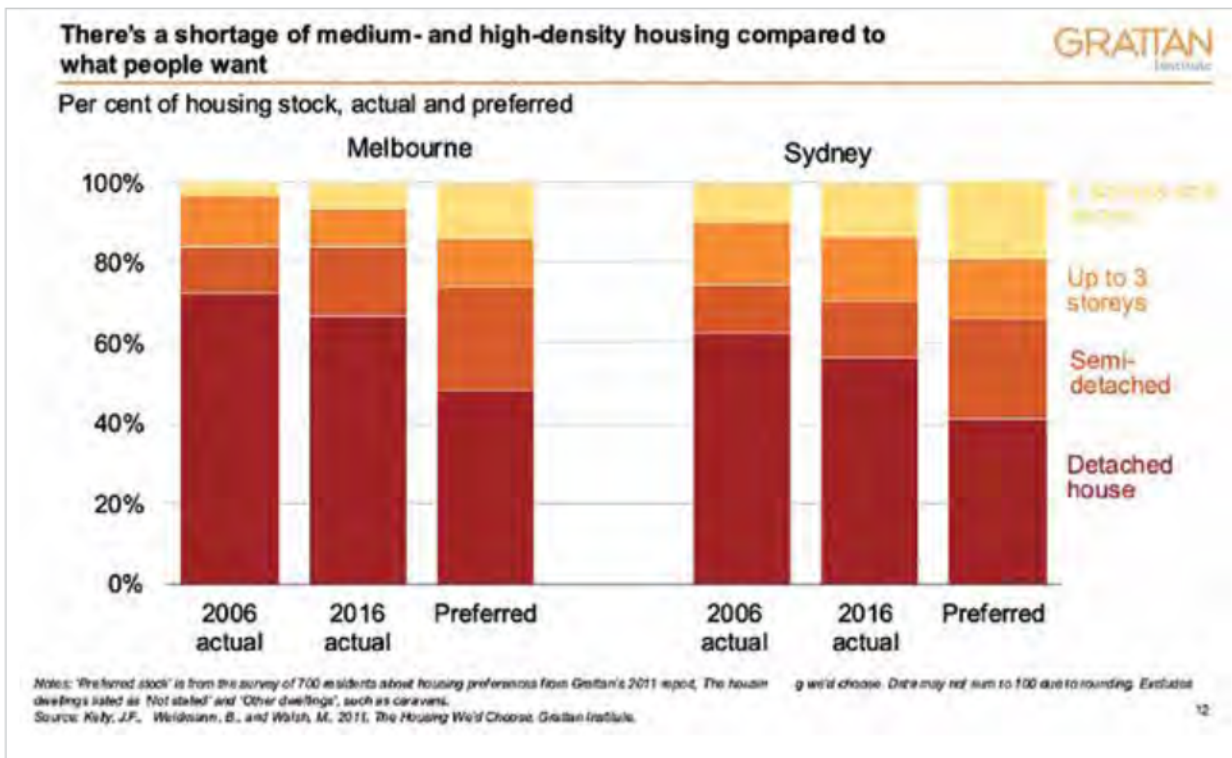
7 Jenner and Tulip (2020) estimate that home buyers will pay an average of \$873,000 for a new apartment in Sydney though it only costs \$519,000 to supply, a gap of \$355,000 (68 per cent of costs). There are smaller gaps of \$97,000 (20 per cent of costs) in Melbourne and \$10,000 (2 per cent of costs) in Brisbane. See: Jenner, K. and Tulip, P., (2020), The Apartment Shortage. Reserve Bank of Australia Discussion Paper.

8 Daley, J. and Coates, B. (2018), Housing Affordability: Reimagining the Australian Dream, Grattan Institute, pp. 26–27.

9 Unfortunately, the fact that Australians are overwhelmingly concentrated in just five cities means we can't easily conduct similar comparisons for Australian cities since a restriction on housing at one location will increase demand and hence prices for housing at other locations in the same city. So variations in relative prices across the city will substantially understate the total effect of variations in restrictions.

10 Gyourko, J. and Molloy, R. (2015), Chapter 19 – Regulation and Housing Supply, Handbook of Regional and Urban Economics, Vol. 5.

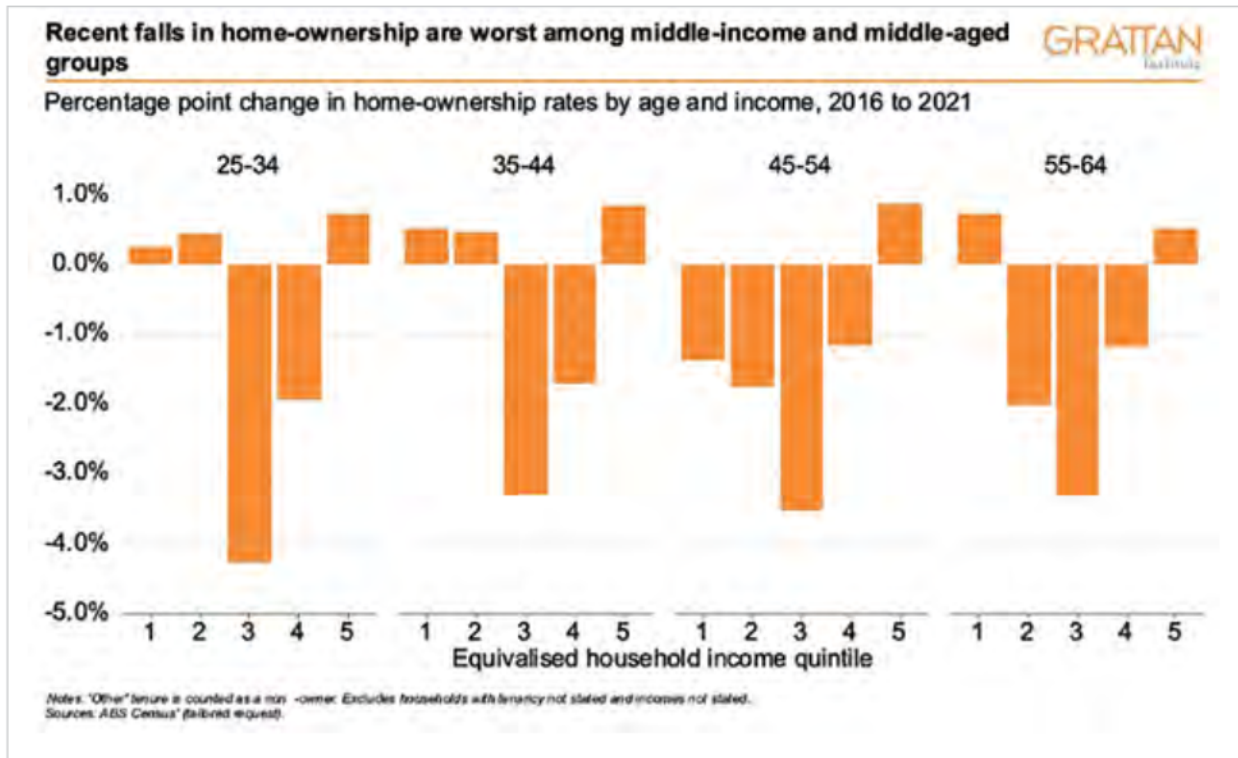
11 Fitzgerald, K., (2022), Staged Releases: Peering Behind the Land Supply Curtain. Prosper. Murray, C., (2021), A housing supply absorption rate equation.



a townhouse, semi-detached dwelling, or apartment in an inner or middle suburb, rather than a house on the city fringe.

The stock of smaller dwellings – townhouses, apartments, etc – made up 44 per cent of

Sydney's houses in 2016, and 33 per cent of Melbourne's. Yet, Australians say they actually want those numbers to be 59 per cent in Sydney and 52 per cent in Melbourne.



The Great Australian Nightmare

Within living memory, Australia was a place where housing costs were manageable, and people of all ages and incomes had a reasonable chance to own a home with good access to jobs. But the great Australian dream of home ownership is rapidly turning into a nightmare for many young Australians.

People on low incomes – increasingly renters – are spending more of their income on housing, especially in the form of rent. More than half of low-income Australians in the private rental market suffer rental stress, especially those in the capital cities.

One in five working-aged households who rent are in financial stress, defined as skipping a meal, using charity, pawning something, or not heating the home. The ugliest outcome from this imbalance is simply more people without a home. The number of homeless Australians relative to population ticked up from 2006 to 2016.¹²

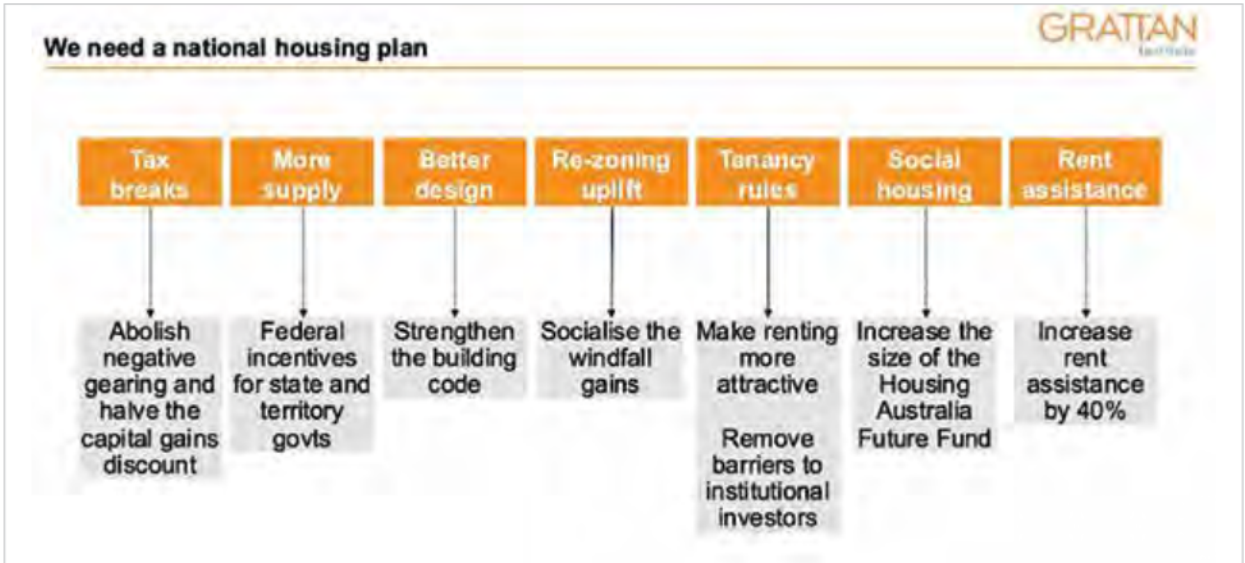
Since World War 2, Australia has been a nation of homeowners. Home ownership rates peaked at more than 71 per cent in 1966. Almost three quarters of the nation was on the property ladder and living the dream – home ownership was celebrated as an indicator of success, security, and quality of life.

But now home ownership rates are falling fast, especially among the young and poor. Between 1981 and 2021, home ownership rates among 25-34 year-olds fell from more than 60 per cent to 40 per cent, and among the poorest 40 per cent of that age group it has more than halved, from 57 per cent to 28 per cent.

Since the last Census, we’ve started to see accelerating declines among middle-income households too, with noticeable falls in home ownership at all age levels, and including older, middle-income households.

Home ownership is also falling among poorer older Australians. Among the poorest 40 per cent of 45-54 year-olds, just 53 per cent own their homes today, down from 71 per cent four decades ago.

¹² Coates, B. (2020), Homelessness is a growing problem, Presentation to the Inquiry into Homelessness in Victoria.



We need a national housing plan

The Albanese Government has pledged to establish a national housing and homelessness plan. If I could make a pre-emptive submission, I would highlight the following priorities:

We have a choice

In Australia’s past, both low- and high-income earners, young and old, owned homes. Homelessness was rare. But over the past 40 years, housing in Australia has transformed.

Today, home-ownership largely depends on income, and how wealthy your parents are. Housing is contributing to widening gaps in wealth between rich and poor, old and young.

Lower-income households are spending more of their income on housing and are under more rental stress.

But governments have continued both to promise improved affordability, and to prefer the easy policy options. It is no surprise that trust in government continues to fall.

If governments really want to make a difference, they need to explain the hard choices, to prepare the ground for the tough decisions that need to be made.

Either people accept greater density in their suburb, or their children will not be able to buy a home, and seniors will not be able to downsize in the suburb where they live. Economic growth will be constrained. And Australia will become a less equal society – both economically and socially.

This is a problem we can fix, but only if we make the right choices. •

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<https://grattan.edu.au/news/the-great-australian-nightmare/>

Watch the YouTube speech:



<https://www.youtube.com/watch?v=C-DDtSIZSyc>

