Better housing futures

Stimulating Private Sector in Affordable Housing

Report to Affordable Housing Forum by The Allen Consulting Group

Executive summary

Introduction

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

It impacts directly not only on 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.

A shortage of affordable rental housing (estimated at 150 000) has implications not only for the individuals and families, 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 Australian's access to affordable housing. These include the provision of public housing, rent assistance, the first home owner's 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 .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 .1

WHAT ARE THE ESSENTIAL FEATURES OF COST ESTIMATES?

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

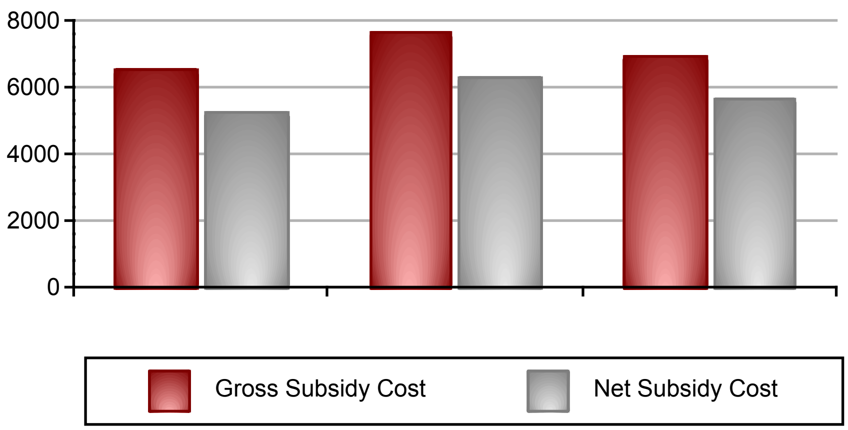
- All three models incorporate the full value of capital price risk, regardless of whether market risk is borne by government or the private sector.
- All three models involve the allocation of rental price risk to tenants, although this is something that tenants value positively as it translates into 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 (Bonds, Partnerships, Tax Credits) in terms of government subsidies required.

Figure .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.

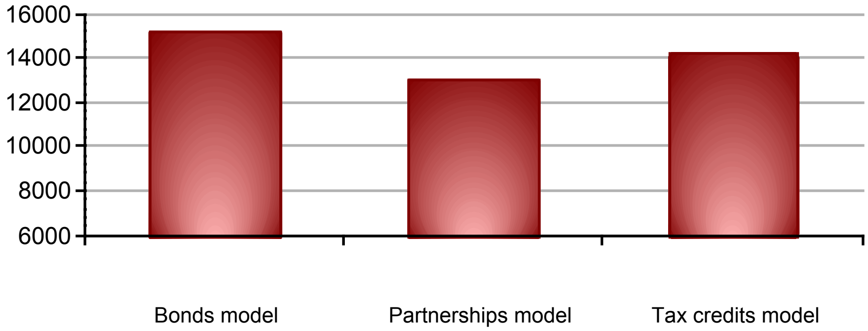
These costs compare favourably with the subsidy of over $9 000 per household per annum for the wealthiest owner-occupiers.

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 with (from left to right) the Bonds, Partnerships and Tax Credits models. Such programs would ultimately assist up to 150,000 households per annum and make a significant dent in the affordable housing shortage.

Figure .2

INCREMENTAL HOUSEHOLDS ASSISTED PER ANNUM



Source: The Allen Consulting Group

Using the Bonds model, 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, regulatory frameworks and to 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.

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