economics group

Housing: Paving the Road to Recovery?

April 2014

Key Points:

- **As the mining investment boom has waned, the new home building sector has been recovering from near-recessionary lows.**
- **New home building activity has historically displayed strong links with the broader non-mining economy, most notably household consumption expenditure and employment growth.**
- **Further updates to these non-mining elements of the economy will shed much light on whether new home building is actually leading a broader recovery, or, if its links to the broader economy have structurally changed.**
- **With new dwelling commencements forecast to grow over the coming two to three years, there is potential for household consumption to improve and play a greater role in an emerging non-mining economic recovery.**
- **A break in the historical relationship between new home building and employment growth has emerged in recent months. A non-mining economic recovery will be cemented by a labour market improvement – a key indication that this is progressing will be to observe whether employment growth resumes its relationship with new home building and catches up with the sector's recent growth.**
- **Housing also has a key role to play in longer term structural challenges that Australia faces, particularly regarding the ageing population and structural fiscal pressures faced by the federal budget. In addressing these structural challenges policy makers must consider reforms to both expenditure and taxation and the necessary role of housing in such reforms.**

The Australian Economy is currently at an important juncture. The mining investment boom is waning and in its wake the lingering fallout from the first and second iterations of the GFC has been exposed.

There has been a protracted period of business cost cutting (rather than investment) which has translated into a weaker labour market and compounded consumers' already heightened caution and thrift. Alongside these cyclical issues are some major structural dynamics at play, largely stemming from Australia's ageing population. As a result, without major reform, the federal government's already weak fiscal position will continue to deteriorate.

This paper looks into the role of housing as a leading indicator of broader economic activity, particularly as the economy re-balances away from mining and related growth

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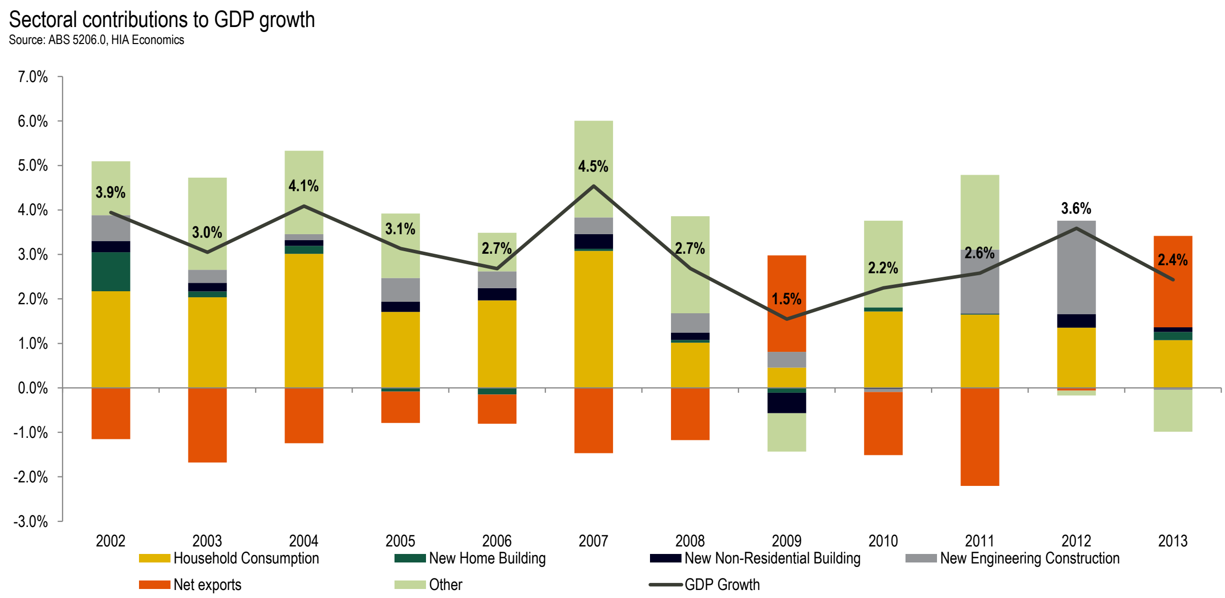
to the non-mining sectors. The current new home building recovery is pointing to potential for growth in household consumption expenditure, an important element to the non-mining recovery. The key, however, will be to observe the effect of residential construction on the labour market. Historically, new home building activity has acted as a strong lead of employment growth, but a break in recent months has emerged. Understandably the hope is that the labour market will eventually catch up with the developments in new home building.

This paper also considers the role that housing can play as Australia addresses the broader structural challenges facing its society and economy, including the long-term ageing of the population.

The current economic cycle and housing's emerging leading role – in consumption, the labour market and consumer confidence

The chart below demonstrates the issues of immediate consequence. That is, the winding down of the mining investment boom and the need for growth to be rebalanced away from this source to other non-mining sources. New engineering construction (which captures and reflects the most visible element of mining investment) accounted for around half of aggregate GDP growth in 2011 and was the majority share in 2012. In 2013 this share fell to zero. Nevertheless, it did not represent a drag on aggregate growth.



For new home buildings part, this sector bottomed out in 2012 beforeembarking on a path of recovery.In 2013 the new home building sector made its largest contribution to GDP growth in almost 10 years (0.2 percentage points). This path of recovery appears on track to continue and make stronger contributions to overall economic growth in the near term.

Beyond the direct contribution to GDP, new home building appears to be on track to resuming its role as a leading indicator of broader economic activity, particularly through its lead of other key macroeconomic indicators, most notably household consumption and employment growth.

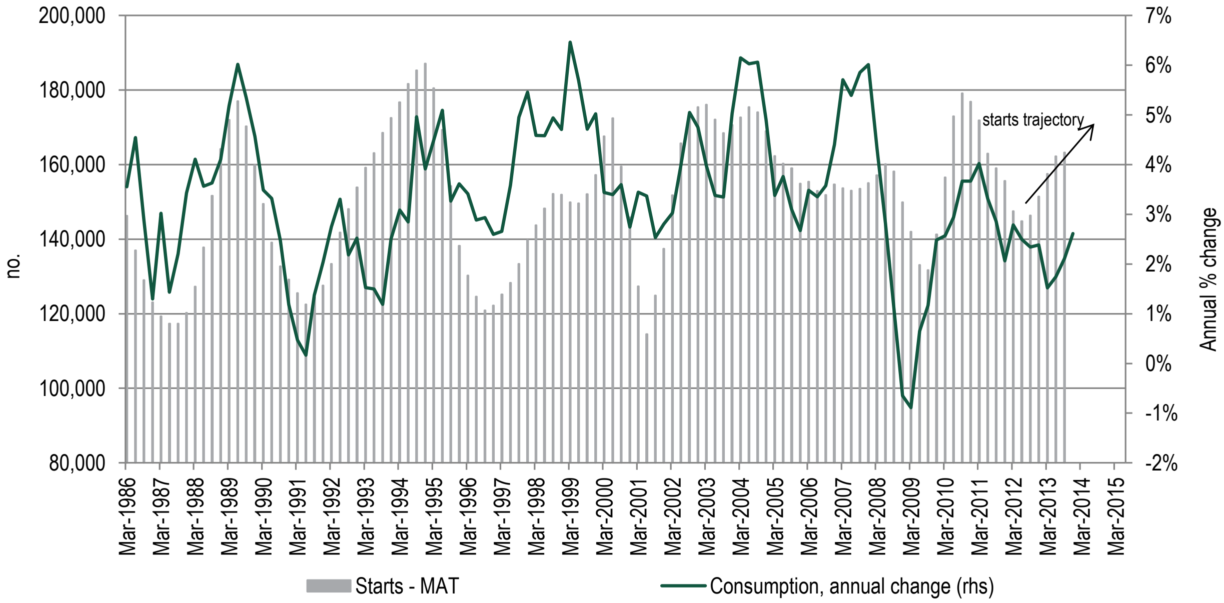
Housing and consumption expenditure

Household consumption expenditure since the onset of the GFC is a shadow of its former self. Furthermore, the smaller contribution of household consumption expenditure to GDP growth has occurred despite relatively fast population growth. While aggregate household consumption expenditure has grown by an average of 2.7 per cent per annum since 2010, the per capita average growth rate has been just 1.1 per cent. In 2013, per capita consumption growth was a barely positive 0.2 per cent. A recovery in new dwelling commencements (housing starts), however, is pointing to potential improvements to come.

The relationship between housing starts and household consumption expenditure is fairly intuitive; with each new home built emerges the requirement for various household goods – ranging from kitchen appliances through to bathroom fittings – that ultimately will be recorded under household consumption expenditure in national accounts.

Furthermore, stronger new home building activity typically occurs during times of dwelling price growth. When home owners see the value of their equity rise, this often leads to a greater propensity to spend on consumption items. Rising starts volumes would therefore also have positive implications for domestic retailers and manufacturers which supply household consumption goods. While a break in the relationship between household consumption and new home building was apparent from the mid-1990s through to the 2000s (ie. household consumption remained fairly buoyant without the impetus of a growing home building sector), the nexus appears to have reemerged in the current post-GFC era. With starts forecast to grow over the coming two to three years, household consumption, at the behest of new home building, appears on track to improve and play a greater role in an emerging non-mining economic recovery.

Starts and household consumption
Source: ABS national accounts, HIA Economics



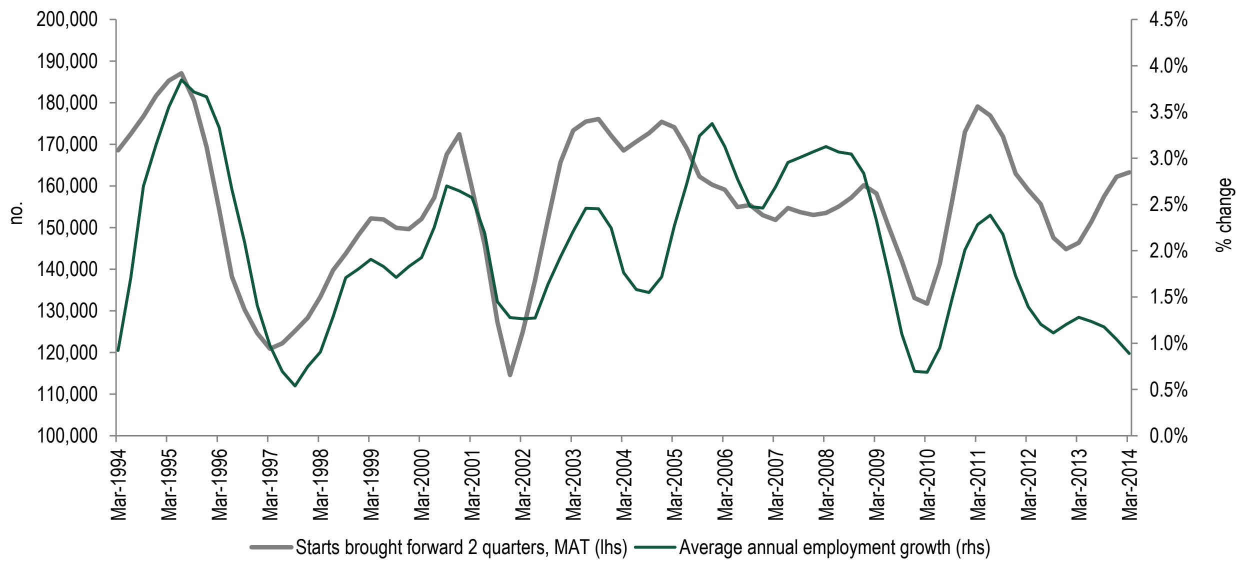
Housing and the labour market and consumer confidence

Residential construction is a significant employer in the economy and this forms its direct link to the labour market. HIA estimates that in mid-2011 the sector's labour force amounted to just under 370,000 people across Australia, which translates into around 3 per cent of the total workforce at that time. Beyond this direct link, residential construction also has strong links with other key sectoral employers in the economy including real estate services, finance, manufacturing and retail trade.

The chart below shows a reasonably strong relationship between employment growth and starts, albeit with the exception of the 2000s. The broad observation is that as housing starts have increased (or declined), the rate of employment growth has increased (or decreased) about six months later. Coming updates will shed much light on whether this relationship will resume as we move through 2014, or, if there has been another structural break similar to what occurred during the 2000s. The latter outcome would indicate that new home building is not set to lead the broader economy to strong growth outcomes in 2014/15.

The chart also depicts the first round recovery in housing starts that took place in 2012/13. As yet, there is little sign of employment having followed suit, although recent labour market updates, including job ads and broader labour force statistics, could be showing nascent signs of such a recovery. Notwithstanding these recent encouraging updates, the labour market overall can still be characterised as the Achilles heel to the economy's non-mining recovery.

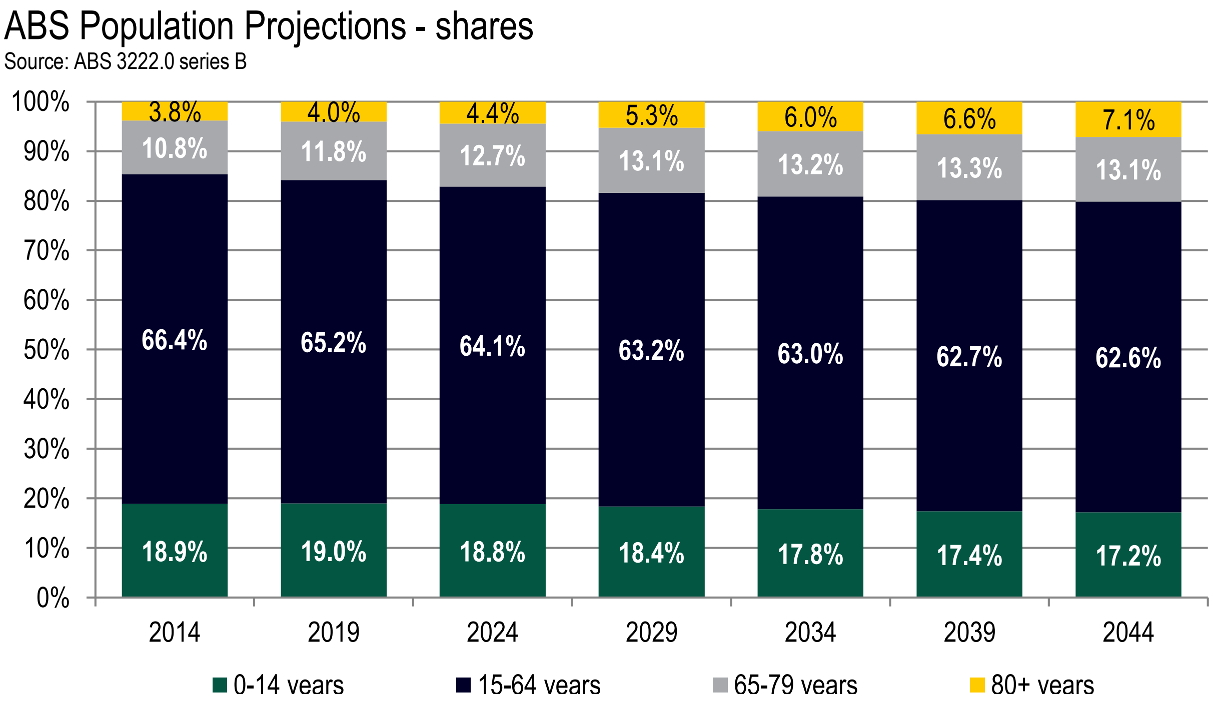
Starts and employment growth
Source: ABS Labour Force, Building Activity, HIA Economics



A material improvement to the labour market would have considerable benefits for consumer confidence. Already, some of the seeds to improved confidence have been sewn. As mentioned earlier, dwelling prices play an important role in consumer confidence, particularly among home owners who may have started feeling wealthier as the value of their dwellings has risen over the past 12 months. However, throughout late 2013 and early 2014, consumer confidence surveys have still identified consumers' concerns about the labour market as a key element of weakness in confidence. Improvements in the labour market will therefore form another crucial element to further boosting consumer confidence, which will in turn have positive implications for household expenditure. Householders who are confident about their employment prospects (as well as their wealth situation) will be more likely to translate this confidence into greater spending. As described earlier, a key part of a broader recovery in the non-mining sectors of the economy will be driven by household consumption expenditure.

Structural challenges ahead – an ageing population

Australia's ageing population poses major challenges to the longer term health of the economy. Currently there are 455,000 Australians aged 85 and over. Using the ABS's mid-range population projection, this group is projected to grow to over 1 million within 25 years. As the population ages, the proportion of working age people supporting (in an aggregate sense) those who are retired will decline. Without major reforms, this trend will compound the pressure on Australia's capacity to fund the increasing expenditure associated with an ageing population.



Necessary taxation reform and the role of housing

In late 2013, the Parliamentary Budget Office (PBO) found that Australia's structural budget balance (the underlying position of the budget after adjusting the actual budget balance for impacts of major cyclical and temporary factors) had deteriorated from a surplus range of 1.75 to 3.25 per cent of GDP in 2002/03 to a deficit range of 1.50 to 2.75 per cent of GDP in 2012/13. Furthermore, without taxation and expenditure reforms, the PBO estimated the structural budget balance to remain in deficit into 2016/17, at which point it is expected to be in the 0.25 to 1.50 per cent range. The key drivers of the projected structural budget deficit includes growing costs of the new major programs, including DisabilityCare Australia and the National Plan for School Improvement.

An ageing and retiring population beyond the 2016/17 timeframe of the PBO's analysis would see these key taxation and expenditure developments intensify. Consequently, Australia's two most senior economic officials, the Treasury Secretary and the Governor of the Reserve Bank of Australia, are drawing attention to the necessity for an open and broad debate on Australia's tax system.

Reforms to Australia's taxation must consider the housing sector. New housing is the most heavily and inefficiently taxed sector in the Australian economy. The broader housing sector in Australia contributes nearly $40 billion in taxation revenue to federal, state and local governments in Australia each year – 11 per cent of the total taxation revenue collected by all tiers of government.

Taxes on new housing are not only excessive, but are disproportionate relative to the rate of taxation on other sectors of the economy – the average tax burden on the residential building sector is estimated at around 31 per cent of the value of output, which compares to an economy-wide average of 24.4 per cent. These taxes are also highly inefficient. A prominent example is stamp duty which, as acknowledged by the Henry Tax Review, discourages people from changing their place of residence as their personal circumstances change.

As the population not only ages but also grows, it will become increasingly important that people are free from impediments such as stamp duty, to move to residences they judge most appropriate. The removal of stamp duty is particularly important in the context of an ageing population. As household sizes tend to be smaller amongst the older segment of the population, their use of the housing stock is disproportionately intense. In the context of a rather constrained dwelling stock, removing stamp duty would make it easier

for older households to move to smaller dwellings. This would free up larger residences for bigger households, ensuring that the housing stock is used more effectively.
While stamp duty and many of the other taxes are levied on a state/territory and local government level, the Federal Government's fiscal situation would be a beneficiary of taxation reform which brings about greater tax efficiency at all levels of government. Independent research has shown that reducing tax on the residential construction sector (provided this is funded by a broad-based, more administratively efficient tax), as well as removing planning delays and uncertainties, could increase GDP permanently by 1.91 per cent.

An ageing population and Commonwealth housing expenditure

Within the long-term ageing of Australia's population is a growing cohort with inadequate retirement provision. This situation is set to increase the demands on publicly-funded housing assistance programmes in the absence of reform. Already, Commonwealth allocations for social/public housing programs to support low income and welfare housing exceed $4.5 billion every year. Expenditure on housing assistance through Commonwealth Rent Assistance payments alone are projected to exceed $3.9 billion in 2013/14, which represents an 8.1 per cent increase on the expenditure of 2012/13. These ballooning costs are symptomatic of a housing market facing a number of barriers constraining the responsiveness of housing supply to a steady increase in underlying demographic demand. The resultant shortage in housing stock places upward pressure on dwelling prices and consequently on the rental market.

Increasing Australia's home ownership rate to levels in line with historical norms would lead to reduced demand for Commonwealth housing assistance, over both the short and long term. Doing so will require government at all levels to address the constraints on housing supply.

While many of the obstacles to the provision of an adequate supply of new housing fall within the responsibilities of state/territory and local governments, the Commonwealth still has a key role to play in addressing these obstacles. The Commonwealth can tie funding for public/social housing programs to related performance targets, particularly targets with both strategic and practical housing delivery benchmarks, state and territory governments would have access to new housing supply performance incentives.

Housing and adapting to an ageing population

Beyond the aforementioned high-level reforms, housing will play a more obvious and direct role in assisting the ageing population. Policy makers recognise the clear benefits afforded to older Australians who age in their own homes – maintaining a quality of life that includes independence and remaining active in and connected to their existing communities. Accordingly, the federal government funds home-based care packages to assist ageing in home and these packages include home safety and modification – an element where the residential construction sector can play a direct role in the broader process of adapting housing for an ageing population. Residential builders are also increasing their awareness of opportunities to design new homes to take account of universal housing design options.

Conclusion

With the Australian economy still in slowdown mode, the housing sector has the potential to be a key driver of economic growth, particularly given the strong historic linkages between new home building and household spending, employment and consumer confidence.

Notwithstanding this potential, the relatively high taxation burden on housing prevents the sector from making a much fuller contribution to economic activity.

Looking beyond the immediate horizon, there are key challenges to the economy, largely stemming from the long term ageing of the population. In particular, this phenomenon is contributing to the emergence of a structural budget deficit at the federal level. In addressing this structural challenge policy makers must consider reforms to both expenditure and taxation and the necessary role of housing in such reforms. On the taxation side of the ledger, any reforms must consider the relatively high taxation burden on housing and the inefficiencies of such taxes.

On the expenditure side of the ledger, the aforementioned role that the Commonwealth can play in incentivising states and territories to address constraints on housing supply would aid affordability and promote home ownership. This would contribute significantly to reducing the housing-related expenditure burden on the federal budget over the long term.