The housing rental market in Australia

Submission to Senate Community Affairs References Committee

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Summary: Housing rental stress is a more widespread problem than the more widely discussed household mortgage stress. This is the case across Australia. The problem has been worsening. Rising interest rates may exacerbate it, not because landlords 'pass on' higher interest costs but because over time higher interest rates discourage construction and mean the incomes of the poor are lower than would otherwise be the case.

Introduction

It is timely that the Senate is inquiring into rental stress.

The aspects of housing affordability attracting most media attention are the challenges facing young aspiring home buyers, and, even more so, the stress rising interest rates put on the household budgets of recent purchasers.

But while home-owners attract headlines, the problem of housing affordability is most acute for the over 100,000 homeless Australians and those on low incomes renting in the private market (see Table 1 below). Rental stress is more widespread than is mortgage stress, and this is the case all across Australia not just in some cities.

The relative neglect of the private rental market is understandable politically. The mortgage belts in the outer suburbs of major cities contain many of the traditional 'swing seats'. But policy discussions should not be driven by just political considerations.

In 2023, there is increasing commentary that renters are facing further increases in rent. But this is not undisputed and, even among those who agree, there is disagreement on the magnitudes and the causes. This submission argues that the current tightening in monetary policy will not increase rents due to landlords 'passing on' higher interest rates. But it may have a medium-term impact if it leads to a lower rate of construction.

Some background

The long cited rule of thumb is that about a third of Australian households own their home outright, a third have a mortgage and a third rent. While broadly correct, this obscures some longer-term changes.

Figure 1 tracks the proportion of households renting since the first Australian census in 1911. The proportion renting reduced in the decades following World War II, as the working class moved from the poor quality rental housing in the inner city into newer housing in the suburbs.[2] By 1989 it had

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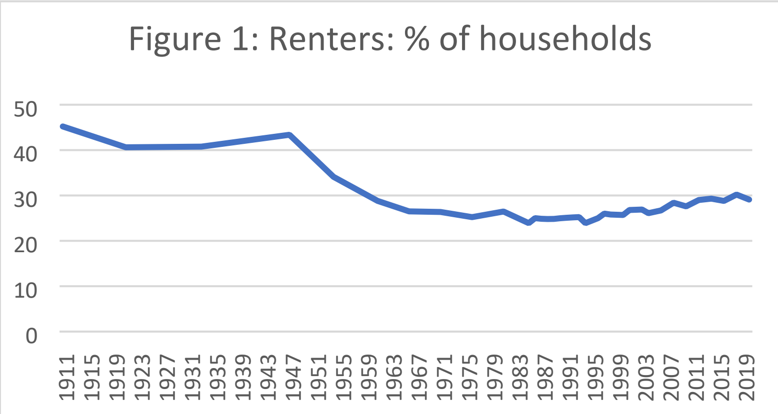
[1] The authors are a senior lecturer, student and associate professor respectively in the Canberra School of Politics, Economics & Society at the University of Canberra but this submission is made in a personal capacity.
[2] Morris, Hulse and Pawson (2021, p 2) noted that the inner city rental housing was often of poor quality, was poorly maintained and lacked even basic amenities such as hot water and sanitation.

been estimated that around 90 per cent of the baby boomers eventually became homeowners, even if they rented when first leaving the parental home.[3]

But the proportion renting has risen again since the 1980s. There are now 2½ million households renting, about 30 per cent of the total.



Home ownership has long been called 'the Great Australian dream'. This may make rental the Australian nightmare. Rental was often seen as a temporary resort – a 'rite of passage'[4] - for young Australians while they saved a deposit to buy a property. The private rental market has been called 'predominantly a transitional housing tenure'.[5]

It is sometimes suggested that home ownership is less desired by young 'digital nomads'. But surveys reveal most young Australians still aspire to own a home rather than rent. A study by Simon and Stone (2017, pp 6, 12) concluded that '*generation rent* represents a reflection of higher housing prices rather than a shift in preferences'. But despite the ongoing preference for ownership, there are increasing numbers of long-term renters and many younger people doubt whether they will ever own a home.

Renting is not necessarily always a bad thing. A housing market characterised by more rentals could be associated with a more flexible labour market, particularly if there are large transactions costs (such as stamp duties[6]). What are often seen as the virtues of home ownership – such as a sense of community engagement – may be more a result of security of tenure. The European model of longer leases may also provide this.

The Australian emphasis on home *ownership* is not the only model which can work well. A number of very affluent European countries have a higher proportion of households renting than do Australia. In Germany about half the population rent. Build-to-rent had been encouraged as part of the post-war reconstruction programme. There are a number of controls to protect tenants. German landlords are allowed to raise the contractual rent up to what is called the local reference rent, which is the average rent within a given area. But generally landlords may not raise rents by more than 20 per cent in three years, although they may be allowed to increase their rents by up to 10 per cent after the property is modernised. It is also difficult for landlords to evict a tenant unless there is a serious breach of the contract.

Renting is even more prevalent in Switzerland. Housing is expensive to buy. Taxes in Switzerland are also tenure neutral as homeowners are subjected to an imputed rent, capital gains, property, wealth,

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[3] Cited by Mares (2018, p 9).
[4] Bridge et al (2003, p 121).
[5] Morris, Hulse and Pawson (2021, p vii)
[6] Vidyattama and Hawkins (2021).

and transfer taxes. There are also legal protections for renters, who can appeal against evictions or rent increases to rent administration boards.[7] If their appeal is upheld, there can be no eviction or rent rise for three years.

The rental market in Australia is primarily a *private* rental market. Public housing has been increasingly tightly targeted and now accommodates less than 3 per cent of housing and other forms of 'social housing' only another 1 per cent. A fifth of renters had government pensions and allowances as their major income source.[8] Among immigrants, 70 per cent start out in the rental market.[9] Since the early 1990s many of these have been international students.

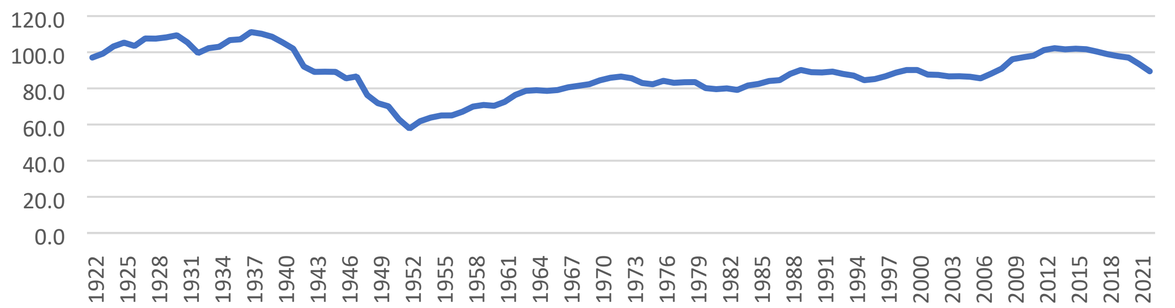
The Australian rental market is dominated by around 2 million individual 'mum and dad' investors who usually own only one or two properties.[10] By contrast, in some European countries corporate ownership is more common. Strata titling in Australia encourages individual rather than corporate investment in rental properties.[11] Generous tax concessions to individual investors also play a role.

The private rental market is around two-thirds houses and one-third apartments.[12] Around ¾ of landlords had loans; they accounted for around a quarter of housing loans and over nine-tenths of them bought existing properties.[13]

Superannuation funds might seem a logical investor in rental housing, and able to offer long leases, given their large balance sheets and long horizons. But they appear to have very little involvement, leading Yates (2016, p 332) to suggest a bond-issuing or unit trust 'Affordable Housing Finance Corporation' may be necessary to mobilise funds from superannuation for affordable housing.

A longer term analysis (Figure 2) shows the relative price of rents falling during the second world war and then rising during the post-war boom. Since the current rent series was included in the CPI in 1972, it has not grown on average very differently to the total CPI basket. As a result, the 'real' or 'relative' price of rent is little different now to what it was half a century ago.[14]

Figure 2: Relative price of rents



[7] Werczberger (1997).
[8] 2011 data from Hulse et al (2012, p 26).
[9] Hulse et al (2012, p 14).
[10] Morris, Hulse and Pawson (2021, p 46). Only 4% of investors have four or more investment properties.
[11] Hulse et al (2012, pp 23, 29).
[12] Pawson, Milligan and Yates (2020, p).
[13] 2011 data reported in Hulse et al (2012, p 16).
[14] Hulse et al (2012, p 36) also commented on this.

The CPI rent series is calculated on a 'constant quality' basis. So it does not reflect the rise in rents due to Australian houses having grown steadily larger – they may now be the largest in the world - even while the average number of people in houses has steadily declined.[15]

In assessing the amount of affordable rental housing, Hulse et al (2019, p 34) pointed out that often low income earners are unsuccessfully competing with higher income earners for the limited stock of relatively cheap rental property.

Even if the overall rental market is large it may not be suitable for the poor. There are incentives for investors to concentrate on the upper end of the rental market and not maintain the properties at the more affordable end. Yates and Wulff (2005) reported that this had led to a shortage of affordable rental housing, both in Australia and in other comparable countries.

Over time the rental market has become more concentrated on the middle; Hulse at al (2019, p 3). Writing for Anglicare Australia, Bourke and Foo (2022) examined over 45,000 properties listed on realestate.com.au. Just eight were affordable for a single person on JobSeeker and just one for a single person on Youth Allowance. Even a full-time worker on the minimum wage could afford less than 2 per cent of the listings.

How does the incidence of rental stress differ across the country?

There is no single way of measuring and defining the problem of rental affordability; Nepal, Tanton and Harding (2010). The most common approach in Australia uses a financial indicator known as 'housing stress' which incorporates both rental stress (when applied to private renters) and mortgage stress (when applied to mortgagees). In Australia, the measure is usually defined as being when a household in the bottom 40 per cent of the income distribution spends more than 30 per cent of its disposable (after-tax) income on housing costs.[16] Yates and Milligan (2007, p 9) described it as a 'robust rule of thumb'.

In Australia the proportions renting and with mortgages were lower in the regional areas where a higher proportion own their home outright. A higher proportion of renting households were in the bottom 40 per cent of the income distribution (45 per cent, compared to 25 per cent of mortgagees). This is consistent with private renting being the resort of those who cannot raise the deposit to buy a home, or for other reasons cannot get a loan. This is especially the case outside capital cities where just over half the private renters are in the bottom 40 per cent of the income distribution. Therefore, private renting is supposed to be a way to avoid mortgage stress. Despite this, there are still higher proportion of people that pay more than 30 per cent of their disposable income among renters than among those with a mortgage.

This stress is especially high in Sydney and Hobart. This is followed closely by the rest of Queensland and New South Wales. Given the relatively higher incomes in Sydney, the higher rate of renter stress is in Hobart (29 per cent), Rest of New South Wales (29 per cent) and Rest of Queensland (27 per cent). Sydney follows at 25 per cent. The renter stress in South Australia and Western Australia are also higher outside the capital city while Melbourne has higher rental stress then the rest of Victoria.

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[15] Famiano (2022, pp 7-8, 52-54).

[16] In Australia the 30 per cent rule is used by many home loan lenders in Australia as a guide to how much a household can borrow—and is used by real estate agents as a guide to whether a lessee can afford to rent a property; Nepal, Tanton and Harding (2010). Examples in the literature include Hulchanski (1995), Morris, Hulse and Pawson (2021, p 108) and Bourke and Foo (2022). It is also used by the Australian Bureau of Statistics. Hulchanski notes the housing cost-to-income threshold employed has risen over time. It was 20 per cent in the 1950s and 25 per cent in the 1980s and the OECD now sometimes uses 40 per cent.

Table 1: Share (%) of households in housing stress

	Private renters	Mortgage payers		Private renters	Mortgage payers
Greater Sydney	25	12	Rest of NSW	29	7
Greater Melbourne	20	11	Rest of Victoria	17	8
Greater Brisbane	23	10	Rest of Queensland	27	7
Greater Adelaide	21	13	Rest of South Australia	24	8
Greater Perth	21	14	Rest of Western Australia	22	8
Greater Hobart	29	11	Rest of Tasmania	16	7
Australian Capital Territory	17	7	Northern Territory	18	13
Australia	23	10			

Table 1 and the maps (Figure 3) compare the percentage share of renting and mortgagee households in 'housing stress', defined as being in the bottom two income quintiles and spending over 30 per cent of income on housing, in different regions. Renters are more likely to be stressed than mortgage payers. This is not just true on a national average but in all states and in both metropolitan and regional areas.

The pattern within and outside capital cities themselves are varied. The housing price and rental cost are likely to be lower farther from the CBD. Therefore, families may have to move to the outskirts to afford housing. This can also be the case for workers moving to areas outside the capital cities that are still within commuting range of their workplace; Vidyattama, Tanton and Nepal (2013).

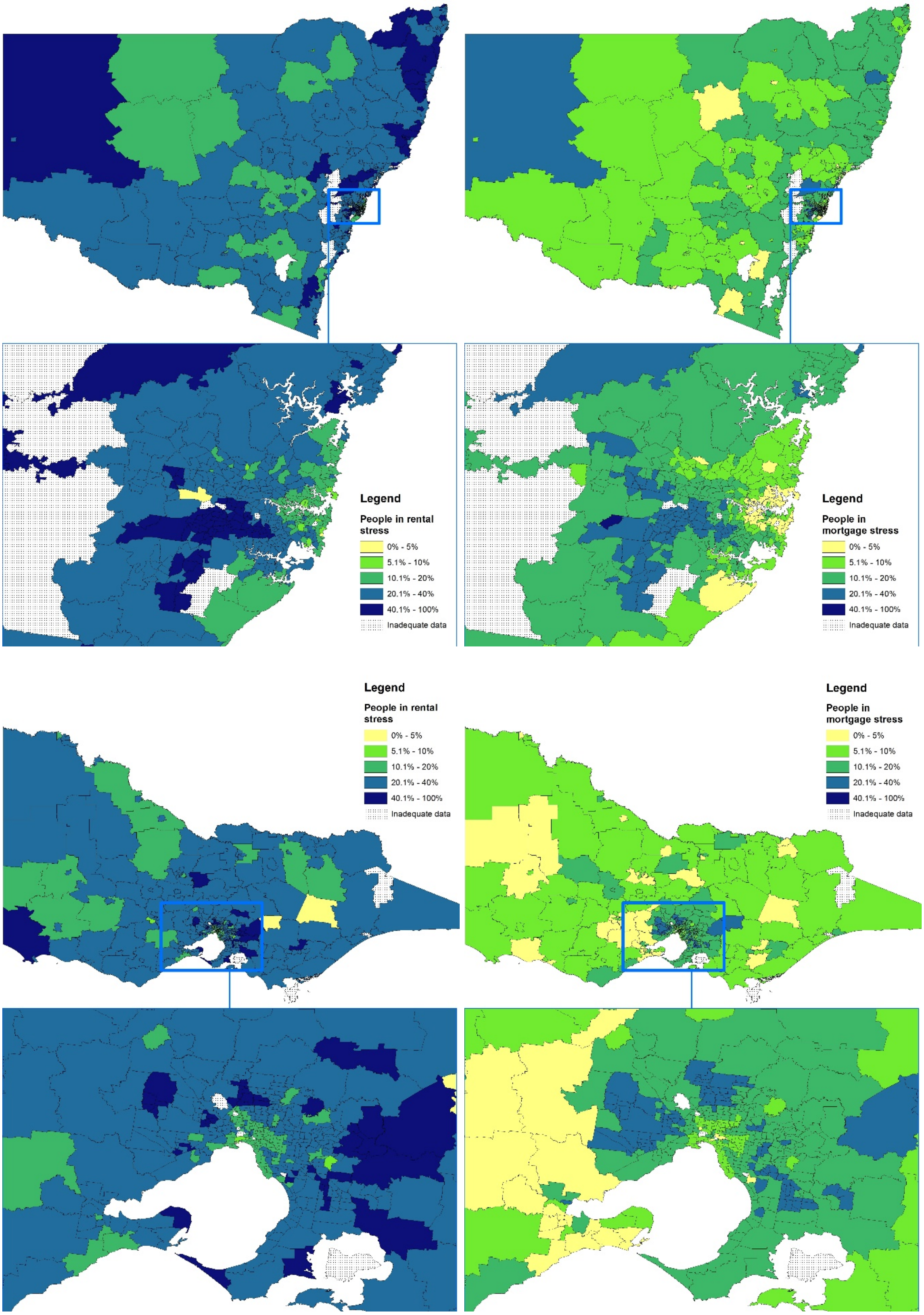
The small area estimation technique known as spatial microsimulation can be used to estimate the distribution of housing stress in two biggest cities in Australia – Sydney and Melbourne. Table 1 shows the two cities have contrasting characteristics. While Sydney is the capital city with the second higher rate of rental stress, Melbourne is the capital city with the second lowest rental stress.

Although housing prices and rents in the inner parts of the international cities of Sydney and Melbourne are the highest in the country, so are the incomes of those owning property there. Mortgage stress in those areas is accordingly mostly below 10 per cent. The incidence of rental stress in both inner cities is above 10 per cent. There are pockets where it is higher; being above 20 per cent around Haymarket. Nevertheless, this kind of area has been identified not far from the inner city with Marrickville in the inner South and Croydon / Ashfield in inner West already have higher than 20 per cent rental stress.

The pattern of prices and affordability in the inner city has changed over time as some suburbs are redeveloped or gentrified. Ellis (2015) has described how over a few decades suburbs like Paddington, Newtown and Balmain in Sydney, or Fitzroy and Northcote in Melbourne, went from 'scary to edgy to trendy to pricey'.

The areas a bit further out from inner cities show more rental stress. The western and south-western suburbs of Sydney are well known for their level of high disadvantage and the map shows areas such as Parramatta, Auburn or Canterbury within 20km from inner city already have higher than 40 per cent rental stress.

Figure 3



Source: Author spatial microsimulation estimation using ABS *Survey of Income and Housing 2019-2020* and Census 2021

The Melbourne inner city has relatively low rental stress (around 10 per cent). The area where the rental stress start to exceed 10 per cent can be found in Maribyrnong in the West and Monash in the Southeast. Areas with much higher housing stress, above 40 per cent, include Brimbank in the western suburbs, but a bit further out in the eastern suburbs (Dandenong) and Nilumbik in Yarra ranges.

In the regional areas of NSW, much rental stress is mainly identified in the coastal area of northern NSW although there are several area in the southern coast as well (Ulladulla and Port Kembla). In these areas, housing prices and rents are higher due to holidaymakers and the affluent residents of Sydney and Canberra buying second 'holiday' homes.

By contrast in the far west the problem is not so much high rents as low incomes. In Victoria, the high rental stress is identified in parts of Heathcote, Southern Grampians and LaTrobe Valley.

Table 1 and the maps do not reflect the 3.5 percentage point rise in interest rates so far in the post COVID tightening cycle, nor the rent increases during 2022. Another part of the stress faced by renters in the private market is the anxiety of worrying about the prospect of having to move at short notice and that it may be hard to find another dwelling that is not even less affordable.[17] Furthermore, unlike the mortgagors, the renters are not building up a stake in an appreciating asset which will help them prosper in retirement. This is likely to be a third kind of stress.

Recent developments

The rental market was strongly affected by the COVID pandemic and associated policy responses. Border closures meant population growth almost halted. It was noted that on the demand side 'job losses have been much more pronounced for younger workers, who are more likely to rent homes' while 'on the supply side, with the number of international tourist and domestic travellers falling, a large number of short-term accommodation providers have shifted their properties onto the long-term rental market'.[18]

The result was an increase in vacancies and downward pressure on rents. Rents fell in the June quarter of 2020 (for only the first time since the data were first collected in 1972). But it proved short-lived; Ellis (2022, Graph 12).

The Covid pandemic may have accelerated the trend towards smaller numbers of occupants in homes. As Luci Ellis (2022), then with the Reserve Bank, put it;

> It is no surprise that the pandemic has changed how we think about our homes. There is nothing quite like being confined to your home for months on end to make you appreciate having a home that meets your needs, or rankle at one that does not. Spurred by the experience of lockdown and self-isolation, many people understandably wanted a bit more space, and perhaps a garden. Some also needed space where they could work, or perhaps just fewer flatmates to share that space with…. at least some Australians have voted with their removalists' van, by moving out of their share house and in with their partner.

This increased preference for more space has offset the decline in population growth resulting from the border closures. One estimate is that the decline in average household size since early 2020 led to around 120,000 additional households being formed, a significant increase in the demand for

[17] Mares (2018, p 10).
[18] Evans, Rosewall and Wong (2020, pp 75-76).

housing.[19] An alternative analysis is that the decline in household size is mainly driven by smaller numbers of children in households, which would not have the same implication.

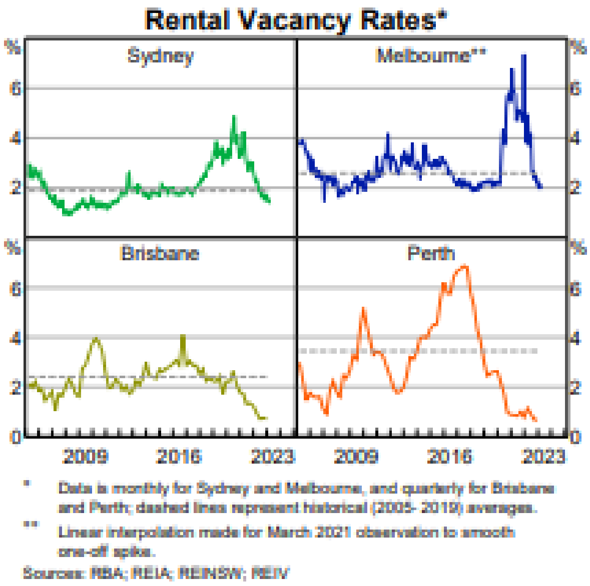
Further pressure may be put on the rental market by increased immigration following the reopening of the national border. One estimate is that over the coming year there could be almost ¼ million net immigrants, who could want almost 100,000 properties.[20]

The 'rent' component of the Consumer Price Index rose by 5 per cent over the year to March 2023. But this is a measure of *average* rent. Other sources suggest that *new* rents rose more steeply. Data from CoreLogic shows that newly advertised rents grew by around 10 per cent during 2022.[21] The growth is similar around the states, and similar in metropolitan and regional areas.

As the average tenant only moves every one to two years[22], and rental agreements are commonly for at least a year, an increase in new rents will take time to be reflected fully in the CPI series.

The rental vacancy rate has now dropped to a low 1 per cent and is particularly low in Brisbane and Perth. This is despite a period when the dwelling stock has grown faster than population. The managing director of AHURI suggested 'a healthy rental system has around a 3 per cent vacancy rate to allow for churn', calling the current situation 'a choked system'. This rule of thumb is commonly used[23] and 3 per cent is also around the long-term average vacancy rate.

Figure 4



Source: Reserve Bank of Australia (2023, p 29).

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[19] Agarwal, Gao and Garner (2023, p 4).
[20] Agarwal, Gao and Garner (2023, p 4).
[21] Agarwal, Gao and Garner (2023, p 4).
[22] Mares (2018, p 158).
[23] Dr Michael Fotheringham, appearing before the Senate Select Committee on the Cost of Living, 2 February 2023. Mares (2018, p 149) also cited 3 per cent as the 'equilibrium vacancy rate'. Hulse et al (2012, p 38) referred to 3 per cent as being 'often said' to be the equilibrium. Saunders and Tulip (2019, p 16) concluded that 'a vacancy rate of 3 per cent would keep rents growing at the same rate as other consumer prices'. Property analyst Leanne Jopson (2022) concluded that asking rents fall once the vacancy rate exceeds 3 pr cent and rise if it falls below 2 per cent.

There are other signs of increased rental stress. Reserve Bank economists recently reported that:

> National Debt Helpline website traffic where rent is cited as a concern has increased since mid-2021, with rent consistently being one of the two most reported concerns. Further, community service providers participating in the Bank's liaison program report that demand for financial assistance and counselling has also increased, primarily for renters. [24]

What drives rents over time?

There is currently debate about whether landlords 'pass on' interest rate increases by raising rents. The following exchange ensued when the Reserve Bank governor appeared before the House Economics Committee:

> Mr Jerome Laxale MHR: Out there in the suburbs, it's pretty clear that rents are going up because of interest rate rises, but here in this building, we hear the opposite. So which is it?
> Dr Philip Lowe: Many landlords are putting the rent up and saying to their tenants, 'Interest rates are up, so I've got to put my rent up.' They say that, and that's true, but they can only do that if the market allows them to. You can only put your rent up if there's a shortage of rental accommodation and the tenant can't go elsewhere. All our work suggests that it's the vacancy rate that explains most of the movements in rents. That's what the underlying economics is. The explanation that the landlord gives the tenant for putting their rent up isn't, 'Because the vacancy rate is low, I can extract more rent out of you.' But you can't put your rent up if there are a lot of vacancies because the tenant will ultimately go somewhere else. Both perspectives are right. The critical issue here is the lack of rental accommodation. That's what's driving higher rents, not higher interest rates.[25]

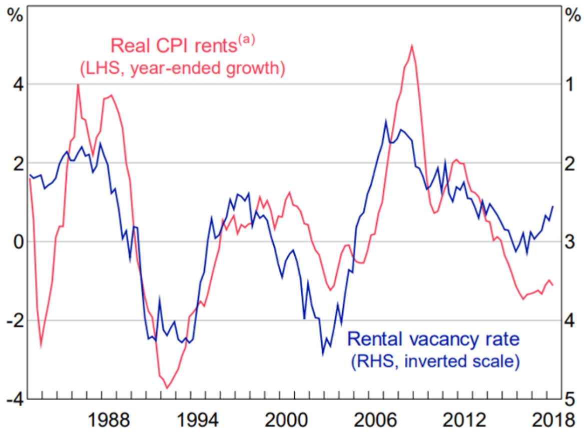
The managing director of AHURI also attributed rapidly increasing rents to the low vacancy rate and there is a lot of support for this view.[26] It is also clear from Figure 5.

There has been a long debate about the extent to which landlords can pass on costs to tenants. A common example is the assertion that restraints on negative gearing would increase rents. This has been termed an 'urban myth'.[27] But it was a powerful enough political narrative that in 1987 the Hawke Government reversed its 1986 decision to abolish negative gearing. This was an expensive decision. Negative gearing is responsible for around $20 billion in lost government revenue each year.

Figure 5

[24] Agarwal, Gao and Garner (2023, p 7).
[25] *House of Representatives Economics Committee Hansard*, 17 February 2023, p 14.
[26] Dr Michael Fotheringham, appearing before the Senate Select Committee on the Cost of Living, 2 February 2023. Saunders and Tulip's (2019, p 17) concluded 'the dominant influence on real rents is the vacancy rate'. Property analyst Leanne Jopson (2022) concluded 'landlords can't just put up the rent just because their holding costs including interest rates go up. If tenants are delivered a steep rent increase, they will simply move if they can find cheaper accommodation elsewhere'.
[27] Pawson, Milligan and Yates (2020, p 192).

Figure 10: Real CPI Rent Growth and the Rental Vacancy Rate



Note: (a) Deflated by annualised growth of trimmed mean CPI over the previous three years
Sources: ABS; Authors' calculations; RBA; REIA

Source: Saunders and Tulip (2019, p 18).

The true impact of interest rates on rents may be more indirect. Higher interest rates tend to lead to home prices being lower than they otherwise would be. This encourages renters to aspire to buy. But the ability to do so depends on whether the drop in house prices offsets the impact of the higher interest rates on home loan repayments (relative to incomes, which themselves may be lower than otherwise when the higher interest rates slow the economy).

Saunders and Tulip's (2019, p 7) modelling concluded 'interest rates have a large and highly significant direct effect on construction activity'. They argued this is consistent with other Australian and overseas studies.[28] Paul Krugman (2014) once quipped that 'one of the dirty little secrets of monetary policy is that it normally works through housing'. Much of the impact comes from the effect on housing prices.

In the Reserve Bank's own MARTIN model housing rents are modelled as depending on the balance between supply (the stock of housing) and demand (assumed proportional to the wages component of household income); Ballantyne et al (2019). There is no direct influence from interest rates.

Interest rates also affect the incomes of renters in different ways to owners. With their lower wealth, there is little additional income from interest on their bank deposits. But higher interest rates dampen economic activity and employment. It has been observed that lower income earners are more affected by economic fluctuations than are middle income earners[29], suggesting renters would be more affected than owners. This is another way that higher interest rates increase rental stress (and with this channel interest rate increases have more impact on rental stress than on mortgage stress).

A majority of rental investors reported operating at a loss, according to ATO data. Investors accept these losses as they expect them to be offset by capital gains (taxed at concessional rates) over time and in the interim the losses can be offset against other income. In this way, landlords are subsidised by negative gearing and capital gains tax discounts.[30]

[28] It seems inconsistent with Hulse et al's claim (2019, p 22) that Australian research has shown the price elasticity of dwelling supply to be quite low.
[29] Stone (2016).
[30] Pawson, Milligan and Yates (2020, p 191).

Capital gains tax at the marginal income tax rate was introduced by the Hawke Government in 1985. There were two important changes by the Howard Government in 1999. The tax was applied to nominal rather than real gains but only half the gain was taxable. The capital gain tax concession reduced government revenue by over $20 billion in 2022-23, with ¾ of the benefit accruing to the top 10 per cent of tax filers.[31]

The outlook

The current monetary tightening will lead to an increase in unemployment.[32] The latest Reserve Bank (2023) forecasts envisage the unemployment rate rising from its recent trough of 3½ per cent to 4½ per cent by end-2024. This will lead to some newly unemployed people moving in with relatives or friends, dampening the demand for rental properties. This will lead to an increase in vacancies. At some point, demand will recover but by then the higher interest rates will also have slowed the construction of new housing (in part through house prices being lower than they otherwise would be).

The Reserve Bank (2023, p 33) reported that its business liaison suggested that shortages of labour were delaying some construction projects and residential construction activity is expected to decline due to lower sales and poor consumer sentiment.

Peter Tulip, a former RBA housing specialist now with the Centre for Independent Studies, argued that this process will take two to four years but 'in the long run, high interest rates lead to an increase in rents'.[33]

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[31] Australian Treasury, *Tax Expenditures and Insights Statement*, February 2023, p 13.
[32] Bullock (2023).
[33] Cited by Patrick (2023).

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