

# AHURI WORKSHOP. Housing Affordability. November 13 2003

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## **Measuring Housing Affordability.**

### **1 Introduction**

This brief paper looks at the problems of measuring and conceptualizing housing affordability and the uses to which such measures are put. I do not want to repeat the ground paved by King (1994), Bray (1995) and Landt and Bray (1995) in their papers which focused largely on the technical problems in the major measure of affordability used in Australia, the 25 or 30% housing cost to income benchmark. This paper takes a different perspective and includes, first, a new method of measuring affordability not discussed in either of these papers, the budget standard method, and second, raises concerns that we have become trapped by the current affordability measures and we need to move on to new ways of thinking about affordability if we are to put affordable houses on the ground rather than debate how big the problem is and what are its causes.

To get a handle on the issue of measuring affordability we need to ask what are the measure used for. There are four major reasons but with the latter two not really being given much attention in Australia.

- Assessment of underlying need;
- Measure of Performance of the housing system, e.g., public housing provision, Commonwealth Rent Assistance, private market outcomes
- Assessment of the financial well-being of recipients of housing assistance
- To guide the actual provision of affordable housing

The first two are the commonly used reasons in Australia. The *assessment of underlying need* is concerned with measuring how many households, particularly in the two bottom quintiles, have housing costs that exceed the 25 or 30 percent benchmarks. The answers provide us with an indication as to what scale of housing assistance is required to reduce need and is exemplified in the work of Berry .

The second, *market performance*, also uses some housing cost to income measure but is used to evaluate whether performance of the housing systems or its subparts is improving or worsening, Thus if more and more households are paying more than say 30 percent of their income in housing costs over time it measures an erosion of market affordability. In the Housing Assistance Act 1996 Annual report there is table (C2) which shows the number of households paying less than 20, 25 and 30 percent of their incomes in the public and community housing system. This is a measure of targeting of the public housing system. The CBA/HIA Housing affordability index earning is a measure of the changing affordability of home ownership ie of private market performance. It measures the ratio of average household disposable income to the qualifying disposable income for the purchase of a median priced house.

*Assessment of financial well-being* refers to measuring whether, after meeting housing costs, a household has enough financial resources left to pay for the other necessities of life. This is a much less used measure and we too readily assume that this is covered by the 25 or 30 percent benchmark. In fact there is no necessary relationship between this benchmark and financial well-being. Here affordability is determined by calculating whether household income exceeds some measure of consumption well being e.g. the poverty line or budget standard. The former is exemplified by Vipond (1986) and Burke (1998).

The last one, *the guide to actual housing provision*, is hardly used in Australia and refers to what concept and measure of affordability can be provided to relevant stakeholders, e.g. builders, developer, local government, housing associations, to guide the actual provision of new housing units in a financially sustainable way.

## **2 The 25 and 30 Benchmark**

Before looking at the latter ones in more detail we need to review briefly the benchmark measure of 25 and 30 percent; the main measure for the first two measurement reasons.

Why 25 or 30 percent? The rationale for such benchmarks (why not 10%?) are as much philosophical judgments based on a society's values and its historical and institutional structures than for any technical reason.

One rationale for the 25 per cent benchmark is based on a rule of thumb that housing costs are normally around a quarter of a household's income. This is not sophisticated evidence based policy, but appears to have emerged from historical observation of people's housing practices and financial institutions' lending practices in the private sector. While the National Housing Strategy (1991) had the effect of consolidating 25 and ultimately 30 per cent as benchmarks for affordability in Australia the NHS only gave cursory attention to the rationale for these benchmarks, providing a brief overview of what some other countries set in terms of benchmarks (many are much lower) and then apparently choosing an upper end benchmark of 30 per cent, the Canadian core housing needs model. The upper end benchmark was also seen to fit contemporary practices in terms of home ownership lending conditions by financial institutions (NHS 1991: 6-7). A historical review of the North American origins of the 'right' amount of income to spend on housing also found that it was largely grounded in banking practices and could be traced back to the 1920s and 1930s. It was also based on some rough and ready judgments of what an average low-income worker spent on rental housing in North American cities. Both suggested 25 per cent (Feins and Lane 1981). However, such rule of thumb benchmarks are set by private market requirements, not necessarily by what a household can afford.

Importantly a major assumption of 25 and 30 per cent benchmarks is that rent payments have first claim on a household's budget, i.e. a public housing tenant is expected to pay at least 25 per cent of their income in rent and if this does not leave enough for other essential expenditures then that is an income – not a housing – problem. This assumes that housing is not a key component in any income security system, and that income supplements are the appropriate way to ensure adequate standards of living, not housing.

An alternative approach to affordability is to assume that other expenditure items have first claim on the budget, and housing cost should be the residual. This concept of affordability was influential in rent setting practices of the early public housing

system in Australia. The principle of measurement is simple. If the necessary expenditure for all other items is identified, then what is left over is how much is available for rent. This should be how much people pay. This approach assumes that housing programs should be the instrument for addressing all income problems; that is, that housing is the linchpin for a social security system. This might, for example, create a requirement that rents should be around 9 per cent of income (Stone 1993). There are two methods for broadly determining a non-shelter first measure of affordability: that of the poverty line and that of a budget standard.

### **3 The Poverty Line**

In Australia the most commonly used non-shelter first method of affordability is the Henderson poverty line, established by the Commission of Inquiry into Poverty (chaired by Ronald Henderson) in 1974-75. The method was to identify that level of income necessary to afford a certain minimum standard of living. It was based on a number of doubtful assumptions and, while it is criticised for not reflecting contemporary standards of living and associated costs, it is updated quarterly by the Institute of Applied Economic and Social Research at the University of Melbourne, and until recently was the only measure for evaluating the non-shelter first concept of affordability (Maher and Burke 1993).

### **4 Budget Standard**

This method assumes that housing programs should be designed to reduce housing costs to an amount that leaves sufficient left over to cover an acceptable minimum standard of expenditure consistent with a modest budget. On the principles of this model of affordability, housing is just one part of a set of programs that address social security issues. The method here is to identify an acceptable standard of housing expenditure as a basis for setting a general housing cost to income ratio. This might be anywhere between 15 and 30 per cent, depending on household type and location and the bundle of other household expenditures. Until recently there has been no budget standard in Australia to evaluate the effects of housing affordability against, hence the use by default of the Henderson poverty line. In 1998 the Social Policy Research Centre (SPRC) at the University of New South Wales developed indicative budget standards for Australia and these are now a more robust alternative to the poverty line (Saunders et al. 1998).

### **5 Non-Shelter First to Shelter First: Rent Setting and Affordability in Public Housing**

When the states and territories first established their public housing systems, a key policy issue was the effective level of affordable rent that tenants should pay. The method were a combination of rule of thumb and budget standard growing out of the Harvester Judgement of 1907 which set a living wage based on what an unskilled labourer required to meet the normal needs of himself, his non-working wife and three children.

The residual rent model of affordability principle formed the basis for the Commonwealth Housing Commission's recommendations of 1944 which in turn led to the first CSHA a year later (McNelis 2001: 45). This laid the foundations for all subsequent social housing provision for the next forty years. Clause 11(1) set the benchmark for rebate of rents at one-fifth of family income equal to the basic wage, with families whose income was less than this receiving a further rebate by one quarter for any amount below the basic wage. Rebates decreased by one-third for any amount above the basic wage. The income to which the rent related was defined as the whole of the income of the highest income earner, two-thirds of the next

highest earner's income, and one-third of other household members' income up to some maximum, then set at 30s.

While the income definition changed over time, the rent to income ratio was still broadly operative in 1991 at the time of the NHS and was only changed in the 1998 CSHA. Thus, for most of the postwar period, the rent to income ratio was structured in a way which, depending on income and family size, meant that the appropriate percentage could be anywhere between 15 and 25 per cent. With some state and territory variations, we are now looking at a policy environment where 25 per cent (i.e. the NHS affordability benchmark) is used by both public and community housing, at least for new tenants.

Looking at this history, we can hypothesise that both the 1991 NHS and 1998 CSHA benchmarks were chosen less as measures based on housing need, but to minimise the potential budget costs of low income housing assistance and to keep public housing agencies financially viable in a context of more and more households receiving a rebate and of contracting real expenditure on public housing. What started out in public housing as rents being set to leave enough for day to day living has now become a rent first system

## 6 Using the Budget Standards

Burke and Ralston in an AHURI funded study used the Social Policy Research Centre Budget standard and unit record files from the ABS Household Expenditure Survey (HES) to identify how many households in the two bottom quintiles in public and private rental fell below the budget standard for those households where the data was available. (Burke and Ralston 2002)

The study compared the budget standard measure with the 25 and 30 per cent of income measures and the Henderson After Housing Poverty Line.. Table 1 shows that the revised budget standard, particularly for public renters, produced a very different outcome to the other measures.

**Table 1: Comparing methods of measuring housing need: percentage above affordability benchmarks or below poverty line or revised budget standard**

	Renting, public		Renting, private	
	%	Count	%	Count
25 per cent	18.8	70,742	66.4	366,394
30 per cent	7.8	29,492	57.0	314,581
After housing poverty	18.0	57,033	54.6	234,393
Revised budget standard	64.8	195,048	78.8	325,138

On the 25 and 30 per cent affordability benchmarks, the data would suggest that state housing authorities could be relatively sanguine about the effects of housing assistance. Approximately 18.8 per cent exceed the 25 per cent benchmark, and only 7.8 per cent the 30 per cent benchmark. Even these figures appears somewhat surprising, given that rents are typically set around the 25 per cent benchmark. But it should be remembered that, firstly, these figures are based on disposable (after tax) incomes, and public housing rent rebates are based on pre-tax income, and, secondly, housing costs in the HES survey include service charges, house or contents insurance, and any expenses designated by the respondent such as self-

maintenance. These additional costs and lower income measure would push many over the 25 per cent benchmark and explain the anomaly. For private tenants, the data reaffirms the findings of other studies that substantial proportions, and absolute numbers, of lower income households are experiencing severe affordability problems relative to *any* of the accepted benchmarks.

When we look at the budget standard, it is clear that percentage benchmarks do not allow for an adequate standard of living. Despite rent rebates and, in the case of many private tenants, rent assistance, the amount of household subsidy is insufficient to prevent a sizeable proportion falling below the minimum budget standard: 64.8 per cent of public tenants, and 78.8 per cent of low income private tenants. This finding suggests five broad policy options all of which for various reasons are problematic:

- Adopt the 'do nothing' alternative, acknowledging that a sizeable minority of Australian tenants have to live at below an acceptable living standard, with the social and economic costs that may flow from this;
- Introduce income support reforms which raise pensions and benefits for households to a level whereby they can meet the standard, but with sizeable budgetary implications;
- Restructure public housing rents so that they are set at a level, which enables a household to achieve minimum budget standards, i.e. a residual rent model more akin to that which characterised the first forty years of public housing. This would, however, impact on state housing authorities' financial viability;
- Create greater opportunities for this low income group to earn labour market income and thereby raise incomes to the level where less direct assistance is required, as hinted at in suggested reforms of the next CSHA;
- Initiate programs, e.g. affordable housing initiatives, to reduce the cost of rental housing so that rent assistance goes further than it currently does in assisting affordability. While important, this does not address the problem of incomes simply being too low to achieve an acceptable living standard, and therefore must be a complement rather than *the* option.

The major implication of this research is that it challenges the orthodoxy of belief in Australia that, once provided with public housing, a tenant, by virtue of the rebate, is able to live at a satisfactory, if basic, level. Achieving affordability, where this is based on a rent first benchmark notion, is not a sufficient goal. Affordability should mean having sufficient to live on after paying housing costs, rather than how we currently conceive of it, i.e. having costs below some rent to income benchmark.

The 25 or 30 percent benchmarks, after housing poverty, or budget standards measures show different outcomes around the same theme, large numbers of low income households, despite different forms of government assistance, have an affordability problem. However when we review the policy implications of reform along the lines suggested above it is not too difficult to conclude that we can expect no major changes. Incremental reforms are the call of the day and therefore we need affordability measures appropriate to incrementalism.

## **7 Guiding the actual provision of affordable housing.**

There is a growing momentum of interest in the private sector, local government and government agencies such as VicUrban in notions of affordability. Their interest is not in the numbers experiencing affordability but in getting affordable units on the ground. And here conventional measures of affordability are more a hindrance than

help. Builders developers interested in the provision of affordable housing want to know what is an affordable dwelling for their municipality or site and what subsidies can help make any development affordable. Telling them that an affordable dwelling is one, which is 25 or 30 percent of someone's income, means nothing. The 25 or 30 percent benchmark when translated into rent setting practice is also becoming a problem for a number of community housing agencies around the country grappling with financial sustainability. Having a rental income set at 25 percent of their income means there is no necessary relationship to costs of provision particularly for an agency contemplating a new development in a high cost area.

In addition to benchmark measures of affordability we need therefore need to be developing local housing market and site-specific concepts of affordability to guide interested stakeholders in the actual provision of affordable housing. In the USA where they have more policy levers to provide affordable housing to assist (and sometimes direct) the private sector to provide affordable dwellings they provide housing affordability targets but with different targets for different regions of municipalities. This is in recognition that the land component of any housing construction is going to vary locationally and it is unrealistic to have the same affordability target for each area. They thus use measures such as an affordable dwelling is one that is *75 percent of the median value for a property of that type in that area* or *affordable by a household whose income is 60% of the median income for households in that area*. These provides a broad guideline for what to aim at and we should be developing equivalent affordability measure for Melbourne's areas or municipalities. Thus a two bedroom unit in the Docklands might be \$290,000 and still be defined as affordable while in Moorabbin it might be \$230,000 and in Dandenong \$180,000.

But this still does not take us far enough!. We have to appreciate that every site will have different land costs and development opportunities associated with potential densities, environmental constraints, car parking, relationships to other properties, etc and thus what is affordable will also have a site specific dimension. In other words we have to get more skilled at saying for any site (1) what proportion of the development could be made affordable given the constraints of that site and (2) for the specific affordable units that go on to such a site, what rent or price can be achieved given these site conditions and whatever production and managements structures can be created to maximize supply and demand subsidies. Here the achievable rents define the affordability for that site. The possible subsidies are identified below and can only be worked out on a site-specific basis between governments, developers and builders and potential management agencies, eg, a housing association.

### **Supply subsidies**

#### Capital Subsidies

- Discounted land
  - Density bonus
  - Land tax exemption
  - Stamp duty exemption
  - Government/philanthropic grants
- #### **Demand Subsidy**
- Rent assistance
  - Rate exemptions
  - Cross subsidy from market rent units
  - Tax exemption for charitable status

Thus for a specific site, e.g. a. Local governments might provide land (if they have any) at a market discount, or they might give a density bonus; the Office of Housing

might assist cash flow by buying some units at market price a form of capital subsidy, the developer might take a lower return, the builder might build with fittings at a lower cost (no granite bench tops), while governments might waive land tax or stamp duty. On the other hand having some tenants receiving rent assistance, management by an agency that has tax exemption status and a rate discount all provide demand side subsidies. Putting all this together could mean for site A (in a high cost location) that the affordable rent for a two-bedroom property is \$220 a week while for site B ( a lower cost location) it is \$180 per week. These become the affordability measures for this site. Who goes into such properties are those households who can sustain that level of rents with no other subsidy unless they are public housing tenants in receipt of a rebate. This moves notions of eligibility for affordable housing away from social housing eligibility guidelines to other criteria, e.g. key workers housing or what criteria of eligibility that fits the needs of the agencies managing this form of affordable housing. that would have to be created to as part of making such housing work. Identifying who is eligible is a policy problem of separate concern to this paper. The point here is that if we are to get even a few hundred more affordable houses into the system each year we have to rethink our concepts of affordability beyond 25 and 30 income benchmarks and income related rent setting practices.

The various measure of affordability discussed in sections 2 to 7 are summarised in appendix one.

## **8 Too Much Affordability**

Finally I would like to make few points about too much affordability. The concern with the affordability problem has obscured the fact that there are still areas where there is high affordability, eg, the older outer suburbs such as Broadmeadows, Dandenong, Frankston, and Werribee They might not be affordable in terms of the 25 or 30 percent benchmark if you are on a Centrelink income but they remain affordable for many lower to middle income households (Burke and Hayward 2001) But the reasons they remain affordable is because of negative perceptions by the wider community as to their poor amenity and employment opportunity. In a recent study completed for the City of Greater Dandenong by the Swinburne ISR we found that between 1996 and 2001 the net male population movement for Dandenong was an additional 580 males (Burke 1993). However disaggregated for income there was a 793 out movement in the highest income range but largely matched by an in movement of 609 males in the lowest income ranges. The problem with high affordability, as exemplified by such data, is that such areas are drawing in the lowest income households as these are the only areas they can afford while at the same time higher income residents are leaving for areas of higher amenity. In the long term this process creates areas of limited social and economic sustainability. The affordability issues should therefore be seen not just in terms of creating more affordable housing in high cost areas but improving amenity and opportunity in low cost areas so that a wider socio economic range of households will choose to live in such areas. This suggests very different policy options and creates a different understanding of how to achieve affordability.

**8 Conclusion.** Conceptualising and measuring affordability needs to be rethought. The affordability problem is no longer about social housing and rent assistance it is about how to extent affordability to a broader range of income group and about engaging with local government and the private development/building industry. This requires moving beyond 25 and 30 percent benchmarks to new ways of measurements and conceptualisation which are much more product and industry focused.

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## Appendix One

<b>Affordability measure</b>	<b>Targeted at.</b>	<b>Purpose</b>	<b>Problems</b>
<i>Housing Costs as percentage of income,</i>	Two lowest income quintiles, First home buyers, All households	Measuring need if related to 25/30 benchmark Assessing performance	How do you treat rent assistance? Is it an income or is it a rent supplement? What is the validity of the 25 or 30% benchmark
After Housing Poverty line. Number and percentage that fall below poverty line or budget standard after meeting housing costs?	Two lowest income quintiles	Measuring client well being	What is validity of poverty line or budget standard
<i>Threshold Income</i> , i.e., income required to purchase property in designated rent or price range, median price	NA	Measuring performance,	If mortgage what assumptions do you make about the deposit?
<i>Housing Market Affordability target</i> , eg what priced house can be put into an area for people whose incomes are less than 75% median income.	Local Government Builders developers Housing providers	Guiding actual provision of affordable housing	What should be the income target?
<i>Site Specific/</i> . At what rent or price can an affordable dwelling be achieved given the specific site conditions and production and management possibilities	Local/state Government Builders developers Housing providers	Guiding actual provision of affordable housing	Understanding and developing the set of conditions that makes affordability work for that site