Retirement Income Review Consultation Paper – Heffron SMSF submission

January 2020

Prepared by
Martin Heffron
Director

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1 Introduction

Thank you for the opportunity to contribute to your important work.

Heffron SMSF Solutions has been a provider of SMSF products and services for 21 years. We employ around 80 people in Brisbane and Maitland and have a national profile with clients in all states.

We are privately owned. Meg Heffron who is a co-founder and Heffron's Managing Director was a panellist on the Super System Review (known as the Cooper Review) in 2009/10. [1]

There are many organisations that are better placed to provide the Review with answers to the hard data questions you have asked for so our submission is aimed at providing input of a more subjective nature, based on the experience of the organisation and its senior staff.

Rather than answer each question individually we have therefore used a format that pulls together our responses into categories that answer your questions indirectly. We hope you find that approach useful and constructive.

We acknowledge that the Review's Terms of Reference (TOR) and request for input did not specifically ask for recommendations. Nevertheless, we commence our submission with a number of them. Our experience suggests that each of these recommendations is either essential to the design of any effective retirement income system or is agnostic to the design and philosophies underpinning that design. They are policy themes rather than specific policy recommendations and, in our view, represent the highest altitude, highest value targets.

We have followed that up with a risk assessment that looks at world-wide wide factors as well as factors specific to the current design of the Australian system.

We agree that deciding what success looks like is crucial to the design of an effective Retirement Income (RI) system and have responded to the questions on RI system principles in a separate section.

A number of the questions in the Consultation Paper (CP) seem rather philosophical and answers will inevitably be subjective and political. In order to be clear on when we are expressing subjective and philosophical views, we have tried to restrict them to a specific section in our submission.

Finally, we have a section on some specific questions we believe should be answered by the Review

Thank you for taking the time to read our submission. We are happy to attend any face to face or telephone meeting to follow up or clarify any points.

[1] Super System Review Final Report - 2010

2 Recommendations

2.1 CONTEXT

The challenge created by increasing human longevity is not surprising or unique to Australia.

For the purposes of policy development, the challenge can be categorised into the following broad areas of policy:

- Health
- Aged care
- Housing
- Retirement income

However, as with many other jurisdictions, Australia tends to address these independently rather than in a co-ordinated fashion.

In our view, the primary reasons for this are:

- The lack of clarity around the integrated and symbiotic nature of the relationships between these policy areas; and
- A lack of clarity around what success looks like for each one of them

Responsibility for the main policy areas of policy impacted by increasing longevity sit within different jurisdictions (i.e., state and federal), departments and ministers. For example:

- Public housing and rental assistance are a state matter
- Health is ostensibly a state matter but largely funded by the Commonwealth

The founding fathers did not envisage the longevity challenge when they established the governance structures for our nation!

2.2 SET CLEAR GOALS FOR WHAT A SUCCESSFUL RETIREMENT INCOME SYSTEM LOOKS LIKE

One of the biggest challenges to successful policy development in the retirement income space is a lack of clarity and bi-partisan political alignment around what success looks like for the space as a whole.

The conditions need to be created in which the purpose of Australia's retirement income system and measures for its success can be decided with bipartisan support because without that:

- It is difficult to assess the effectiveness of current policies (there is no benchmark or agreed measure of success)
- It is difficult to design better ones (for the same reasons)

- RI outcomes for people are too much of a hostage to the next general election. Given the long-term nature of RI planning for the individual and increasing RI self-reliance, regular, significant policy changes undermine confidence in the system (leading to poor sustainability of the system and under or over saving by individuals) and are ethically indefensible

The need for bipartisanship in this area of policy in particular has support from other jurisdictions. For example, Sir Stephen Webb (the UK's ex-Pensions Minister) expressed similar sentiments in a newspaper article recently.[2]See also Appendix A.

2.3 ESTABLISH BIPARTISAN AGREEMENT ON THOSE GOALS

To be clear, we are not advocating a bi-partisan approach to RI policy. We are advocating for bi-partisan agreement on what success looks like for the RI system in Australia. There will inevitably be healthy disagreement on how to achieve that success but less variability than we would see without that agreement.

There are particular attributes of retirement income planning that make that case for this type of an approach.

For example:

- The increases in the various age cohorts and in longevity itself are reasonably predictable. Policy is unlikely to have to adapt quickly to unforeseen events;
- For an individual, retirement planning takes 40+ years and individuals will have to fund an increasing proportion of their retirement incomes in the future. Understanding the goals of the retirement system and the potential policy iterations makes it easier to plan for those very long-term goals

Australia does not have a history of bipartisanship. There are no well-worn paths that can be adapted for use in this space.

Candidates for achieving consensus are:

- A parliamentary committee is tasked with recommending an approach. Precedents exists for this. For example, the Defence Sub-Committee of the Joint Standing Committee on Foreign Affairs, Defence and Trade was asked to inquire into the benefits and risks of a Bipartisan Australian Defence Agreement as the basis of planning for, and funding of, Australian Defence capability[i3]

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[2] https://www.telegraph.co.uk/news/2020/01/17/britains-pension-dilemma-has-become-intractable-problem-halls/

[3] Contestability and Consensus - Joint Standing Committee on Foreign Affairs, Defence and Trade – November 2018

- Tasking a citizens' assembly with recommending an approach. A precedent of a kind exists for this in the Citizens' Assemblies that the Republic of Ireland uses for a range of purposes. In fact, one of the reports of the Irish Citizens' Assembly was entitled "How best to respond to the challenges and opportunities of an ageing population" [4]

  In our view, the industry should be a consultant to this process and should not be tasked with making recommendations.

2.4 IMPROVE THE INTEGRATION OF POLICY RESPONSES TO INCREASED LONGEVITY

As mentioned in the section above, the challenge of increasing longevity is predictable and impacts several major policy areas. Despite being predictable, increasing longevity will put our society under increasing stress. It is a major challenge. Better integration of policy across these major policy areas would improve the effectiveness and efficiency of policy development, delivery and outcomes.

We do not have the expertise to know how this is best achieved within the Australian context. For example, does it require separate federal or state Aged Person departments, or the creation of a separate ministry, or a cross departmental committee with longevity policy oversight.

A quick review of other jurisdictions suggests that some of them are taking pro-active policy steps towards achieving governance better suited to this challenge.

For example:

- New Zealand has a Minister for Seniors (in the Cabinet) with responsibilities that include advocating for the interests and issues of older people, overseeing the implementation of the New Zealand Positive Ageing Strategy, and advocating for policies that protect older people's rights and interests[5]
- The Republic of Ireland has a Minister of State for Mental Health and Older People who (among other things) is accountable for developing and articulating government policy on improving the lives of older people. This ministry exists within the auspices of the Irish Department of Health [6]

2.5 IMPROVE FINANCIAL LITERACY

As longevity has increased in Australia, retirement income policy has increasingly transferred retirement income funding risk from the state to the individual (e.g., the Superannuation Guarantee). This created conditions within which the wealth management/funds management/superannuation industry grew strongly.

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[4] https://2016-2018.citizensassembly.ie/en/How-we-best-respond-to-challenges-and-opportunities-of-an-ageing-population/Final-Report-on-how-we-best-respond-to-the-challenges-and-opportunities-of-an-ageing-population/Final-Report-on-Older-People-Incl-Appendix-A-D.pdf

[5] https://www.beehive.govt.nz/ministers

[6] https://www.gov.ie/en/role/66b265-minister-of-state-with-special-responsibility-for-mental-health-and-/

It has been clear to many of us within the industry for some time that the quality (technically and ethically) of the industry was extremely varied. Due partly to their lack of financial literacy (which contributes to a lack of engagement), consumers were largely unable to make good decisions about the quality of their financial service providers or the products they bought and some members of the industry took cynical advantage of that.

The Hayne Royal Commission (and other things) has now shone a light on this. Those individuals within the industry who took advantage of the information asymmetry rightly bear the greatest responsibility for this outcome. However, successive governments who promoted and supported policy settings that required greater financial literacy also bear some responsibility.

Despite long being recognised as important, little policy has been directed at improving the financial literacy of the population. Whatever the purpose of the RI system and the policy settings that are developed to support that purpose, increased financial literacy will improve engagement, improve the ability for citizens to make informed quality decisions in their own interests and better hold the industry that serves them to account.

3 The Proposed Principles

3.1 ADEQUACY

The highly subjective nature of this question is reflected in the significant disparities we get in the answers, even from the experts. For example, the Grattan Institute's (GI) minor stoush with ASFA in 2018 was caused partly by GI's recommendation that all references to ASFA's retirement income adequacy advice be removed from ASIC's Money Smart website – presumably because they thought it was misleading.[7]

An adequate retirement income for one person (or couple) is going to be inadequate for another.

In any case, retirement income is only one component of an adequate quality of life in retirement. As a minimum, we want to see retired Australians living in dignity which means that their basic needs must be met. If the individual doesn't have the financial capacity to meet those basic needs, then the state must step in.

Deciding on a retirees' basic needs is easier to do objectively than deciding on an adequate retirement income in isolation.

A retiree's basic needs are:

- Food
- Water
- Sanitation
- Adequate accommodation (housing)
- Health care
- Aged care (support for individuals who lose the ability to care for themselves in their own homes)

If these are the criteria for an adequate and dignified retirement, how does Australia measure up?

If we assume that the health care and aged care systems provide minimum, adequate state funded support, an adequate retirement income must enable the retiree to live in dignified housing (water, shelter and sanitation) with a level of income that enables the retiree to eat, pay the running costs of their accommodation and have a some left over for discretionary spending.

Given the significant cost of housing in Australia, this analysis then lands us with two fundamentally different categories of retiree:

- Those who own their own homes
- Those who don't

[7] Money in retirement (more than enough) – John Daley and Brendan Coates – Grattan Institute p5

The implications of this for the future adequacy of our current system is discussed in the section on Risk below.

3.2 EQUITY

As described in the CP, retirement incomes will vary depending on an individual's circumstances, life experiences and lifetime decisions. We agree that the principle of equity applied in this case should not be designed to create similar retirement income outcomes for all Australians.

We agree that the principle of equity should be applied to test:

- If the retirement income support provided by the state (via direct payments or tax concessions) is equitable for individuals in similar situations (e.g., same level of wealth); and
- Is appropriately targeted to those who need it most.

In our view, there are three categories the panel should consider when assessing state funded equity across different cohorts:

- Direct state retirement income related payments (e.g., age pension, rental assistance, aged care funding)
- Tax concessions provided (e.g., principal place of residence exemptions, superannuation tax concessions, CGT concessions on death)
- Means test impacts (e.g., the saving on age pension benefits for retirees who have saved enough of their own wealth)

3.3 SUSTAINABILITY

We agree the sustainability of the system is an important principle. Without it, any system will be short lived.

It is a truism that increasing longevity will be increasingly expensive. Someone will have to pay. Increasing longevity risks impacting the sustainability of any retirement income system. We do not believe this rather stark fact has been well communicated to the community at large. A better appreciation of this across the community through improved financial literacy would facilitate a better debate and create the conditions for effective reform.

3.4 COHESION

We believe the principle of cohesion should be applied to the challenge of increasing longevity as a whole rather than just the retirement income aspects (see Recommendation section above).

4 Risks

The purpose of this section is to identify systemic risks to the ability of our retirement income system to deliver any of four the principles identified in the CP.

4.1 EXTERNAL FACTORS

External factors are world economic and social trends and forecast trends that impact on Australia's retirement income system. They are largely beyond the control of Australia. Policy can only adapt to these trends. It cannot materially affect their existence. In our view, there are more down-side risks from these trends than upside opportunities. The trends will either increase costs or decrease Australia's ability to fund the retirement income system. Given that analysis, it is our view that Australia's retirement income policy stance with respect to funding commitments should be risk averse and conservative.

4.1.1 Increasing longevity

Increasing longevity is a risk to the sustainability of any retirement income system. This impact is understood within government and industry but not within the broader community.

4.1.2 Historically low interest rates

We are not economists but the general consensus within that community is that historically low interest rates are here to stay for some time.

Low interest rates impact the retirement incomes system because they will:

- Reduce the income of retirees
- Influence some retirees and pre-retirees to invest more aggressively. Risk and return are two sides of the same coin. Returns get a lot of coverage in our community because they are well understood. Investment risk gets little coverage and is poorly understood.
- Reduce deeming rates for age pension purposes and therefore increase the cost of the age pension

4.1.3 Carbon dependency

Australia's economy is highly carbon dependent.

We are one of the highest CO2 emitters in the world on a per capita basis and nearly 30% of our exports are made up of coal and gas[8]

The world is slowly moving away from carbon-based energy sources and Australia will have to replace these exports with other products if our standard of living is to be preserved. This is a

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[8] https://oec.world/en/profile/country/aus/

significant but long-term threat to Australia's financial security which has implications for our retirement income policy settings given the long-term nature of those liabilities.

4.2 INTERNAL FACTORS

These are risk factors created by Australia that can be mitigated with action by Australia.

4.2.1 Policy paralysis

At three years, federal parliamentary terms are very short in Australia compared with other democratic jurisdictions and our government has been quite unstable for the last decade.

If successful delivery of the policy principles requires significant reform, the recent track record of government suggests this will be difficult to achieve.

In particular, any reform of the current generous treatment of the principle place of residence (PPR) will require brave leadership. House prices have become a divisive issue with two different stakeholder groups within the electorate. For a politician, it makes deciding whether you want house prices to go up or down a career threatening decision.

Bipartisan agreement on what a successful retirement income system looks like would mitigate this risk.

4.2.2 Housing affordability

Shelter is a fundamental human need and affordable shelter is vital for dignified and adequate retirements.

Sydney and Melbourne are now two of the least affordable places to live in the world.[9]

A lack of housing affordability has many facets but one of the main causes are house prices. Australia's house prices are amongst the highest in the world.

This fact is not in dispute and the evidence is easy to find.[10]

The phenomenon isn't a result of extraordinary income rises in Australia either. [11]

House prices have grown much faster than income and the average house price in Australia now sits at around 8 times average weekly ordinary times earnings. These purchases have been funded by debt. Australian household debt is now amongst the highest in the OECD. [12]

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[9] http://www.demographia.com/dhi.pdf
[10] https://www.afr.com/companies/financial-services/australian-property-still-world-s-most-expensive-despite-sharp-falls-20190508-p51l5x
[11] Grattan Institute Report - Housing Affordability – Re-imagining the Australian Dream (Daley and Coates) p 16
[12] https://data.oecd.org/hha/household-debt.htm

A lack of housing affordability is causing and will continue to cause economic and social damage. It is one of the biggest challenges we currently face as a community and a high value target for our policy makers.

Economic consequences:

- Household sector debt in Australia is now around 120% of GDP.
- The economy is too reliant on the building sector and capital is diverted away from more productive uses. Investing in an expensive home won't improve Australia's productivity and certainly won't result in improved wages growth. Expensive housing is simply inefficient.
- Australia's net foreign debt is around $1tn, approximately 60% of our annual GDP.

Social consequences:

- Outright home ownership amongst among older Australians (55-64) has slipped by nearly 30% in the last 20 years from 72% in 1995-96 to 42% in 2015-16.[13]
- Younger Australians cannot buy a home. The tax and social security system encourage older Australians to stay in their large homes which has negative impacts on intergenerational equity.[14]
- Households that rent have increased from under 26% in 1991 to more than 32% in 2016.[15]
- Homelessness is increasing again after a period of decline[16]

This housing affordability crisis has a number of implications for Australia's retirement income system:

- For the increasing cohort of Australians who retire without owning a home the current retirement income system is unlikely to provide them with an adequate income because rental assistance is relatively low compared to housing costs in most capital cities
- For the increasing cohort of Australians who still have a mortgage outstanding on retirement, it is likely they will need to use some of their superannuation balance to pay off their mortgages which increases the likelihood of reliance on the age pension
- Some recent modelling by Michael Rice[17] forecasts a decline in overall reliance on the Age Pension to fund retirements. It would be useful to know if this modelling includes an assumption that more people will retire with mortgages and use their superannuation to pay it off

A more cohesive approach to the longevity challenge recommended above would quickly identify the threat this poses to retirement income adequacy and would facilitate better solutions.

[13] Grattan Institute Report - Housing Affordability – Re-imagining the Australian Dream (Daley and Coates) p 73
[14] Ibid p 70-71
[15] https://www.abs.gov.au/ausstats/abs@.nsf/0/88BF225497426920CA257F5C000989A8?Opendocument
[16] https://www.aihw.gov.au/reports/australias-welfare/homelessness-and-homelessness-services
[17] The Age Pension in the 21st Century – Michael Rice – prepared for the Financial Services Forum 2018

Interestingly, housing ownership and affordability is getting attention in other jurisdictions with the Economist newspaper recently including a special report on the issue from a global perspective.[18] Two of the eight articles in the special report from that edition are included as Appendix B.

4.2.3 Lump sums

Once a condition of release has been met, lump sum payments in Australia are completely unrestricted and are tax free if the recipient is over age 60.

This creates the risk that superannuation tax concessions get wasted on lump sums paid out on retirement that are not used to fund retirement incomes. They are consumed or used to pay off debt. In turn, this results in “double dipping” whereby the state funds both superannuation tax concessions and the age pension.

4.2.4 Investment returns

A key aspect of financial literacy is understanding investment returns, investment risks and the crucial link between them. Because of the lack of financial literacy in Australia these issues are poorly understood.

Investment returns are easy to understand and usually expressed as simple percentages. They have been getting a lot of attention recently.

In our view the current approach to reporting investment returns is inadequate creating the risk that poor investment decisions will be made.

There are several ways in which an investment return can be calculated but there is no regulatory or statutory guidance on how to calculate that return. This creates the risk that an investor is not comparing apples with apples when comparing returns. The Cooper Review recommended that a consistent approach be developed, the government accepted the recommendation, but no action was forthcoming[19]

In addition, every investment return comes with risk. The risk is the other side of the coin to the return. In contrast to investment returns, investment risk is a poorly understood concept. Strategic asset allocations tend to be used as the main proxy for risk but as with investment returns there is no regulatory or statutory guidance on what each of the normal allocation terms (e.g., balanced, growth etc.) mean. The Cooper Review also made several recommendations on this issue relating to My Super products which government accepted in principle, but no standards have yet been regulated. [20]

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[18] The Economist – 16 January 2020 edition
[19] Stronger Super – Government Response p31
[20] Ibid. p34

5 Philosophical Questions

Some of the questions in the CP appear somewhat philosophical. Responses to those questions will inevitably contain strong elements of opinion. The fact that some of those questions remain open is because we don't yet have clarity around the purpose of our retirement income system and its pillars.

In our view:

- The state should have an obligation to ensure its citizens enjoy a dignified retirement for those unable to provide that for themselves. We have explained what we think that needs to look like in the section on adequacy above.
- The state should also provide incentives to its citizens to provide for their own retirement because this can alleviate the burden on the state, promote sustainability of the system and provide a better retirement income than the state is willing to fund on its own.

6 Key Factual Questions the Review Should Try and Answer

In this section we have made suggestions on some of the key factual questions the Review should seek to answer in assessing the existing system

- What is the purpose of our RI system, what does success look like and how do we get bipartisan support for that purpose?
- What RI tax incentives are being wasted on non-retirement related outcomes?

  For example:

  - The bequest of superannuation wealth
  - The bequest of PPRs by testators who have received material support from the age pension
  - Lump sums taken and used for purposes other than providing a retirement income
- The reliance on the age pension is falling. Will the fact that an increasing number of people are retiring with a mortgage in the future reverse that trend?

7 Conclusion and Summary

In summary, the positive aspects of the existing system are:

- Most Australians currently enjoy a dignified retirement (we have explained what we mean by this above)
- Many Australians have used the tax incentives offered to create sufficient wealth to fund retirements that are comfortable rather than adequate
- The hard cost of providing the Age Pension is relatively low as a percentage of GDP compared to our OECD peers

The negative aspects are:

- A lack of clarity around the overriding purpose of the system and how to measure success
- A general lack of financial literacy within the community that compromises the ability of many people to make good retirement income related decisions
- A lack of cohesion across the major policy areas that impact an ageing population
- The increasing lack of housing affordability threatens inter-generational retirement income equity and the ability of the existing system to deliver dignified retirements in the future because the current system relies on the majority of retirees being homeowners
- It is likely that tax concessions offered to support and subside retirement incomes (including some of the concessions on the Principal Place of Residence) are being wasted and used for other purposes

Britain's pension dilemma has become an intractable problem in the halls of government

Follow SIR STEVE WEBB

17 JANUARY 2020 • 6:00PM

One enormous practical barrier to a successful pension commission is HM Treasury

This week's call by the Pensions Minister for the establishment of an independent 'pensions commission' (https://www.professionalpensions.com/news/4009256/tanks-permanent-pensions-commission) sounds at first sight eminently sensible. Who could object to people of good will setting aside their differences, combining their expertise and coming up with solutions to the pension crisis? And given the success of an earlier pensions commission, chaired by Adair Turner, which paved the way for the highly effective policy of 'automatic enrolment' (https://www.telegraph.co.uk/business/2019/01/08/pension-auto-enrolment-working-much-done/)into workplace pensions, surely there is nothing to be lost?

But independent commissions of this sort have a far-from-unblemished track record, and can sometimes contribute to delay when what is actually needed is some political will and decisiveness.

Consider the issue of funding long-term care. More than twenty years ago there was a Royal Commission (no less) on long-term care set up in the early years of the first Blair administration. This came up with a proposal that social care should, like the NHS, be free at the point of need. But the authors of the Commission report failed to secure the necessary political buy-in. As a result, the key recommendation went nowhere and all that happened was that several years had elapsed with nothing being done.

It is not only the example of the Royal Commission on long-term care which should make us think hard about whether commissions are a panacea for knotty policy issues.

In 2011, Sir Andrew Dilnot was sent away to apply his immense analytical skills to resolve the care funding conundrum. The Dilnot report (https://www.telegraph.co.uk/finance/personalfinance/insurance/longtermcare/8614800/Dilnot-Commission-your-questions-answered.html) duly set out an intellectually coherent solution, capping lifetime care costs and increasing the contribution of the state. The report gained some traction in government and even led to legislation in the form of the 2014 Care Services Act. But that Act was never implemented. Post the 2015 General Election, the political pressure for short-term funding to tackle the immediate care crisis meant that the Government's enthusiasm for funding a longer-term solution quickly waned.

Whether it is the Royal Commission in the late 1990s or the Dilnot Commission of the last decade, it is quite clear that having really capable people thinking deeply about an issue isn't enough to resolve a deep-seated problem.

'For reckless bosses who put your pension at risk, there will be no place to hide'

Read more

So, what was it that meant that the ‘Turner’ Commission could be a success where the other two ultimately failed to resolve the issue?

One of the key things that Adair (now Lord) Turner did was to build political consensus. And my concern is that any new pensions commission at this stage would struggle to get political buy-in. This is for two main reasons.

The first is that the political polarisation of recent years means that the scope for political consensus on controversial issues is very limited. Whilst it is certainly true that the Conservative pensions minister and his Labour shadow have been a model of consensus in recent years on technical pensions matters, the manifestos of the two main partie (https://www.telegraph.co.uk/money/consumer-affairs/party-vote-60s/)s reveal a chasm when it goes to more challenging issues.

Fundamentally, the big decisions about pensions, especially in the face of an ageing population, are profoundly political. They revolve around the relative contribution of rich and poor, the relative burden to be faced by young and old, and the pension provision for employees in the public sector against those in the private sector. These are highly political trade-offs where there is no single right answer. The conclusion that you reach on these issues is likely to reflect your political values and a group of wise technocrats is unlikely to come up with a solution acceptable to all.

The second enormous practical barrier to a successful pension commission is HM Treasury.

The Treasury guards its role jealously, and subcontracts it to no-one. It is simply not going to charge an independent commission with re-designing pension tax relief, when this sort of thing is the bread and butter of why politicians get elected and why the

Treasury exists. The Department for Work and Pensions has a better track record of building and maintaining consensus in pensions than the Treasury simply because many of the areas of its responsibility require largely technical solutions. But DWP has not been able to achieve consensus on changing state pension ages – despite involving independent experts such as Sir John Cridland to do a review – because these issue are, again, profoundly political.

We have a simple choice. We can indulge in wishful thinking and set up yet another commission where experts and people of good will get together to try to thrash out solutions but ultimately see their recommendations largely ignored. Or we can accept the political reality that ultimately governments need to grasp the nettle to resolve some of these knotty problems and press the government to make a decision and get on with it. Only the latter is likely to break the limbo in which too many major public policy issues now sit.

Steve Webb is Director of Policy at Royal London and was UK Pensions Minister 2010-15

Menu

Special report

Jan 16th 2020 edition

Housing

Housing is at the root of many of the rich world's problems

Since the second world war, governments across the rich world have made three big mistakes, says Callum Williams

THE FINANCIAL crisis of 2008-10 illustrated the immense dangers of a mismanaged housing market. In America during the early to mid-2000s irresponsible, sometimes illegal, mortgage lending led many households to accumulate more debt than they could sustain. Between 2000 and 2007 America's household debt rose from 104% of household income to 144%. House prices rose by 50% in real terms. The ensuing wave of defaults led to a global recession and nearly brought down the financial system.

From the 1960s to the 2000s a quarter of recessions in the rich world were associated with steep declines in house prices. Recessions associated with credit crunches and house-price busts were deeper and lasted longer than other recessions did. Yet the damage caused by poorly managed housing markets goes much deeper than financial crises and recessions, as harmful as they are. In rich countries, and especially in the English-speaking world, housing is too expensive, damaging the economy and poisoning politics. And it is becoming ever more so: from their post-crisis low, global real house prices have since risen by 15%, taking them well past their pre-crisis peak.

Traditionally politicians like it when house prices rise. People feel richer and therefore borrow and spend more, giving the economy a nice boost, they think. When everyone is feeling good about their financial situation, incumbent politicians have a higher chance of re-election.

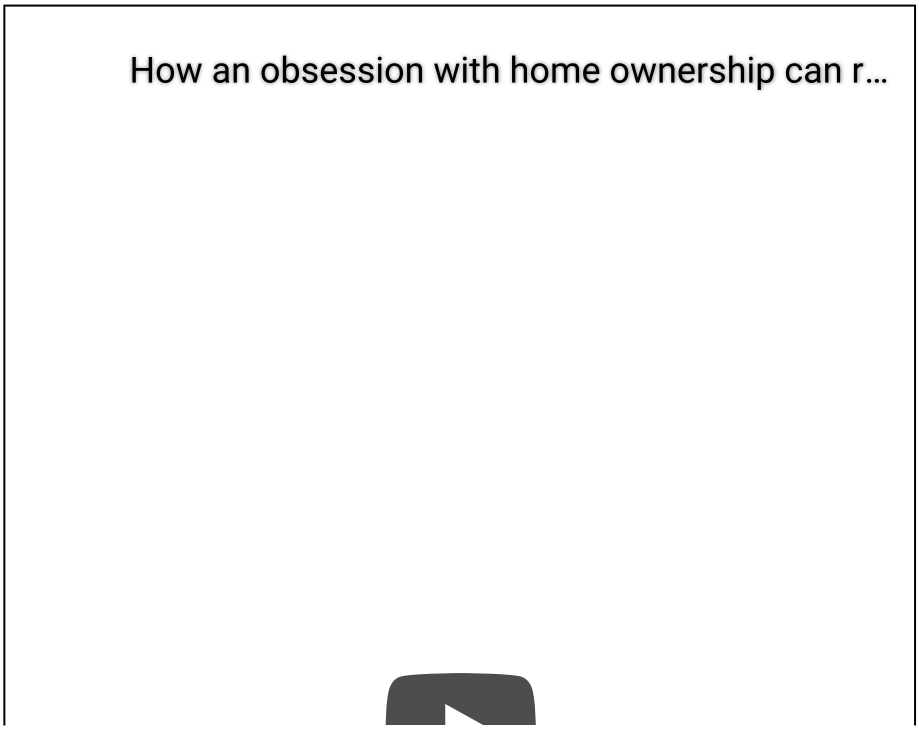
But there is another side. Costly housing is unambiguously bad for the rich world’s growing population of renters, forcing them to trim spending on other goods and services. And an economic policy which relies on homebuyers taking on large debts is not sustainable. In the short term, finds a study by the IMF, rising household debt boosts economic growth and employment. But households then need to rein in spending to repay their loans, so in three to five years, those effects are reversed: growth becomes slower than it would have been otherwise, and the odds of a financial crisis increase.

Malfunctioning housing markets also hit the supply side of the economy. The rich world’s most productive cities do not build enough new houses, constraining their growth and making them more expensive than they would otherwise be. People who would like to move to London, San Francisco or Sydney cannot afford to do so. Since productivity and wages are much higher in cities than outside, that reduces overall GDP.

So it is bad news that, in recent decades, the rich world has got worse at building new homes. A recent paper by Kyle Herkenhoff, Lee Ohanian and Edward Prescott argues that in America this process has “slowed interstate migration, reduced factor reallocation, and depressed output and productivity relative to historical trends”. Constraints on urban growth also make it harder to reduce carbon-dioxide emissions, since big cities are the most efficient built forms. In America there are more building restrictions in places which have lower emissions per household.

Housing is also a big reason why many people across the rich world feel that the economy does not work for them. Whereas baby-boomers tend to own big, expensive houses, youngsters must increasingly rent somewhere cramped with their friends, fomenting millennials’ resentment of their elders. Thomas Piketty, an economist, has claimed that in recent decades the return to capital has exceeded what is paid to labour in the form of wages, raising inequality. But others have critiqued Mr Piketty’s findings, pointing out that what truly explains the rise in the capital share is growing returns on housing.

Other research, meanwhile, has found that housing is behind some of the biggest political shocks of recent years. Housing markets and populism are closely linked. Britons living in areas where house prices are stagnant were more likely to vote for Brexit in 2016, and French people for the far-right National Front in the presidential elections of 2017, according to research from Ben Ansell of Oxford University and David Adler of the European University Institute. Political disputes sparked the protests in Hong Kong, but the outrageous cost of accommodation in the city-state has added economic fuel to the political flames.



This special report will argue that since the second world war, governments across the rich world have made three big mistakes. They have made it too difficult to build the accommodation that their populations require; they have created unwise economic incentives for households to funnel more money into the housing market; and they have failed to design a regulatory infrastructure to constrain housing bubbles.

Happily, they are at last starting to recognise the damage caused by these policies. In Britain the government now openly says that the housing market is "broken". Scott Morrison, Australia's prime minister, has pledged to make housing more affordable. Canada's recent election was fought partly on who would do more to rein in the country's spiralling housing costs. Carrie Lam, Hong Kong's chief executive, has put housing front and centre in her response to the protesters.

They need to learn from places where the housing market broadly works—and those places do exist. As this report shows, flexible planning systems, appropriate taxation and financial regulation can turn housing into a force for social and economic stability. Singapore's public-housing system helps improve social inclusion; mortgage finance in Germany helped the country avoid the worst of the 2008-10 crisis; Switzerland's planning system goes a long way to explaining why populism has so far not taken off there. Governments across the world need to act decisively, and without delay. Nothing less than the world's economic and political stability is at stake. ■

Housing
Shaking the foundations

This article appeared in the Special report section of the print edition under the headline "Housing is at the root of many of the rich world's problems"

APPENDIX B

Menu

Special report Jan 16th 2020 edition

Home ownership

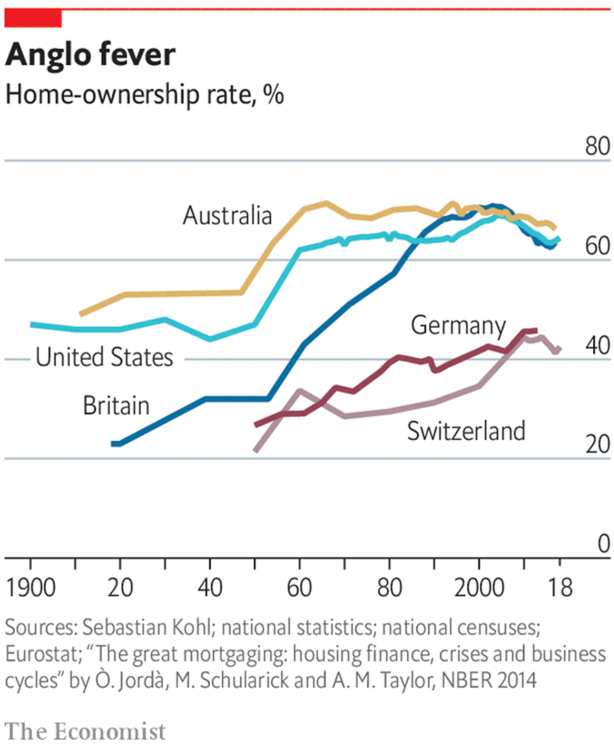
Home ownership is in decline

That is not a big cause for concern

MORE THAN nine in ten Singaporeans are homeowners, a higher rate than in any other rich country. And what a nice place it is to live. The city-state is rich, stable and has virtually no crime. The streets are clean.

Singapore seems to confirm what conservatives have long believed: that home ownership makes for richer, happier folk. Lee Kuan Yew, its first prime minister, was a big fan, arguing that it gave ordinary people "a stake in the country and its future". Margaret Thatcher's "right-to-buy" programme in the 1980s, allowing Britons in social housing to buy their property at knock-down prices, is said to

Britons in social housing to buy their property at knock-down prices, is said to have been influenced by the Singapore model.



It might be seen as worrying, then, that for the first time in a century home ownership in the rich world is in decline (see chart). Yet having more renters might not be such a bad thing.

For most of the past millennium, the only people with a good claim to be homeowners were landed gentry and farmers who worked the fields. Then, from the mid-20th century onwards, home ownership was democratised. A combination of rising household incomes and government policies helped more people get onto the property ladder. In most countries home ownership peaked around the year 2000.

America has some of the most generous fiscal incentives to become a home-owner. Official estimates suggest that the government forgoes over $200bn a year (over 1% of GDP) subsidising homeowners through the tax code, with policies including a tax deduction on mortgage interest and not taxing the income homeowners implicitly earn by avoiding paying rent. Mark Zandi of Moody's Analytics adds that subsidies to mortgages provided by Fannie Mae and Freddie Mac—two government-sponsored enterprises that support much of the country's mortgage finance—and the Department of Housing and Urban Development amount to a further $9bn or so a year.

America is especially generous, but schemes to boost home ownership are common. Most rich countries do not charge capital-gains tax on the sale of an owner-occupied house. Inheritance-tax regimes routinely make exemptions for housing. Many countries subsidise mortgages and down-payments. Yet for all this, the factors pushing home ownership down are now stronger.

One possibility is that younger folk may be less interested in home ownership. After all, many millennials desire "asset-light" lives in which they rent cars, music and clothes, rather than owning them. Why not housing too?

The private sector has spotted an opportunity. Silicon Valley types are bullish on "co-living", where people rent a dwelling and share common spaces such as kitchens, washing facilities and gyms. Hmlet, a co-living firm, is expanding in home-ownership-obsessed Singapore. Sharing a kitchen might sometimes be annoying, but Hmlet's properties are well kitted out.

The attraction of co-living is, however, exaggerated. The majority of people would still prefer to be homeowners. Surveys from America suggest that the share of people who think that home ownership represents a good investment is growing.

Economic factors may be a bigger cause of the decline in home ownership. With weak earnings growth since the crisis, young folk have struggled to accumulate savings for a down-payment. Tighter regulation of mortgage markets since the financial crisis has made it tougher for first-time buyers to acquire finance. Baby-boomers, looking for a return on their savings, are pushing aside prospective first-time buyers and becoming landlords. As millennials have taken on more student debt, buying a home has become trickier.

How low could the home-ownership rate go? It seems unlikely that rates in the English-speaking world will ever approach Germany's (with a rate of just 44%) or Switzerland (40%). Home-ownership rates are the product of history and culture. Countries with a history of weak real house-price growth—Germany and Switzerland fit the bill—have lower owner-occupation, because fewer people see buying a house as a worthwhile investment. Densely built places also tend to have lower home ownership. People are generally less keen on owning a flat in a high-rise block than they are in a detached house (55% of Germans live in apartments, a high rate by international standards).

Politicians across the rich world bemoan the emergence of Generation Rent. "American home ownership rate in Q2 2016 was 62.9%—lowest rate in 51 yrs," tweeted Donald Trump when he was campaigning for president. "WE will bring back the 'American Dream!' " Boris Johnson, Britain's prime minister, seems equally concerned about his country's falling rate of owner-occupation.

But lower home ownership need not be a cause for concern. For one thing, owning a home is not necessarily the route to riches that many people believe it

to be (see article). The evidence that home ownership is good for society is, in fact, fairly weak. There are many counter-examples to Singapore. Romania probably has the world's highest home-ownership rate, at 96%, but it has its fair share of social problems. Switzerland, at the other end of the scale, nonetheless has low crime and high social trust.

Academic studies offer only weak support for the idea of promoting home ownership. One paper suggests that owner-occupiers have better-tended gardens. But if nice shrubbery were a goal of public policy, it might be a better use of public money to subsidise wheelbarrows and trowels. Another study in America found that homeowners' children were far more likely to graduate from high school—even after controlling for parents' earnings. Researchers have struggled to discern which way the causality runs, however: does home ownership make good parents, or do good parents become homeowners?

Other evidence, meanwhile, finds that home ownership carries costs. The stresses of paying back a big mortgage are real. And the mad dash in the 1990s and 2000s to create "property-owning democracies" ended with the global financial system on its knees.

Home ownership does subtler sorts of economic damage, too. Indebted homebuyers are 30% less likely to become entrepreneurs, according to one study. Responsibility for a large mortgage debt may make people loth to take on further risk. When the home- ownership rate in an American state has risen, a sharp rise in unemployment has followed, according to David Blanchflower of Dartmouth College and Andrew Oswald of Warwick University. Homeowners are less willing to move to find work.

As the rented sector has grown in size, and as Generation Rent becomes a more powerful constituency, governments are putting more effort into improving the sector. One increasingly popular measure is rent control. London's mayor, Sadiq Khan, has advocated restricting rent rises in the capital. Berlin's legislators recently voted to freeze rents for five years. Paris reintroduced rent controls last year, having scrapped them in 2017. Such interventions are misplaced. Rent control generally dissuades investment in new construction, the last thing many of these cities needs.

More promising than rent control, however, is a move towards improving tenancies. Many politicians in English-speaking countries have Germany in mind. There, renting is not seen as a second-class tenure. It is fairly secure: the average tenancy lasts for 11-12 years, compared with 2-3 years in Britain. Some 3m Germans are members of tenants' organisations, which can bargain on their behalf with landlords (the mascot at one association in Munich is dressed like Superman and calls himself the "Rentstopper").

Emulating the German experience will be tricky. In Germany landlords treat tenants well not just to be nice, but because they have an incentive to do so. In recent decades Germany has seen little house-price appreciation. Since making money through capital gains is difficult, German landlords' best hope of getting a decent return is through keeping their tenants in place for as long as possible. Only if house prices in other countries were more stable would their landlords start to behave in this way, too.

Still, governments can make some reforms. Britain has abolished letting fees, a murky system of charges slapped on by estate agents using a methodology that renters and landlords rarely understood. Spain is moving to give renters longer tenancies as standard. New Zealand is passing rules to ensure that certain basic standards for rental accommodation are met.

Perhaps the most promising development, however, is growing private investment in the rental sector. Since 2010 global institutional investment in residential property has more than doubled in real terms, not only because investors are looking for yield in a low-rate world but also because the number of potential customers is rising. Across America the share of the rental sector owned and operated by companies is rising, according to research by Hyojung Lee of Virginia Tech. By one estimate, the annual number of homes in New York City bought by professional investors has doubled in a decade.

An expansion of corporate housing will raise average standards in the rental sector. Big firms may be more professional than mom-and-pop landlords, and may also benefit from economies of scale which allow them to provide better-quality accommodation at lower prices. "Build-to-rent" apartment blocks often include goodies such as gyms and free Uber rides with the rent.

That said, corporate landlords have a more transactional relationship with their tenants. A study of Atlanta, Georgia, published by the Federal Reserve Bank of Atlanta in 2016, found that large corporate owners of single-family rentals were 8% more likely than small landlords to file eviction notices. To help the poorest or most vulnerable members of society with their housing needs, governments may need to do more. ■