

Chapter 12

Income Related Loans for Low Income Households¹

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12.1 Introduction

Home ownership is a major goal for many Australian households. For households that have low, irregular incomes, however, home ownership and even adequate rental accommodation may be unachievable. In this chapter, we consider the housing problems facing low income households and how these households might be helped through a system of income related loans (IRL) that provide a type of insurance for housing. We call this IRL system a ‘housing lifeline’.

Australia has one of the world’s highest levels of home ownership. In 1999–2000, there were around 7.2 million households in Australia. Approximately 70 per cent of these households lived in their own home while 26 per cent rented accommodation. While current home ownership rates are approximately 69 per cent in the United Kingdom and 67 per cent in the United States, they are only approximately 41 per cent and 51 per cent for Germany and Netherlands respectively (Productivity Commission 2003, p. 29).

Further, by international standards, a large proportion of Australian home owners — almost 90 per cent — live in stand-alone or separate houses. In this sense, the quality of home that is owned by most Australian households is high compared to countries where apartment living is the norm.

Traditionally, however, many low income households in Australia have been excluded from home ownership and rely on the rental market for their housing needs. Further, these low income households are more likely to be dependent on government housing. To give an example, if we consider households comprising an adult couple with children, approximately 79 per cent own their own house and only 20 per cent are renting. Conversely, for one-parent households, only 49 per cent are home owners, 30 per cent rent from private landlords while 17 per cent rent from State or Territory Housing Authorities.² Of all renters, approximately one quarter rely on housing provided by a government authority.

For both owners with a mortgage and renters, housing costs Australia-wide come to approximately 20 per cent of gross income. But housing costs as a percentage of income vary significantly between geographic locations and between households. In particular, low income households may find adequate housing unaffordable, particularly in high-cost areas of Australia such as Sydney and Melbourne.

Housing affordability for low income households may be exacerbated or assisted by the interaction between different markets for housing and between housing and associated markets. As noted by Rothenberg *et al.* (1991, p. 3), '[h]ousing is not ... a single commodity but a complex of variously related commodities; the urban housing

market is not one perfect market but a set of interrelated submarkets'. Housing differs substantially in terms of quality between inner city apartments, affluent separate dwellings and outer urban public housing. For many households, housing is also a major investment asset. Indeed a house is the single largest asset most households will ever purchase.

Housing markets are inextricably linked with each other. As new high quality dwellings are built and purchased by the most affluent households, lower quality housing becomes more affordable for purchase by lower income households through a type of 'trickle down' process referred to as 'filtering'. The rental market and the market for home ownership are similarly connected through factors of supply and demand. For example, the construction and purchase of inner city apartments in Sydney, Melbourne and Brisbane for investment purposes has driven the rental returns on these apartments down to approximately 3 per cent in 2003 (Productivity Commission 2003, p. 21).

Housing markets are also tied in with financial markets. Most households require borrowed funds to buy a house and the lack of availability of mortgage funds can limit the housing options for low income households.

In order to design government policies to appropriately assist low income households with their housing needs, it is important to understand both the drivers of housing affordability and the linkages between housing markets and related markets. In this chapter we will argue that government policies towards low income housing have often been geared towards households with a long term income problem. In other

words, governments and welfare groups have concentrated on households that face long term affordability problems for housing. An obvious solution for households facing a long term problem of housing affordability is for the government to provide on-going rent assistance for these households, or for the government to directly provide housing for these households. As we note below, such policies have been widely adopted in Australia and overseas.

While some low income households are well served by these policies, they fail to address the needs of households who face a short-term income crisis. We argue that these households can be better served through a system of income related loans, similar in motivation and justification as the other IRLs examined in this book.

As we explain below, this ‘housing lifeline’ would not simply provide *ex post* protection for low income households but would also increase *ex ante* accessibility to housing and related financial markets for low income households. A system of income related loans for housing reduces risk for both the buyers and providers of housing services, both from bankruptcy and with respect to the payment difficulties associated with other forms of financial assistance. As well, the proposed system helps to eliminate the undesirable consequences of asymmetric information in housing markets.

12.2 Background Issues and the Nature of the Problem

Housing Affordability

Low income households face a housing crisis if adequate housing is unaffordable. In Australia, the past decade has seen low interest rates, low

unemployment and a relatively stable macroeconomic climate. These factors have resulted in a significant rise in the price of (owned) houses. Australian Bureau of Statistics figures show that over the three years from July 1998 to June 2001 the weighted average price of existing dwellings in Australia's capital cities rose by almost 8 per cent per year.³ This increase in housing prices feeds directly into rental prices, although as noted above the rental market, for example in inner Melbourne and Sydney, has been complicated by a significant growth in apartment stocks in recent years.

While the increase in housing prices reflects general prosperity in Australia, this prosperity has not necessarily been evenly distributed over the population. In particular, a rise in general house prices can lower the affordability of housing to those households who are dependent on low incomes.

Housing affordability is often defined relative to household income. For example, the National Housing Strategy (Department of Community Services and Health 1991) considered housing to be affordable if 'housing costs ... leave households with a sufficient income to meet other basic needs such as food, clothing, transport, medical care and education'. Under this definition, if a household is spending more than 25 per cent (for rent) to 30 per cent (for mortgage repayments) of its income on housing, then that household is experiencing an affordability problem.

Of course, this type of definition of affordability could apply to high income households who spend a lot on housing. Thus, this benchmark on affordability is usually only applied to households that fall into the bottom 40 per cent of the overall

distribution of income. In Australia, in 2001, the affordability threshold based on 30 per cent of the second quintile of average weekly household income was only \$141 compared with the median weekly rent in Australia of \$183 and a median weekly mortgage repayment of \$230.⁴ Berry and Hall (2001) determined that the proportion of private tenants in the bottom 40 per cent of the overall distribution of income paying more than 30 per cent of household income on rent is around 70 per cent Australia-wide, with an even higher rate in Melbourne and Sydney.

A definition of housing affordability that considers housing costs as a proportion of income does not allow us to easily distinguish between a housing problem and a low income problem *per se*. Low income households could be experiencing problems with housing affordability for two alternative reasons. The first is that these households, because of their low income, are finding many of the essentials for daily life to be unaffordable, including housing, food, and clothing. Thus, their income is low relative to the general cost of living in society and these households have an income problem rather than a specific housing problem. Alternatively, low income households may be finding it hard to make ends meet because housing, as a specific commodity, is highly priced relative to other essentials and as a result housing eats up much of the household's disposable income. Such a family has a problem of housing affordability.

To separate between issues of housing affordability and issues of general affordability, Glaeser and Gyourko (2002) adopt an alternative approach. They argue that a housing affordability problem arises when housing is expensive relative to its fundamental costs of production, including construction, taxation and regulatory costs. For this reason, they advocate using a benchmark of the physical costs of

constructing a house as a means of determining whether and where housing is too expensive.

If we believe that there is a housing crisis, then presumably the correct housing response will be to build more housing. However, the social cost of that new housing can never be lower than the cost of construction. As such, for there to be a 'social gain' from new construction it must be the case that housing is priced appreciably above the cost of new construction. (Glaeser and Gyourko 2002, p. 2)

Using this approach we can gain a sense of the affordability problem by comparing housing prices in a particular area to the construction costs in that areas.

As can be seen from Figure 12.2, house prices have increased at a faster rate than the cost of building materials in Sydney. A similar pattern is evident in Melbourne in relation to house prices and construction costs in general (Figure 12.3). In other capital cities, a divergence between house price increases and construction costs is a relatively recent phenomenon (occurring in the last two years or so).

Figure 12.2: Sydney House Prices and Building Materials Costs

HERE

Figure 3: Melbourne House Prices and Construction Costs

HERE

The potential divergence between construction costs and overall house prices can be seen from the following table reproduced from the Australian Consumer Association (2003). In this table, ‘project houses’ include the costs of housing without land while ‘established homes’ include both land and house prices as a package.

Table 1 here

Notice that, in Sydney, Melbourne, Brisbane, Perth and Canberra, there is a growing divergence between construction costs and house prices. This is not evident in other cities. Indeed, in Hobart and Darwin, there is a trend in the opposite direction; suggesting an improvement in housing affordability in those cities.

To the extent that housing affordability, particularly for low income households, has fallen in a range of Australian cities, there is scope for government assistance to low income households. Roughly speaking, these government policies can be classified as either supply-side responses or demand-side responses.

Government housing policies for low income households: supply-side issues

Supply-side policies around the world typically comprise a variety of public housing projects and developments. In Australia, the bulk of public funds for housing development come through the Commonwealth–State Housing Agreement. This agreement involves capital grants to State Housing Authorities who in turn provide public housing and direct aid to community housing organisations for social housing.

These payments also fund crisis accommodation, and loans and grants to private investors to offset initial costs.

In the past, United States housing policies have had a similar thrust. In recent years, however, there has been a move away from supply-side to demand-side policies (Quigley, 2000).

In Britain, there is a long tradition of state provided public housing; usually managed by local councils. This policy has undergone a revolution in the last two decades with strong moves towards owner-occupier solutions and private sector ownership. This has been achieved primarily by substitution of government funds for demand-side policies.

In the Netherlands, a significant level of housing stock remains in public hands with management provided by housing associations in a largely decentralised manner.

A recent major proposal to address low income housing affordability in Australia commissioned by the Affordable Housing National Research Consortium (AHNRC) has focussed on a supply-side response. The AHNRC is a national committee with representatives from the housing, building and development industries, trade unions and not-for-profit organisations. It commissioned the Australian Housing and Urban Research Institute (AHURI) and the Allen Consulting Group to undertake an extensive study into the nature of the affordable housing problem and the options for public policy in this regard.

Their report (AHURI, 2001) advocated and costed a preferred policy response that involved:

- *Public debt raising.* The state and territory governments should raise debt through a long-term bond issue at market prices to private investors. Institutional investors were seen as potential purchasers of these bonds in the current environment of low public debt in Australia.
- State government acquisition of new and existing dwellings. Housing authorities in each state (or SHAs) would use the funds to acquire dwellings.
- Federal government subsidised rent. Those dwellings would be let out at low rents to eligible tenants. This will mean that the returns on the government dwellings will be insufficient to cover the bond financing costs (as these are at market rates) and the operating costs on the dwellings. The gap would need to be covered by the Federal government for the life of the program.
- *Progressive sale.* The dwellings would not remain in public hands indefinitely but would be progressively sold off when they fell vacant. The sale would be used to repay debt.
- *Sunset.* Those dwellings still in government hands at the end of 20 years would be sold and the remaining debt would be retired. Sitting tenants at that time would have to be relocated. Of course, it is also possible that an SHA may decide to retain this stock in public hands. In this case, state governments would be required to bear subsidy costs.

The Consortium argues that this program is cost effective for the Federal government

because for each dollar in subsidy, \$4.50 in housing can be acquired – that is, \$3.50 comes from private investors. This is compared to the alternative where all \$4.50 comes directly from the Federal government.

It is argued by the Consortium that this approach involves a public-private partnership and brings new private funds into public housing. Such a claim, however, is simply an illusion of accounting. Government expenditures on housing can and always have been met by a combination of taxation and government debt. The Consortium is arguing for an increase in debt rather than taxation to fund public housing. They compare this to the alternative where public housing is funded totally out of taxation revenues. As Berry (2002, p. 9) notes: ‘the Consortium model reinvents public borrowing for social housing’.

The AHURI proposal suffers from the presumption that those households who are not adequately served by an unfettered private housing market must be removed completely from this market. Such a presumption leads to a policy where public housing is financed, owned and managed by the government.

The fallacy underlying the above presumption was recognized by the great urban activist Jane Jacobs. When considering the housing needs of low income households, she notes that:

these are people whose housing needs are not in themselves peculiar and thus outside the ordinary province and capability of private enterprise, like the housing needs of prisoners, sailors at sea or the insane. Perfectly ordinary housing needs can be provided for almost anybody by private enterprise.

What is peculiar about these people is merely that *they cannot pay for it*
(Jacobs, 1961, 323–4; italics in original).

Inadequate private provision and allocation of housing does not necessitate public provision and allocation of housing (eg, Olsen 2001). Further, public provision and allocation of housing necessarily ignores significant aspects of individual tastes and preferences. In other words, public housing, while attempting to solve a failure of the private market, also neglects the benefits of housing allocation associated with the private market. It replaces individual and household choice with some form of bureaucratic decision making.

Government housing policies for low income households: demand-side issues

While supply-side policies focus on government provision of housing, demand-side policies assist households to gain suitable housing through the private market. Thus, demand-side policies involve less micro-management than supply-side policies and provide greater discretion to the recipient households.

A common policy, both in Australia and overseas, is to provide low income households with rent subsidies. This type of policy has many forms, including subsidies paid directly to low income private tenants and direct payments to landlords to ‘compensate’ for the provision of housing to low income households. The calculation of the relevant subsidies, eligibility criteria, specificity of the payments and mode of payment differ widely between jurisdictions.

In the United States, part of the Section 8 voucher program provides subsidies for low income households who choose to live in a certain minimum standard of accommodation. The subsidy covers the difference between 30 per cent of the household's income and a defined 'fair market rent'. The scheme is administered through a local public housing authority which determines the 'fair rent' for the unit. The relevant household, once they rise to the top of a waiting list, can search for any dwelling that satisfies the programs requirements.⁵ The public housing authority then pays the subsidy directly to the landlord on behalf of the tenants. The tenants pay the difference between the subsidy and the actual rent of the dwelling. Eligibility for the program is geographically based, with relevant households having less than 50 per cent of the median income for the relevant area.

In Australia, a similar type of rental assistance is available, for example to individuals who receive a government pension or to households with dependent children who satisfy relevant criteria under the family tax benefit scheme. Payments are made to households who rent a dwelling from a private landlord and the payment is made to the household in addition to the other benefit payments being received by the household.⁶ Rent assistance is calculated at three quarters of the rent being paid by the household above a minimum threshold, up to a maximum payment. For example, for a family with a single adult and one or two dependent children, the maximum payment in 2003 was \$109.48 per fortnight. Rent assistance only applied if your rental bill was at least \$109.06 per fortnight and the maximum rent (to receive the maximum payment) was \$255.03 per fortnight. The payments do not vary across cities or regions. For this reason, it targets low nominal income rather than low real income households.

Rental assistance schemes need careful design. Because they tend to be based on current rather than lifetime income, they can easily lead to poverty traps for low income households. These programs may be viewed by governments as a drain on funds, and as the US experience shows, they may involve funding that only covers some and not all low income households. Depending on the form of payment and the dwelling criteria, these schemes may distort dwelling choice. For example, the Australian scheme which has an *ad valorem* subsidy effectively reduces the marginal price of housing to low income households once rent is above the minimum threshold and until it reaches the maximum. Such a subsidy will tend to push rental demand towards the maximum thresholds. This can involve households choosing ‘too high’ a level of housing relative to other inputs of equal or greater importance to family welfare (e.g. clothing, food, education, child care, etc). It can also lead to ‘bunching’ in the rental market, where much rental accommodation is offered near the maximum cut off with a reduction in more moderate housing.

The design of the US Section 8 program leads to restrictions on the choice of housing by its users. The minimum standards condition combined with a top spending limit of 40 per cent of income greatly reduces the range of quality of housing that can be selected by tenants in the program. The minimum standards condition necessitates regular inspections by the authorities and additional upkeep by landlords. This burden would decrease the supply of properties made available by landlords for this program.⁷

The waiting lists associated with the section 8 program mean that it is unlikely to assist those households facing short term, temporary distress. In addition, once a household reaches the top of the waiting list they may need to move home in order to participate in the program, due to their current dwelling not meeting the program minimum standard. This clearly increases the transaction costs inherent in the program and effectively reduces the choices of participants who wish to remain in their current dwelling.

Governments may assist low income households to purchase housing rather than rent housing through some form of 'ownership subsidy'. The first home owner scheme in Australia represents an ownership subsidy scheme. It only applies to first home owners and has very broad eligibility criteria. In this sense, it does not focus on low income households, although such households also enjoy the benefits of the scheme.

The US section 8 program includes vouchers for first home owners. Like the rental vouchers program, it is administered through public housing authorities and has minimum quality requirements for the dwelling. The scheme has minimum and maximum income criteria and also an employment criterion. It is generally only available to first home owners. This said, there is no separate funding for this home ownership scheme. Public housing authorities who participate in the scheme must draw funding from other voucher arrangements and authorities do not have to participate in the scheme.

Governments may also use the tax system to implement demand-side housing policies. In the US, the Low-Income Housing Tax Credit programme provides tax

relief for investors in long-term low income housing. There is certainly scope, therefore, for governments to use tax relief to encourage investment in housing for particular types of households. However, the scope for tax relief to low income households themselves is limited by the fact that those households usually do not incur significant levels of tax relative to housing costs.

A number of alternative demand-side policies have recently been mooted in Australia. Gavin Wood (2001) formulated a proposal that is similar to the US low-income housing tax credit. He proposed two reforms to the tax system:

- *Income tax credit.* Investors with dwellings that have rents below a certain threshold (Wood considers \$100 per week), would receive tax credits.
- *Capital gains tax reform.* There would be relief from capital gains tax on the first \$10,000 of capital gain for these dwellings.

As formulated by Wood, this policy would be an entitlement to any investor at the lower end of rental accommodation. The policy, at its heart, is a government subsidy, albeit that it is organised in a non-transparent way through reductions in taxation payments. The policy also raises issues of accountability relating to length of low income tenancy, the legitimacy of tenants and the nature of the dwelling. The policy may lead to the inappropriate downgrading and degradation of some housing stock, in order to meet the program requirements.⁸ Such a scheme would need to be carefully designed to prevent gaming by investors.

Caplin and Joye (2002) discuss the possibility of using shared equity schemes to increase housing affordability. Under this system, a lender, such as a bank, would

retain an equity interest in a dwelling, reducing the amount of capital required to be borrowed by a household seeking to buy the property. A household would then be able to 'balance' its debt and equity exposure to the housing market, much as commercial businesses manage their mix of debt and equity financing.

While a shared equity scheme may assist to improve overall housing affordability, it is not geared to low income households. As we discuss below, many of these households face significant problems when attempting to access traditional financial or rental markets, so that a share equity scheme by itself may do little to benefit low income households.

Low Income Households and Market Failure

The government policies discussed above tend to focus on longer term solutions to housing affordability for low income households. In other words, the policies are geared towards households who not only have current low income but are likely to continue to have low income for the foreseeable future.

However, housing affordability is often a problem for low income households due to temporary distress. A low income family might find housing affordable most of the time, but can remain vulnerable to income shocks that make housing unaffordable for short periods of time. For example, consider a low income family whose main income earners often experience short spells of unemployment. This may reflect the nature of the jobs held by family members. While over the household's 'life cycle' it might have adequate income for housing, at particularly stages of that life cycle, housing may be temporarily unaffordable. For example, housing stress may occur when

children are young, particularly if this coincides with a period of unemployment for an income earner.

Similarly, low income households may be adversely but temporarily hit by short term income shocks, for example due to illness or accident. These shocks may make housing unaffordable in the short term. Government policies aimed at long-term housing relief, particularly those policies that involve moving to particular dwellings, will often be inappropriate in these circumstances. Indeed, to the extent that a household must 'lose' its current housing before it can receive government assistance or faces high effective marginal tax rates once government assistance is accessed, government policies may inadvertently change short-term housing distress into a long-term affordability problem.

In theory, financial markets should be able to deal with problems of short-term loss of income. However, it is well understood that financial markets suffer from potential problems of asymmetric information that may lead to market failures such as credit rationing.⁹ These market failures will fall most heavily on low income households.

Credit rationing arises due to adverse selection problems in financial markets.

Potential lenders may have difficulty distinguishing between individuals who would be able to make repayments and those who cannot. As a result, potential lenders may be reluctant to provide funds to customers who appear more risky; for example individuals with a lack of credit history or who are proposing more risky investments.

This problem of asymmetric information is different to a problem of risk. After all, risk accompanies all lending and, in the absence of information asymmetries, more risky borrowers would simply face higher interest rates than less risky borrowers. Rather, the problem is that the potential lender cannot adequately distinguish between high and low risk borrowers and so may be reluctant to lend any funds.

Note this problem of uncertainty is paralleled in the provision of private sector finance for higher education, as elaborated in Chapter 2, and among other possible IRL applications including for drought relief (Chapter 9), elite athlete financing (Chapter 10) and social investment projects (Chapter 13). That is, lenders find it difficult to determine which borrowers in these contexts will be able to make repayments and which will struggle. With respect to student borrowers, for example, there is a lack of suitable collateral in the case of default, leading to the under-provision of finance.

Further, the problem of information cannot be solved by simply raising the interest rate on borrowed funds. Raising interest rates may simply act to dissuade the low risk borrowers leaving only the high risk borrowers. After all, the high risk borrowers, who know that there is a higher chance they might default on the loan, will be less influenced by interest rates. In this way, a simple interest rate charged equally to all potential borrowers, adversely selects for borrowers with a higher risk profile. To attempt to solve this problem a lender might try to ration credit; attempting to infer borrower risk through indirect means.

In the financial markets that provide loans for purchasing housing, a number of standard tools have developed to deal with adverse selection. Lenders often ration credit on the basis of income history and income potential. Borrowers who have a steady history of income earnings or who are trained and employed in 'stable' professions are more likely to receive funds than potential borrowers with variable income histories or who are employed in less stable industries. This clearly has an undesirable effect on low income households, particularly those with a chequered history of employment. Such households will tend to be excluded from access to housing finance.

Lenders may also deal with adverse selection by shifting risk back onto the borrower. This is most easily achieved by requiring a large deposit on a house before funds are provided. This reduces the risk that the financier will be stuck with a house that is valued at less than outstanding debt if default occurs. But again, low income households will be most adversely affected by this solution, as they are least able to save for a significant housing deposit while at the same time paying for rental housing.

Lenders can also shift risk onto a third party, requiring potential borrowers to have a third party guarantee the loan. Again, low income households are adversely affected by this solution as they are less likely to have 'richer' family members or friends who can act as guarantors, a point that applies also to prospective student borrowers.

Overall, we would expect that asymmetric information in housing finance markets will impact most heavily on low income households, limiting their access to housing finance.

Similar adverse selection problems arise in rental markets. Investors are keen to rent properties to households or individuals who will be able to pay the relevant rent and who will minimise depreciation of the dwelling. But landlords cannot tell the exact risk associated with particular tenants and will try to infer this risk from other factors. Again, an obvious method used by landlords to distinguish between tenants is their employment history and their current job and income. This discriminates against low income households who are viewed as having a higher risk by landlords.

Other common methods that have historically been used by landlords to vet tenants include the marital status of potential tenants, whether the household includes children and the number of adults in the household. While explicit use of these types of characteristics would violate current anti-discrimination laws in Australia, landlords will still be tempted to try and infer tenant risk from information they can gain about the tenant. This makes the rental prospects for low income households less certain than those for higher income households.

The use of economic discrimination in both financial and rental markets biases those markets against low income earners. This discrimination need not reflect any bias on the part of lenders or landlords. Rather it is simply a rational attempt by lenders and landlords to at least partially overcome information asymmetries in these markets. However, the end result may be to ration many low income households out of the

private markets for housing. Put simply, the market imperfections can make housing unobtainable for low income households.

These problems relate not only to low income *per se*, but also to income risk. If a potential borrower has inadequate income to cover repayments, then that borrower will not be lent the funds to buy a house. However, even if a potential borrower is likely to have adequate funds *on average* to cover a home loan, if that household's income is variable then the probability of default is higher and they may also be able to access housing funds.

Income risk is something that faces all households. It can arise through a number of sources. For example, unemployment is usually associated with a significant but temporary drop in income for individuals and households. Injury or significant illness can also lead to a sudden reduction in income.

An unforeseen drop in income can lead to a large but temporary reduction in housing affordability for the relevant household. For example, if the household is renting, then it may be impossible for the household to make its regular rental payments when it suffers a sudden reduction in income. In such circumstances, the household faces eviction. Similarly, recurring mortgage payments may not be met due to a sudden income shock, leading to potential foreclosure.

Income risk, like any other form of risk, can be reduced by insurance. For example, income protection insurance is available to households. Similarly, both landlords and lenders may be willing to renegotiate agreements to overcome short-term income

shocks. After all, finding new tenants or foreclosing on a mortgage and selling a property are both expensive activities. Both landlords and lenders have incentives to take actions to avoid incurring these expenses. Finally, households may self-insure against income risk, for example by keeping ahead of mortgage payments or by keeping a readily accessible pool of savings.

These solutions to reduce the cost of income risk, however, are less likely to be available to low income households. For a household with a history of unemployment, income protection insurance is likely to be either unavailable or prohibitively expensive. The moral hazard problem facing the insurer makes such insurance unviable. Self-insurance through discretionary saving is difficult, if not impossible, for low income earners. And renegotiation to avoid foreclosure or eviction is less likely to occur for higher risk, marginal households.

Consequently, low income households are likely to face significant residual income risk that creates short-term housing crises for these households. Government housing policies are not geared towards dealing with income risk and short term crisis. For example, Federal government rental assistance in Australia only becomes relevant once a household becomes eligible for other forms of benefits. In the US, Section 8 voucher programs often involve waiting lists, meaning that they are unable to meet the needs of low income households facing short term distress. As a result, existing policies only tackle part of the problem of low income housing.

12.3 Applying Income Related Loans

The Housing Lifeline

If existing government policies geared at low income households housing needs are inappropriate to deal with income risk, what should be done? One approach, first considered in Gans and King (2003) involves the use of income related loans by the government to help households overcome short term income fluctuations. This IRL scheme aims to increase access to financial and rental markets for low income households, by limiting the undesirable consequences of adverse selection on landlords and lenders. It also aims to help protect low income households from the adverse housing consequences of a short-term income shock.

The amelioration of default risks and the effect of income shocks parallel the effect of HECS on the education finance market. These motivations are also clear in the design of IRL for drought relief (Chapter 9), for elite athlete financing (Chapter 10), and for community investment projects (Chapter 13).

The Housing Lifeline involves governments addressing the income risk associated with low income households directly. The government would provide a form of income insurance to these households, to ensure that short term income fluctuations do not create long term housing problems. For example, the government might allow a household that has suffered a short-term drop in income, due to say unemployment or temporary lay off, to draw down a payment (say up to an eventual maximum of \$5,000 to \$10,000) towards rental or mortgage costs. The funds would form an IRL for the household. In other words, a low income household that chooses to draw down

on the housing lifeline is not receiving a gift from the government but faces a liability for future payment. However, this future payment is related to future income, further insuring the household and avoiding long term poverty traps.

To see how a housing lifeline would work in practice, suppose that a household suddenly finds itself facing a crisis where it is likely to be unable to meet short-term commitments for housing payments. A housing lifeline means that the household would be able to draw down a payment from the federal government to tide it over the short-term crisis. This payment would be a loan to the household, but the loan would be automatic. In other words, the household would face few if any hurdles — perhaps no more than a simple liquid asset test — in the short-term when accessing the lifeline funds. However, the household would incur a future tax liability associated with the loan. In other words, the lifeline is an income contingent loan. The liability may or may not have a reduced interest rate associated with it, depending on government policy. For example, to limit long term government exposure to lifeline debt, the lifeline interest rate might be set equal to the long-term government bond rate. This is likely to be substantially below equivalent interest rates available to low income households.

Payments to a household would be capped. The housing lifeline is designed to provide short-term relief, not to provide a permanent source of support for those households who will not have the means to adequately fund housing in the medium to long-term. Thus, while the lifeline might displace other programs such as rental assistance in the short term, it does not replace other long-term welfare programs but supplements these programs by providing more appropriate short-term assistance to low income

households facing temporary crisis. The payments may be capped on both a weekly and a total basis. For example, it might be possible to ‘borrow’ up to \$200 per week under the cap up to a total of \$10,000. Thus, the scheme would provide up to 50 weeks (or more if less than \$200 was drawn upon) support for a relevant household.

The maximum length of the lifeline payments might be twelve months. Even low income households who face a crisis due to unemployment usually find new work within six months. The lifeline is designed to deal with short term stress and it is reasonable that a household that still faces an income crisis after one year requires longer term assistance.

The payments under a housing lifeline would be tied to housing. Thus, funds would be paid directly to a (registered) landlord or lender specified by the relevant household. This would require a contractual agreement that ensures that the funds do reduce the household’s liability to landlords and lenders directly. At present, Medicare payments operate in this manner.

Drawing down the lifeline would be a choice made by the relevant household. But because this access to an instant ‘line of credit’ removes a substantial amount of the risk that would otherwise face lenders and landlords who provide housing solutions to low income households, the lifeline directly addresses the problems embedded in the rental and mortgage markets. Thus, while the lifeline is designed to provide short term housing insurance for low income households and as such is drawn down after a crisis occurs, this insurance will increase the ability of low income households to access

housing markets. It removes some of the problems of adverse selection that otherwise face lenders and landlords.

The risk, of course, does not disappear, but it is both reduced and it is passed onto the government. The risk is reduced because the government takes on a portfolio of 'loans' to low income households. Unlike an investor with only one or two properties, the government can pool the risk of income loss for low income households, reducing the idiosyncratic variability of that risk.

Passing the risk onto the government also has important economic advantages. In particular, unlike a private lender or landlord, the government has the substantial advantage of ensuring appropriate repayment of any lifeline loan through the taxation system. In this sense, an IRL provided by the government involves a lower repayment risk than an equivalent private loan. These features of the lifeline address several of the same conceptual issues that IRL schemes for education finance, drought relief, elite athlete financing, and other case studies considered in this book.

The important generic contribution of IRL is as true in this example as it is in the other case studies. The fact that future capacity to pay defines the repayment obligation helps to eliminate the default risk inherent in standard loans for borrowers and lenders. Further, the IRL schemes reduce the need for income protection insurance from the private capital market, some thing difficult to obtain for both students/graduates and low income earners.

As well, the government potentially saves some welfare expenditure through the housing lifeline. Most obviously, to the degree that a household is able to draw down the lifeline so that the household is less reliant on other government assistance, the lifeline reduces demand for short term government assistance. More importantly, by reducing the adverse consequences of a short term income shock, the lifeline should help low income households from sinking into long term poverty. Given the higher average rates of earning of graduates this benefit is likely to be much greater under the lifeline than under HECS.

In theory the housing lifeline could be substantially self-funding. So long as the interest rate charged by the government is above the long-term bond rate on government funds and accumulated debt is eventually repaid, the government will be operating on the same funding principles as any lender.

In practice, of course, full repayment from every household will not be possible. Some households will move from temporary to long-term crisis and will be unlikely to ever gain a lifetime income that would allow repayment. In such a situation, the household can be transferred onto appropriate long-term benefits after the lifeline expires or when the long-term nature of the crisis becomes evident.

At the same time, it must be recognised that the housing lifeline will help low income households who face short-term crisis from becoming dependent on long term welfare. In this sense, the lifeline could be highly cost effective for the government even if it does not cover its own cost because it avoids the government paying other benefits over a longer period of time.

To see this consider a low income household suddenly faced with an income crisis. The household may face eviction or foreclosure. This may force them to move to alternative housing in the short-term and may force them to move onto government benefits. In the medium-term, the crisis will harm the household's credit standing so that it may be harder for the household to gain appropriate housing in the future. Thus, the temporary income crisis may lead to a long-term housing crisis for the household. The timely and temporary intervention allowed by the lifeline can avoid these long-term problems (with the associated long-term government payment of benefits).

The government might also choose to subsidise the lifeline interest rate, or to apply the type of interest rate arrangement which operates with HECS, explained in Chapter 4. Subsidies would increase the cost of the lifeline for taxpayers, but also create greater protection for low income households by limiting their lifeline debt exposure.

Implementing a housing lifeline obviously requires policy makers to address a number of important practical issues. For example, it is important to determine both the weekly draw down available under the lifeline and the maximum debt level available under the lifeline. For example, a weekly loan of around the level of current rent assistance, say \$A200 to \$A250 per week, might be appropriate under the lifeline. Unlike rent assistance, the lifeline would be automatic so that households would not be required pass eligibility waiting periods as is required currently under rent assistance. Alternatively, it might be felt that a slightly higher weekly draw down

should be possible under the lifeline. After all, the lifeline is a loan, not an entitlement.

The example given here is Australian. However the lifeline principle would appear to be highly transferable to other countries. For example, at first glance the lifeline would appear to have a number of advantages over the US Section 8 program. It would likely improve the range of housing choices available for affected households by allowing households to choose their own housing within their affordability constraint. Removing waiting lists and providing the lifeline to all eligible households would improve equity. The lifeline repayment criteria should increase the overall contribution rate by recipients from the current low level, and the contribution rate would be linked to future capacity to pay. Finally the current 3 way contract, with the government agency and the tenant both paying the landlord, would become a series of simpler 2 way contracts, with the government agency paying the household and the household paying the landlord.

As with all government programs, the rules of the lifeline need to be carefully designed to avoid people 'rorting' the system. This involves issues such as potential adjustments for the number of people in the household (in particular, the number of dependents) and for different household configurations. These issues, however, must also be dealt with under the existing social security and taxation system. Lessons from these schemes can be used to implement the housing lifeline.

Critiques of the Lifeline

Since the lifeline was originally proposed in Gans and King (2003) it has raised significant feedback from those interested in low income housing issues. While much of the feedback has been positive, some has raised questions about the usefulness of a housing lifeline. A number of these criticisms are summarised in Productivity Commission (2003, p.153-4). In this section, we briefly consider some of the issues that have been raised regarding the lifeline.

One immediate question that arises with the lifeline relates to private sector financial institutions. Isn't the housing lifeline something that could be done by private financial institutions? Why can't banks and other lenders provide temporary loans to households in crisis? This question however misses the underlying rationale of the lifeline, which is to overcome private sector market failure. Banks cannot easily distinguish between households who face short and long-term housing crises. As they do not wish to manage the risks of loan default, they naturally shy away from lending to households precisely when they might need a loan most.

The government, however, already bears the risk associated with long-term housing crises. Therefore, while it faces funding issues associated with managing its own debt, this is not related to the particular, unknowable status of a particular household. It also has the ability to use the tax system to monitor income and repayments. In this respect, the government is in a better position than private lenders to provide a 'no questions asked' lifeline to households in crisis. They can assist those households for which the crisis is short-lived while continuing to assist those with long-term needs.

A second critique is that the housing lifeline will encourage excessive home ownership, by reducing the risks associated with taking out a home mortgage. With the lifeline, households face a reduced risk of default because of a short-term inability to meet repayments. For lenders, this reduced risk of default will change the criterion upon which they can accept loans from low income households. In this respect, it will improve access to credit.

However, the lifeline does not explicitly encourage home ownership over renting. The lifeline payments will apply equally to owners and renters. Thus, landlords will face lower risks of non-paying tenants and hence, there will be improved access to rental properties for low income housing. The lifeline is designed to make housing more affordable regardless of whether housing is owner-occupied or not.

A third critique is the exact opposite of the second. The lifeline is not appropriate because it does not encourage greater home ownership. For example, it does not directly address the ‘deposit gap’ faced by low income households.

We agree that the housing lifeline does not artificially bias low income households towards home ownership as opposed to rental accommodation. Indeed, it is far from obvious to us that such a bias would be desirable although this type of ‘ownership bias’ seems to underpin much recent concern over housing affordability more generally. However, the criticism also fails to understand the private sector issues that drive affordability problems for low income households. To see this, ask a simple follow up question — why does the ‘deposit gap’ exist?

As noted above, increasing deposit requirements is one way that private sector financial institutions can attempt to overcome asymmetric information. A deposit requirement both reduces bank risk and signals the bank that the borrower can save a reasonable sum of money *at the same time* as paying rent. In other words, the deposit requirement is designed to weed out high-risk low-income households as potential borrowers. It does this by weeding out all low-income households! A policy, such as a ‘home owner’s grant’ that attempts to directly address the ‘deposit gap’ in fact fails to address the underlying market failure that drives this gap in the first place. In contrast, the lifeline is clearly designed to address the market failure in private financial markets. It solves the underlying problem rather than acting as a band aid solution.

A fourth critique of IRL proposals aimed at low income earners is based on the argument that ‘the poor don’t like debt’. The implication is that any IRL arrangement would have low rates of take up by those with lower incomes, due to an aversion to debt, reducing the effective targeting of any such IRL scheme.

Debt aversion is linked to fear of default and subsequent damage to material standard of living and credit reputation. However a properly designed IRL addresses this very issue directly — agents cannot go bankrupt repaying the IRL, because if there is no capacity to repay then no repayment is required.

The Australian experience to date of the HECS scheme, reported in detail in Chapter 4, is strong evidence against this critique. These HECS experiences provide comfort that low income groups would access the lifeline.

Finally, it has been noted that households use a variety of strategies to guard against periods of income stress, such as saving and income insurance. This is of course true, but again fails to consider low income households specifically. As already discussed, these households are unlikely to be able to buy appropriate income insurance and will not be able to 'self insure' through saving. Indeed, if taken seriously, this criticism could be used against all government welfare policies. After all, why have unemployment benefits when households can save to protect themselves in periods of unemployment? Why have government provided health insurance when we could all rely on private insurance?

In fact, the criticism that government intervention is not needed misses the point. The housing lifeline is not aimed at protecting the well off but rather aims to help the least well off in society. The fact that the well off have other private options available to them is good, and we would encourage the use of those options. But this does not mean that low income households can be ignored by the government.

12.4 Summary

The housing lifeline provides a potentially powerful tool to protect low income households against income shocks and housing loss. In so doing, the lifeline opens up financial and rental markets to low income households. It has a number of similarities to other IRL applications in that it is based on lifetime income rather than current income, it limits the impost of government funds while providing short-term relief for relevant households, and it is a product where benefits are determined by the needs and requirements of the low income household themselves. Unlike alternative welfare systems it avoids creating a poverty trap by treating payments as a loan rather than an

entitlement that is 'lost' as income rises. Thus, a housing lifeline can retain incentives for households to take appropriate actions and risks to improve their standard of living.

Most importantly when considered in the context of this book, unlike loans that might be provided in other ways, the lifeline provides both default insurance and the capacity for consumption smoothing. This again is the main message of all IRL applications.

ENDNOTES

- ¹ Thanks to Richard Hayes for excellent research assistance in preparing this chapter, and Bruce Chapman for his helpful suggestions. Parts of this chapter are drawn from Gans and King (2003; 2004a; 2004b).
- ² The statistics referred to here are from the Australian Bureau of Statistics 2003 *Year Book Australia*.
- ³ Australian Bureau of Statistics (2002) *Yearbook of Australia 2002: Housing prices*. At the same time it must be recognised that changing house prices are closely tied to regional factors, particularly outside Australia's urban regions. Thus some country areas have experienced huge rises in house prices in recent years (eg, North coast NSW) while other rural areas have seen house prices fall.
- ⁴ ABS figures presented in HIA (2003).
- ⁵ Demand for the program significantly exceeds the available funds, leading to waiting lists of applicants.
- ⁶ In other words, rent assistance is a supplemental benefit that is only paid to households who are receiving a primary benefit from the Australian government.
- ⁷ See Steele (2001) for a fuller discussion of the effects of Section 8 program design on the choices available to its participants.
- ⁸ As a simple example, an investor seeking to gain the benefits of the scheme could take a single dwelling, rented at \$200 per week, and divide it into two dwellings, each rented at

\$100 per week. At one extreme, this may simply be done as an accounting trick — without even a change in tenants. At the other extreme, where each dwelling requires specific individual features, the division may involve costly (and possibly inappropriate) modifications to the dwelling that reduces its utility for housing.

⁹ See, for example, Stiglitz and Weiss (1981).