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THE IMPACT OF HOUSE PRICE & RENT AFFORDABILITY ON COMPETITIVENESS

- The affordability of housing is a key component of competitiveness and has a direct impact upon the cost of living and wage demands
- For the purposes of this Bulletin, housing affordability is measured by examining the proportion of household income that is spent to meet housing need, whether purchasing a home or renting
- Affordability issues are more acute in cities
- Of the 12 national and international cities compared, 5 had a higher price-to-income ratio than Dublin
- Taking account of the higher cost of mortgage finance in Ireland, only 2 cities (Amsterdam and London) had a higher "mortgage affordability index" than Dublin (i.e. this index combines a price-to-income ratio and the cost of a mortgage; the higher the index, the less affordable property is to purchase)
- In terms of rent as a percentage of income, 3 international cities were found to be less affordable than Dublin, while 8 were more affordable
- Rent affordability is more challenging than mortgage affordability in several Irish cities such as Galway and Cork (i.e. residents are required to spend relatively more of their incomes on rent than they would on a mortgage)
- Affordability is increasingly challenging for renters who aspire to purchase and must save a significant deposit whilst simultaneously paying relatively high rents
- Ensuring a competitive mortgage finance market is important to improve affordability
- A number of international cities have higher price-to-income ratios than Irish cities. This suggests that current Irish price levels could persist in the medium to long run
- It is essential that a long-term approach be taken to ensuring a sustainable housing market - increased supply is required to address growing demand and to dampen house price and rent increases
- To incentivise increased supply, prices need to exceed costs. However as a result of the Central Bank mortgage rules, prices are, in effect, capped relative to incomes (for domestic borrowers). Therefore, there is a need to better understand the elements constraining supply and to then reduce development and construction costs relative to incomes and prices
- The Action Plan for Housing offers an important opportunity to bring a coherent and consistent whole-of-Government approach to housing policy, and to ensure the delivery of housing supply sufficient to meet demand at a price level that is affordable, accessible and sustainable. There is, however, no quick fix to the current challenges

INTRODUCTION

Housing is an essential part of any society, but also one that has been the source of economic vulnerabilities and crises. The primary challenge, at present, is to deliver housing supply sufficient to meet demand at a price level that is **affordable**, **accessible** and **sustainable**.

Affordability of housing is a key component of competitiveness. It impacts upon the attractiveness of Ireland as a location for investment and directly impacts on enterprise costs through wage effects, and indirectly determines the price of Irish goods and services. The cost of housing influences labour mobility and contributes to an economy's ability to adjust to adverse shocks. In short, a well-functioning housing and construction sector is critical to the overall health of society and the economy.

CURRENT CONTEXT

Housing Supply and Demand

By any measure, the collapse in the supply of new residential units in Ireland has been dramatic (Figure 1). From an unsustainable peak of 93,019 units completed in 2006, new housing supply fell to just 8,301 units in 2013, before recovering marginally to 12,666 in 2015.

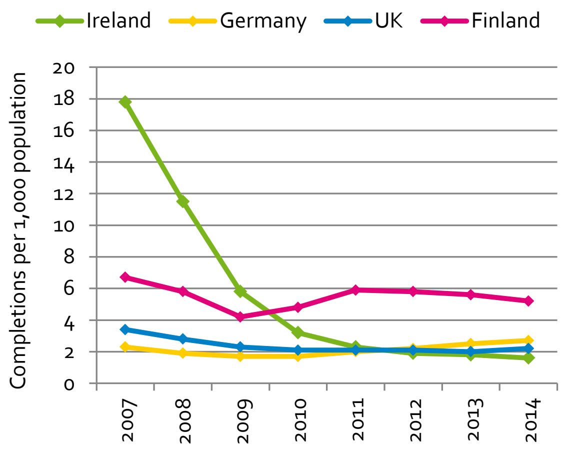
Against the backdrop of this collapse in supply, demand for housing is expected to continue to increase. Irish population growth is amongst the fastest in the EU, and our population is forecast to increase from 4.6 million in 2016 to 5.2 million by 2031[1].

To address the impact of increasing demand - arising from a growing population, the trend towards smaller household size

1 CSO, Population and Labour Force Projections 2016-2046, April 2013

(thus requiring the supply of additional housing units[2]), and the obsolescence of existing stock, the Housing Agency estimates that, at a minimum, an additional 21,000 residential units would be required each year between 2015 and 2017 – a figure we are currently failing to meet, with obvious consequences for prices[3].

Figure 1: Dwelling Completions per 1,000 Population

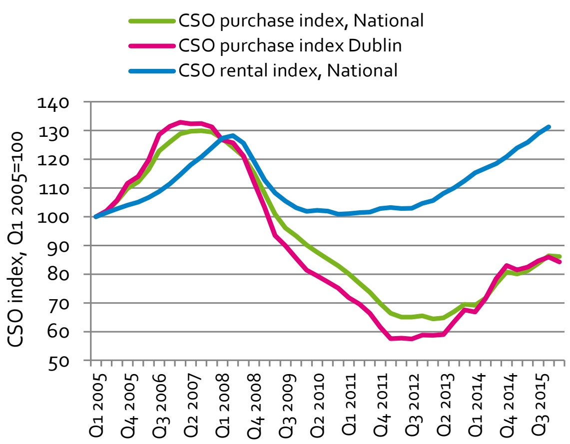


Source: : CSO, Sustainable Development Indicators 2015

Purchase Price and Rental Costs Trends

Figure 2 displays house prices and rents for Ireland from 2004 to 2016. Irish house prices fell dramatically following the onset of the recession. Despite recent increases, the scale of reduction in house prices since 2007 is still apparent and purchase prices remain far below pre-crisis levels.

Figure 2: Trends in Irish House Prices and Rents



Source: Central Statistics Office

The estimates of the peak to trough fall in prices range from 50% to 66%, while the recent recovery in house prices ranged from 9% to 34%.

2 The Housing Agency estimates that, by 2018, 75% of all households will be 3 people or less: 25% will be 1 person; 31% will be 2 person; 19% will be 3 person households.
3 Housing Agency, National Statement of Housing Supply and Demand 2014 and Outlook for 2015-17, July 2015

Examining the rental sector, following a sharp fall at the onset of the recession, average Irish rents in 2016 are above the previous peak witnessed in 2008. The estimated peak to trough reduction in rents ranges from 21% to 28%, highlighting the dramatic market correction that occurred at the height of the crisis. Rent levels subsequently levelled off, and remained stable until mid-2012. More recently, the rental market has seen strong growth. In 2015 the annual growth rate in rental prices was 6-8%, though early indications suggest that the rate of growth may be even higher in 2016.

Recent Policy Initiatives

The housing market has been subject to regular policy interventions over the last decade and a half. Achieving balance between supply and growth in demand to facilitate affordability has been at the heart of many of these efforts. Some of these recent interventions are highlighted below.

In 2015 the Central Bank of Ireland applied **limits to mortgage lending** by regulated financial services providers in the Irish market, restricting loan-to-value and loan-to-income multiples for both primary dwelling houses and buy to let mortgages. The objective of these macro-prudential measures is to to limit house prices relative to income, and ultimately to reduce the risk of bank credit and house price spirals from developing in the future[4].

A series of reforms of the private rental sector was introduced in November 2015 with the principal aim of providing **greater rent certainty**. Other changes relating to Housing Assistance Payment limits and tax relief measures for landlords have also been progressed[5].

On the supply side, the Government's **Social Housing Strategy** 2020 commits to provide 35,000 new social housing units[6], while recent planning legislation has been enacted to **incentivise the use of vacant sites**[7].

Defining Affordability

Housing acts as both a good and an asset. Like any other good, price is determined by the intersection of supply and demand. The main demand factors include income levels, interest rates, demographics, and house prices[8]. Supply is primarily a reflection of a series of costs related to regulation, credit, land and construction.

4 The Central Bank has announced that it will shortly open a public consultation on the mortgage rules, and will publish the results of its review in November.
5 Department of the Environment, Community and Local Government, Stabilising Rents, Boosting Supply: A Package to deliver Rent Certainty and Housing Supply, November 2015
6 Department of the Environment, Community and Local Government, Social Housing Strategy 2020: Support, Supply and Reform, November 2014
7 Urban Regeneration and Housing Act 2015
8 House prices impact demand both in terms of the numbers of potential buyers that are able to enter the market at a particular price level, and in terms of house price expectations which determines the level of speculation that occurs.

Fundamentals such as income levels, population and housing supply tend to evolve relatively slowly, while asset factors such as credit conditions and price expectations can change rapidly, and have been identified as responsible for much of the growth in Irish house prices between 2001 and 2007 and a large part of the fall between 2007 and 2012.

While the term 'housing affordability' has been in widespread use for three decades, as a concept, it is difficult to define. Affordability is a continuum – at one end it is easily affordable, at the other end it is definitely not affordable.

For the purposes of this study, housing affordability is measured by examining **the proportion of household income that is spent to meet own housing need** whether purchasing a home or renting[9]. Two overall indices are calculated, namely the NCC Mortgage Affordability Index (MAI), and the NCC Rent Affordability Index (RAI). The higher the index, the less affordable property is to purchase or rent. Data for 11 international cities and 5 Irish cities is analysed[10].

NCC Mortgage Affordability Index

The **Mortgage Affordability Index** (MAI) captures the cost of a newly purchased dwelling to a household earning the average household income for that city. The index is based on a standardised housing unit taking account of differences in mortgage cost[11]. The MAI can be decomposed into two constituent parts: a **price-to-income ratio**; and a **mortgage multiplier** reflecting the cost of raising mortgage finance.

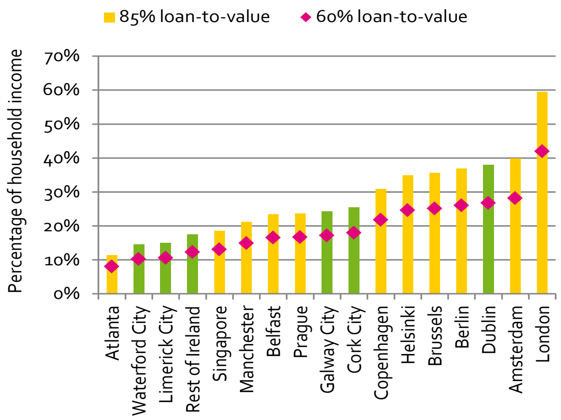
The price-to-income ratio indicates that of the Irish cities, Dublin has the highest ratio, followed by Cork and Galway, both of which report similar levels. Of the 11 international cities examined, 5 show a higher price-to-income ratio than Dublin, while 6 show a lower ratio.

The mortgage multiplier calculates the first year repayment costs of a notional 20-year mortgage, based on an 85% loan-to-value ratio (the MAI for a 60% LTV is also shown). The cost of mortgage finance in Ireland in 2015 was the highest of all countries surveyed, thus reducing the affordability of a new purchase[12].

The overall MAI (Figure 3) shows that while 5 international cities had a higher price-to-income ratio than Dublin, the higher cost of mortgage finance in Ireland meant that only 2 cities (Amsterdam and London) had a higher MAI (i.e. only two were deemed less affordable). The major outliers were London, where a new mortgage would cost over 60% of income, and Atlanta, where a similar sized property would take up just 11.5% of income.

Of the comparator cities, 6 had a higher MAI than for Cork and Galway, and 5 had a lower MAI. For Limerick, Waterford and the Rest of Ireland, only Atlanta showed a lower MAI.

Figure 3: Mortgage Affordability Index, 2015



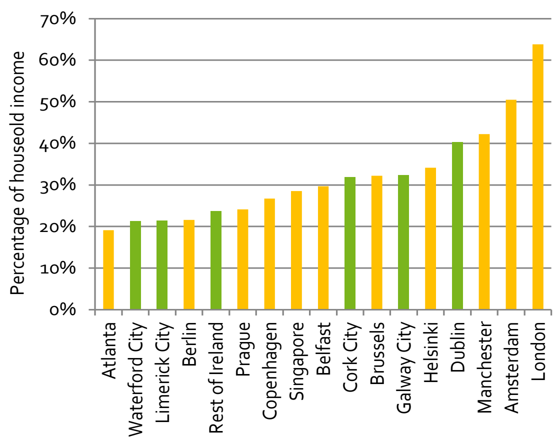
Source: Indecon Economic Consultants

NCC Rent Affordability Index

There has been a dramatic increase in the size of the rental sector in Ireland in the last 20 years – private rental accommodation accounted for 8% of houses in 1991; this had increased to 19% in 2011[13].

The **Rent Affordability Index** (RAI) captures the cost of rent to a household with the average household income for that city. It is calculated assuming a standard rental unit of 70 square meters, regardless of the type of housing (e.g. apartment or a house), and assumes a two-person household, each earning 80% of average disposable income.

Figure 4: Rent Affordability Index, 2015



Source: Indecon Economic Consultants

9 This analysis focuses on the aggregate affordability of housing, rather than affordability of specific sub-sections of the population. Further details on methodology and the assumptions applied are available in the full background report.

10 Comparator cities were selected on the basis on their similarity to Dublin across a range of factors including population, national income, and FDI attractiveness.

11 The impact of taxes and subsidies relating to the purchase or rent of residential property are excluded from this study.

12 Extending the mortgage term out to 25 years reduces the interest rate and therefore, the proportion of income spent servicing the mortgage. In Dublin, an 85% LTV over 25 years would cost 33% of household income compared with 38% over 20 years. Dublin's ranking, however, does not change.

13 NESC, Homeownership and Rental: What Road is Ireland On?, 2014

The RAI shows that three of the international cities were more expensive than Dublin in terms of rent as a percentage of income, while eight were less expensive. Four international cities were more expensive than Galway, while seven were less expensive; eight were less expensive than Cork. For Limerick and Waterford, only one international city had a lower RAI, while for the Rest of Ireland, two international cities had a lower RAI.

Conclusions on Affordability

These metrics suggest a number of issues which merit further consideration in determining any policy response to the issue of housing affordability and housing supply.

- Affordability issues are more acute in cities: The proportion of income spent on mortgages or rent is generally higher in cities than in areas of lower population density. Any measures to address affordability must have a focus on the main cities.
- Rising cost of renting: Many Irish cities fare less well in terms of rent affordability than in terms of mortgage affordability. Given that many in the rental sector now have to save substantial deposits if they are to buy a house, affordability concerns for this cohort are particularly significant.
- Mortgage interest rates: The mortgage finance market is a major determinant of the overall affordability of house purchase. Ensuring a competitive mortgage finance market is important in terms of improving the affordability of Irish housing.
- Sustainability of house prices: A number of international cities have higher price-to-income ratios than Irish cities, suggesting that current Irish affordability levels (and high price-to-incomes ratios) could persist in the medium to long run, regardless as to whether they are considered "affordable" or not.

Next Steps

There is an immediate pressure for intervention but no obvious quick fix. Therefore, it is essential a long term approach be taken to ensuring a sustainable housing market. In this regard, the appointment of a dedicated Minister with responsibility for Housing, Planning and Local Government (alongside the appointment of a Minister of State for Housing and Urban Renewal, and the establishment of an Oireachtas Committee on Housing and Homelessness) is a welcome development. The challenge now is to ensure that a coherent and consistent approach is brought to bear on housing policy, and that the various arms of the State work together to fulfil the commitment in the Programme for Government to provide "affordable, quality and accessible housing" for all.

Likewise, the development of an **Action Plan for Housing** provides an invaluable opportunity to bring a whole of government approach to housing policy, and to put a long term framework in place to deliver a housing market that is sustainable and meets the needs of society.

Where there are indications that housing is not affordable, policymakers are confronted by a number of challenges. Policy can aim to help people afford the housing that is on offer, or it can aim to make what is on offer more affordable. The latter is the more preferable approach as demand side measures generally favour one part of the market over another (e.g. purchasers or renters or vice versa) but don't solve the affordability problem.

Further increases in house prices relative to incomes will not aid affordability, whilst the provision of additional subsidies to aid affordability risks stimulating demand[14]. Increasing the supply of housing is, therefore, essential.

Policy interventions can be designed to address supply across a number of fronts. Such interventions might include policies to **encourage vacant dwellings to be brought on to the market**; **social housing policies**; and policies to incentivise the **expansion of the private rental market**. Ultimately, however, **additional construction** is required.

To incentivise the construction of new residential property, selling prices need to exceed development costs. The Central Bank mortgage rules, in effect cap prices relative to income. If, therefore, prices cannot increase, there is a need to address the other side of the equation and **reduce development and construction** costs relative to income and prices. Development and construction costs include the costs associated with acquiring sites, attaining planning permission, sourcing materials and labour, as well as the associated taxes and levies charged by the State. Unfortunately, there is limited agreement on the elements of the Irish cost base that are out of line. Understanding the cost factors that are constraining supply is a prerequisite for designing effective policy interventions.

Further Reading: This analysis is based on a report commissioned by DJEI on behalf of the NCC, and undertaken by Indecon International Economic Consultants. The full report, entitled *A Study to Examine the Affordability of Irish House Prices* is available to download from the Council's website **www.competitiveness.ie**.

The NCC reports to the Taoiseach on key competitiveness issues facing the Irish economy. This Bulletin has been issued by the NCC Chair and Secretariat.

14 Department of Social Protection, Maximum Rent Limit Analysis and Findings Report, February 2015