

Housing and Austerity: A Two-Way Street

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Context

Simon Wren-Lewis's chapter in this volume outlines a general theory of austerity. Underpinning it is a desire for policymakers – as well as the social sciences – to learn from the experience of austerity over the last decade. In particular, Wren-Lewis makes the point that austerity was, at a global level, unnecessary. The asterisk to this finding relates to particular countries, where austerity at a national level was unavoidable.

Ireland's recent economic history is not only remarkable but also incredibly useful, if policymakers are to learn lessons from the experience of the last decade. The economic journey from 'the poor man of Western Europe' in the late 1980s, through the export-led growth of the 1990s and the credit-led growth of the early 2000s, to the sharp economic contraction in the years after 2007, contains much for other small open economic regions to learn. This is particularly true in the context of a region – Ireland – largely dependent on one city of global significance (Dublin), where that region lacks its own monetary policy and recourse to the traditional levers of trade policy to react to economic shocks. Exposed to global economic tailwinds, and later headwinds, and with an inadequate domestic policy response, two key aspects of the local economy – government spending and housing – bore much of the brunt of Ireland's economic contraction.

With Ireland once again one of Western Europe's fastest growing economies, it is tempting for policymakers locally to assume that lessons have been learnt, or perhaps that Ireland was unlucky in its exposure to global shocks. It is the aim of this chapter to show that the poor management of two key domestically-focused sectors contributed separately and jointly to the severity of the economic correction in Ireland. In so doing, it hopes to highlight some key themes for policymakers to take away from Ireland's experience in austerity and housing.

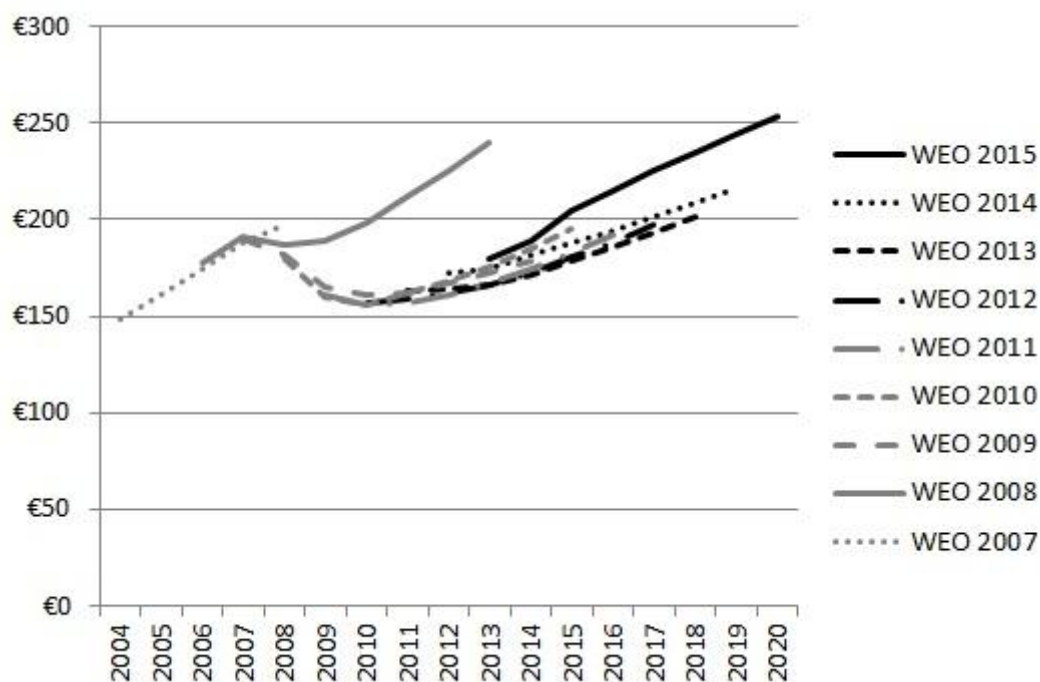
The bulk of this chapter is organised around two key relationships. The first is the contribution that the housing sector made initially to the huge expansion in government spending and thus, by corollary, in austerity. Whereas that section focuses on the effect of housing on austerity, the next section focuses on the reverse: the impact austerity has had on the housing sector in Ireland. The penultimate section draws out the policy implications of the preceding analysis, outlining what principles should act as the foundation for housing policy into the future, after which the chapter concludes.

From housing to austerity

As of 2007, on the cusp of austerity, Ireland's steady state rate of economic growth was thought to be at least 5% a year. In such a world, permanent increases in public sector spending were not thought serious risks, as over a decade of strong growth had meant almost no net gain in national debt and a fall in debt to national income from over 100% to below 30%.

Figure 1 shows projected nominal GDP, in billions of euro, from 2004 to 2020, across a range of IMF World Economic Outlook reports from 2007 to 2015. As can be seen, there is a clear downward revision of expected future growth between 2008 and 2009, coinciding with the Global Financial Crisis. Thereafter, there was very little change in the expected size of the economy in the future, for five years. Only in the 2015 World Economic Outlook report was the future growth path of the Irish economy revised upwards again.

Figure 1 – Projected nominal GDP (€bn), 2004-2020 by IMF WEO revision. (Source: IMF, World Economic Outlook, various years)



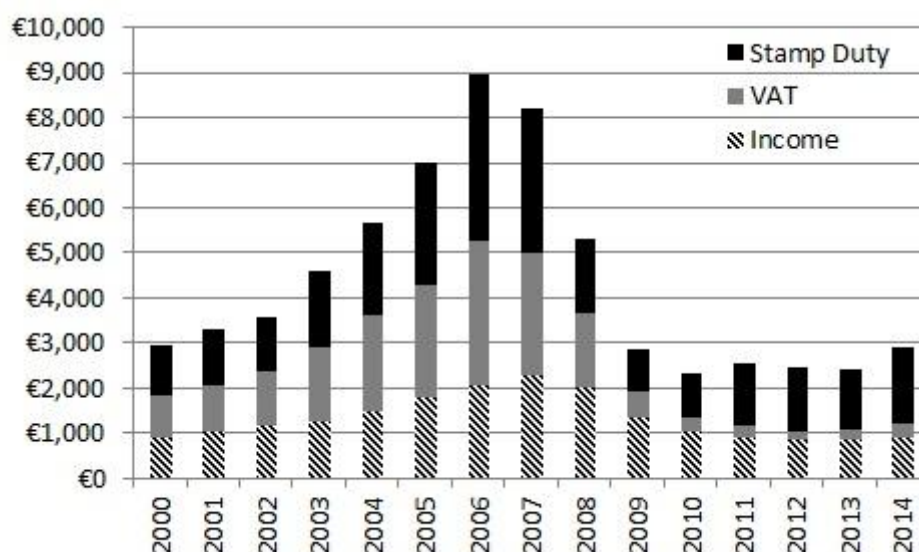
What this means in practical terms is that the economy in 2013 was roughly one third smaller than policymakers – local and international – had expected it to be as recently as 2008. And that year, the economy was only expected to surpass €250 billion in size by 2018, ten years 'behind schedule', if one takes instead the 2007 World Economic Outlook report. This matters because the size of the economy represents the full base of activity that can be taxed and, in practical terms, annual output (a flow) is compared to national debt (a stock), with the rule of thumb being the latter should be no greater than the former. Where national debt exceeds annual output, in short, economic growth must exceed the interest on debt, in order for the debt burden to remain manageable.

The sharp and unexpected contraction in the general economy thus had a clear impact on the public finances. But it also had an impact directly on the housing market. As average incomes declined, and as unemployment rose sharply from 5% to 15%, demand for housing contracted. The direct channel – fewer households can afford the same house prices – is amplified by the fact that housing is an asset on the household’s balance sheet.

Work by John Muellbauer (2007) and Slacalek (2006) outlines the potential for housing to have wealth effects and collateral effects on the real economy, including personal consumption. As housing prices rose, homeowners consumed out of their new housing wealth – but the same holds true in reverse and thus as house prices fell, consumption fell. The context of this shock to the capacity of government to tax and spend was a sustained increase in permanent spending commitments by central Government. Between 2000 and 2007, gross public spending more than doubled, increasing from €26bn to €56bn. Much of this increase was in the form of expanded transfer payments and higher salaries to public servants, with significant extra spending committed through an expensive public sector pay benchmarking exercise.

This very substantial increase in spending occurred without any substantial addition to national debt, being funded instead through taxation revenues. This balancing of spending with receipts was a key risk, as it was ultimately just an illusion of fiscal prudence. Much of the tax receipts were temporary in nature, and predicated on an excessive property sector. For example, between 2000 and 2006, an estimated €6bn in extra revenues came from three areas directly related to the housing market. The first category is income tax receipts from the construction sector, which grew from less than 150,000 workers to more than 250,000. This, combined with increased average earnings, drove direct income tax receipts from construction up from less than €1bn in 2000 to over €2bn in 2006. Excluded from this are other occupations where employment levels grew as a result of the housing boom, including estate agents, financial institutions and related retail, such as furniture.

Figure 2 – Estimated public revenues from property-related sources, 2000-2014. (Source: Calculations based on Department of Finance figures)



The second key category of temporary receipts was in VAT receipts on newly built homes. Between 2000 and 2007, the number of new homes built roughly doubled as did their average value. The net result was an increase in estimated VAT receipts from new homes from less than €1bn in 2000 to more than €3.2bn in 2006. The third and final major category of temporary tax revenues was stamp duty receipts, which were measured directly in government accounts and which were dominated by transaction in housing and in related goods, such as development land. Between 2000 and 2006, stamp duty receipts rose from €1.1bn to €3.7bn.

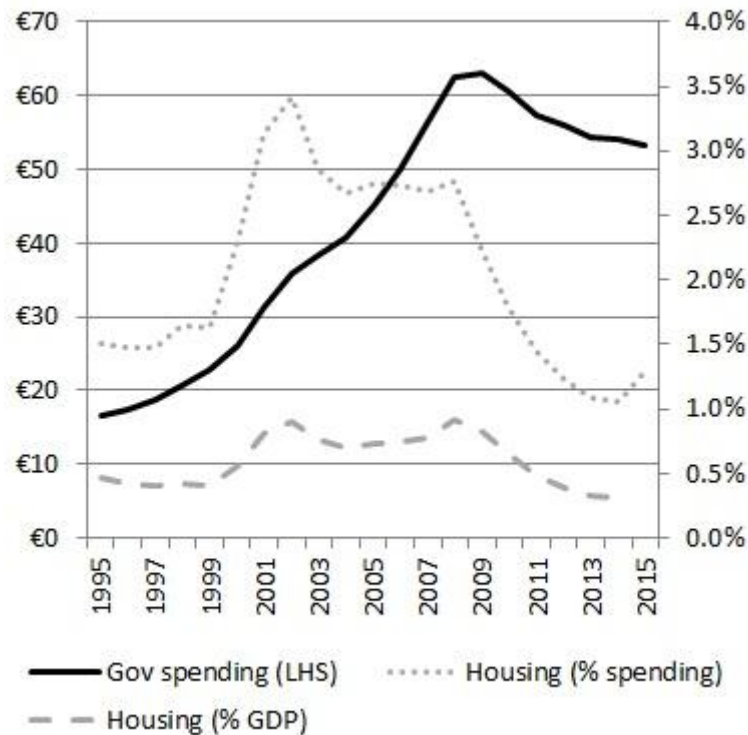
Thus, even from just these three direct areas where housing fed in to receipts, it is clear that housing was a key contributor to the extra receipts that funded Ireland's substantial increase in public spending in the final years before austerity. (See also Julien Mercille's chapter for the impact of property on revenues in another key sector, media.) The figures presented above, based on Department of Finance publications, suggest that property-related revenues rose from €3bn in 2000 to €9bn in 2006. An overview of revenues from these three sources, from 2000 to 2014, is presented in Figure 2.

The sharp decline in economic activity in Ireland after 2007 included an end to the credit-fuelled housing bubble, with a dramatic fall in prices and an even more dramatic fall in construction activity. While prices fell by 55% on average – slightly less for larger properties, and slightly more proportionately for apartments – activity in the housing market fell by close to 90%. This is true across a number of different measures of activity, including transaction volumes and construction of new homes. As a result, what had become a key component of government revenues evaporated. As shown in Figure 2, revenues from income tax, VAT and stamp duty directly related to housing fell from an estimated €9bn in 2006 to just €2.5bn in 2010. This is a gap that has persisted through to the time of writing (late 2015).

While an annual Local Property Tax has been introduced, its revenues are roughly one tenth of the revenues from stamp duties prior to 2006. It is also true that, in terms of the rate levied, the rate in Ireland (at 0.18% of the market value) is significantly below many other developed countries. In many parts of the US, annual property taxes are 1% of the market value or more. Such high property taxes not only provide a sustainable revenue base for local government, they are associated with less volatile housing market cycles, through imposing greater holding costs of property.

The final element of exploring the path from housing to austerity is to note the role played by housing in government spending, rather than government receipts. The extra money spent by the government was spent – roughly proportionately – on housing. Public spending on housing comprised about 2.7% of all government spending throughout the period 2004-2008.

Figure 3 – Government spending (€bn) and the scale of government spending on housing, 1995-2015. (Source: Calculations based on Department of Finance figures)



The fraction of public monies spent on housing had increased substantially from 1.6% in 1999 to 3.4% in 2001, before falling back to this level. This meant that, on the eve of austerity, just short of 1% of GDP was being spent annually on housing by the government. The total level of government spending (left-hand scale) and the fraction of government spending and of GDP spent on housing (right-hand scale) for the period 1995-2015 is shown in Figure 3. Overall, the link between housing and austerity is probably best highlighted by the aggregate statistics: the €10bn fall in government spending during austerity is in large part accounted for by a €6.5bn fall in property-related government revenues during the same period. In this context, austerity became more or less unavoidable, as outlined by John McHale in his chapter in this volume.

A final note is worthwhile on the topic of ghost estates and unfinished developments. There has been much public commentary about the number of vacant homes in Ireland, with some conflation of vacant homes and ghost estates. While there were almost 290,000 vacant homes in the 2011 Census, less than 10% of those (roughly 23,000) were vacant and complete homes in the 2,846 unfinished developments surveyed by the Government in late 2010 (Department of the Environment, 2010; see also work by Rob Kitchin of Maynooth University). The bulk of the estimated 179,000 units in so-called ghost estates were either complete and occupied (78,000) or merely at planning stage (58,000).

In addition, strong housing demand has seen the number of homes in ghost estates fall dramatically since 2010. The number of ghost estates fell from nearly 2,850 to less than 670 in 2015, with number of vacant and complete homes down almost 90% in five years, to 2,800. While Ireland has a problem

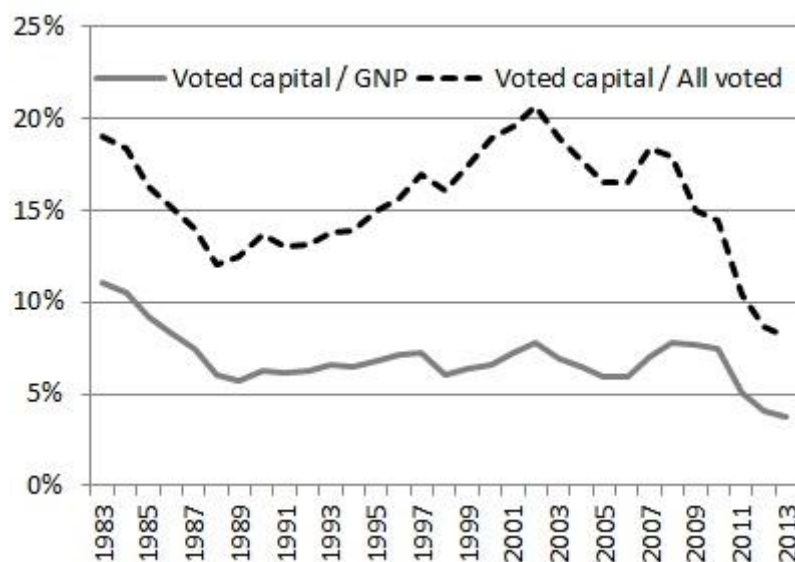
with vacant homes, with a rate of vacancy between 1.5 and 2 times higher than some other European countries, perhaps surprisingly this does not stem from recent over-construction in estates. Other factors, including a lengthy legal and probate system, the Fair Deal scheme and the low level of property tax (which penalises holding property empty for speculative reasons), are likely to contribute to this, although more detailed research is required to understand the relative importance of the various factors.

From austerity to housing

The previous section showed the strong effect that the housing sector had on government spending, both when spending was rising and when austerity took place. This section explores the reverse effect, namely the impact austerity has had on the housing sector. In general, the nature of government receipts has meant that public spending in Ireland since 2000 has been extremely pro-cyclical, with a sharp fall in spending between 2009 and 2014. Not only did the level of government spending fall, spending was also concentrated in three key areas: education, healthcare and social transfers. Of the aggregate fall in government spending of roughly €10bn, it was disproportionately capital spending that bore the brunt of the cuts.

This is shown in Figure 4. Capital spending, in other words investing to meet future needs, has fallen from more than 20% of all government spending in 2000 to less than 10% now. Relative to national income, for every €1 earned, over 10 cent was invested in capital spending in the early 1980s. By 2015, that figure had fallen to just 4 cent. Housing was among the areas of government spending badly affected by the austerity of the post-2007 period. As shown in Figure 3, in aggregate, it fell from roughly 3% of government spending around the year 2000 to approximately 1% 15 years later.

Figure 4 – Voted capital spending by government as a fraction of all spending and of GNP, 1993-2013. (Source: Calculations based on Department of Finance figures)



What is the rationale for government spending on housing? The starting point for housing as a component of government spending is the UN Declaration of Human Rights. The first part of Article 25 of the Declaration states that every household has the right to a standard of living adequate for

their health and well-being, including food, clothing, housing and medical care and necessary social services. The decline in average incomes and in employment between 2007 and 2010 meant that there was a huge outward shift in the demand for social housing in Ireland – the chapter by Whelan et al in this volume describes how austerity affected inequality and those on lower incomes in particular. In the economics of the sector, there were a significantly larger fraction of households with inadequate incomes, relative to the cost of their accommodation.

Unfortunately, in the case of Ireland, social housing had effectively been privatised in the decade to 2007. Part V of the Planning and Development Acts 2000-2006 meant that the burden for funding new social and affordable housing was placed on those who bought new properties, as 20% of new developments were supposed to be set aside for social and affordable requirements. Newly built properties were bought disproportionately by first-time buyers, and first-time buyers were on below-average incomes, relative to society as a whole (even if not necessarily their own age cohort). This meant that the burden for paying for new homes was regressive in nature.

Not only this, the provision of new social housing was entirely dependent on the provision of private housing. The underlying assumption of Part V was that private and social housing were complements: when more of one was needed, more of the other was needed also. Of course, this is not the case. For a given population level, private and social housing are clear substitutes. Thus, when private completions fell from over 80,000 units a year to 10,000 a year, any fraction of that total also collapsed.

With a lack of newly built homes in the social housing sector, greater reliance was placed on the private rented sector to house those on lowest incomes. In principle, this would work provided the subsidies were non-distortive – i.e. they did not affect the incentive to work – and varied by need, i.e. that those on lowest incomes were given the greatest subsidy. Unfortunately, the nature of subsidy adopted was a fixed-amount rent supplement, rather than an income-varying supplement. This meant that so-called ‘welfare tenants’ were pitted against ‘working tenants’ for a fixed pool of rental properties, with rent supplement limits reviewed to ensure recipients were not at an advantage relative to other market participants.

At its most fundamental level, spending on housing is now treated largely as a current account item, rather than a capital account one. This goes against best practice in the area of social housing, in other words debt-financed building of homes for those with inadequate incomes to cover the costs of construction themselves. Compounding this, the nature of rent supplement is about subsidies relative to market rents, rather than subsidies relative to the gap between inadequate incomes and construction costs.

Suppose that a site is to be used for 100 two-bedroom apartments in Dublin. The 2011 Dublin City Council Development Plan makes very specific requirements not only about aggregate floor space, but also about ceiling heights, balcony depths, basement car parking spaces, the number of lifts per floor, orientation and many other features of the unit. Each of these features brings benefits but also incurs extra costs, including the opportunity cost of lost space. A requirement, for example, to have ‘two per core’, i.e. six lift shafts and six stairwells on a floor with twelve apartments – rather than two lifts and stairs, as would be common in other cities – incurs significant costs upfront, on an on-going basis as lifts are costly to maintain, but also in opportunity cost, as three times the floor-space is lost for accommodation. Similarly, a requirement unique to Ireland that almost all units be dual

orientation – and that none of the single-orientation units be north- or east-facing – renders many sites problematic or even without value.

Why this matters for social housing is because of the need to link construction costs to real household incomes. While there is disagreement about the exact magnitudes, estimates as of 2016 about the hard costs of construction suggest that building 100 two-bedroom apartments in Dublin would typically involve hard costs (labour and materials) of at least €1,800 a square metre. With a minimum of 85 square metres under Dublin City Council rules, and factoring in soft costs, such as a 12.5% profit margin, VAT of 13.5%, local authority levies and other fees (such as professionals' fees), this results in a total up-front cost per unit of roughly €275,000 – excluding all land costs.

Allowing for a 5% net yield, with a 20% margin for management and maintenance, this means that the break-even monthly rent required to cover the costs of construction, but not including land, would be nearly €1,400. Realistically, factoring in land costs would mean a break-even monthly rent of at least €1,600 and, depending on the area, closer to €2,000. As of 2016, prevailing market rents for two-bedroom apartments across the country were far below this level. Only in the highest value locations, such as Dublin 2 and Dublin 4, could such rents of roughly €1,800 a month for a two-bedroom apartment be sustained. In cities other than Dublin, average rents for two-bedroom apartments are closer to €700.

It is worth stressing the figures presented above are meant to be indicative, rather than definitive. A transparent government-sponsored audit of the elements of construction costs in Ireland is required, as the figures above rely on information gathered from a variety of sources. Nonetheless, regardless of the exact figure required for building a home, the point remains: the higher are hard construction costs, the less affordable housing is, which hinders housing supply and places greater strain on the social housing sector. In simple terms, if a household with disposable income of €3,000 a month can only sustainably spend €1,000 on housing, what does a monthly budget of €1,000 translate into, in construction terms?

This question shows how it is possible to convert directly from such a break-even rent calculation to the need for housing subsidies by using the income distribution and the rule of thumb for housing affordability, that no more than one third of disposable income should be spent on housing. In other words, what gross household income would be required to be able to afford a monthly rent of €1,800? To afford a monthly rent of €1,800, a household would need to have monthly disposable income of three times this, or €5,400. Allowing for the Irish tax system, this means that only households with a gross annual income of more than €85,000 would be able to afford the minimum allowable unit in Dublin City Council. This corresponds to close to the 90th percentile of the income distribution.

While, in theory, an income-varying subsidy for all those earning less than this amount would restore the principle of access to housing, it is fiscally not feasible for nine-tenths of households to be in receipt of subsidies. As work by Saiz (2010) and Quigley & Raphael (2005) has shown, local policymakers can use housing and land regulations to restrict supply, to the detriment of low-income households. Regulations about housing standards can be viewed as discrimination against those on lower incomes, either intentionally or accidentally.

More generally, the point of this section is to highlight the link between construction costs and social housing. If the hard costs of construction are too high, relative to real incomes, then for a meaningful right to housing services to exist, society must top up those households with inadequate incomes. The higher construction costs are, the greater a fraction of households will need assistance – thus, it is clearly in the interests of the taxpayer to ensure efficiency in construction.

Principles for policy

Once the link between subsidies and construction costs is accepted, this provides a clear policy prescription. The question for voters or policymakers to decide is what fraction of households will be entitled to a housing subsidy related to their income. Leaving aside issues around household composition and the equalisation of income, if that fraction were a third, then the minimum socially acceptable dwelling should reflect the disposable income of the household at the 33rd percentile.

How might this be achieved? Two areas where Ireland's minimum requirements appear to be out of line with its economic peer group are the hard costs per square metre and in the minimum number of square metres allowed for various dwelling types. As outlined above, at €1,800/m² and a minimum of 85m², the break-even rent of a two-bedroom apartment in 2015 was roughly €1,400, excluding land costs. Were construction costs €1,500/m² and if the minimum size of a two-bedroom apartment were 85m², the break-even monthly rent would be closer to €800.

The difference for a family of two adults and two children, earning €45,000 a year, is substantial. In the 2015 status quo, the maximum number of square metres they can afford is 62, but the minimum allowed built is 85. That family, with an above-average income, would require a subsidy of at least €400 a month (more if land costs are included) just to afford the minimum unit. The scenario presented above means that the minimum would be 60m², while lower per-square-metre costs mean the maximum they could afford would be 75m².

Note also that such a system of income-varying housing subsidies would blur the distinction between social and market housing at the margin. When a household moved from, say, the 30th percentile to the 35th, due to a new better-paying job, they would stop receiving the subsidy but would not necessarily have to move accommodation. The same change in reverse, due to an economic downturn, for example, would not result in an eviction, as the nature of the subsidy would offer a for-profit owner excellent collateral.

As mentioned above, the figures presented above in relation to construction costs are meant to be illustrative, rather than definitive. And, in large part, the lack of official figures about construction costs prevents any agreed course of action. In late 2015, the National Competitiveness Council committed to benchmarking residential construction costs in Ireland relative to other countries. This exercise would identify which parameters are most out of line, compared to our peers, and hopefully create consensus on the topic.

It is not clear, for example, why per-square-metre costs in the Republic of Ireland are so high, relative to other locations including Northern Ireland. Some of this may be due to minimum specifications, such as lift and basement car parking requirements. Reynolds (2015) suggests that another important factor is the nature of safety certification. In most developed countries, buildings

are certified as fit for occupation by the local authority. In Ireland, during the housing boom, the rate of inspections was well below 10%, leading to situations such as the well-publicised Priory Hall case.

The response was not to move to certification by the local authority, but rather to move to a model of complete self-certification, typically by the architect. Reynolds (2015) highlights that this new system brings significant inefficiencies, with the cost of certification per unit estimated to be roughly €25,000, compared to approximately €250 in Northern Ireland, where a more standard system of official certification is in operation. On the other hand, those involved in the construction of apartments (rather than one-off homes) argue that BER certification is relatively efficient on a per-unit basis.

Identifying the actions that would have the biggest impact on construction costs must be the priority for the Government, if it is to tackle the lack of new housing supply. In short, the cost of building homes must be reduced so that new homes are affordable to those on average incomes, and to those on below-average incomes if appropriately subsidised.

Conclusion

This chapter has explored the relationship between two key domestic economic sectors: government spending and the housing sector. The first direction of the relationship explored was from housing to austerity. This highlighted the contribution of housing to greater public receipts. While they were largely temporary in nature, contingent on high levels of economic activity, they helped finance a dramatic increase in public spending. Much of this additional public spending was in the form of permanent (or at least hard-to-reverse) spending commitments, particularly around pay and social transfers.

When Ireland underwent a substantial economic correction, such that the level of GDP was at one point ten years behind IMF predictions, this affected revenues and ultimately spending. Core areas of government spending – health, education and social transfers – were by and large protected, resulting in sharp cuts to other forms of spending, in particular capital spending. This includes housing, which is now treated more as an item of current expenditure than capital spending.

The shift in housing policy during the Celtic Tiger phrase, away from debt-financed social housing and towards fixed-amount rent supplement, was particularly unfortunate as it left the state entirely unable to respond to the huge outward shift in demand for social housing after the downturn. More generally, housing is similar to other areas of government spending in Ireland, with a significant lack of countercyclical capacity. Two themes that have arisen in this chapter have been firstly, recognising the importance of capital spending, including housing, on the part of government; and related to this, secondly the importance of shifting government spending from pro- to counter-cyclical.

In terms of reforming policy in relation to housing, one key objective to keep at the heart of housing policy should be giving people freedom of choice – both within housing, allowing trade-offs between size and location, and between housing and other goods, for example where people want to spend a smaller fraction of their income on housing and more elsewhere. If this represents the efficiency motive, the second key objective reflects the equity motive – housing subsidies should assist those with inadequate incomes, and the more inadequate the income, the greater the support.

Currently, the system reflects very few of the attributes of best practice. Minimum specifications are completely divorced from their costs and from the real economy, resulting in regulation – including around safety certification – acting as a tool for discrimination against those on lower incomes. If the 2015 Central Bank mortgage market regulations effectively capped house prices relative to incomes, the same now needs to be done with construction costs, to ensure that where demand exceeds supply, there is a supply response and thus affordable accommodation.

The new government in 2016 faces a range of related problems in housing, including a lack of affordable homes for first-time buyers, an extreme shortage of rental accommodation, a student accommodation crisis and the phenomenon of working homeless families living in hotels. Ultimately, these all stem from an inability of supply to respond greater demand. Until there is consensus about the evidence of why construction costs in Ireland are so out of line with other countries and with incomes locally, these problems will persist.

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