

Small Business in the Construction Industry and its Linkages with the Economy

April 2010

Key Points:

- **99 per cent of participants in the construction industry are sole traders or small businesses.**
- **For every \$1 million increase in construction output, there is an increase in output elsewhere in the economy of \$2.9 million.**
- **Empirical evidence suggests that, in many instances, cyclical movements in aggregate economic growth are preceded by a movement in new home building.**
- **Australia's long term growth prospects are interconnected with the nation's capacity to meet dwelling requirements.**

The construction industry and small business

According to the Australian Bureau of Statistics (ABS), in 2005/06, there were 404,352 businesses operating in the construction industry that were either non-employing businesses (sole traders) or small businesses¹. This number is out of a total 407,188 businesses operating in the Australian construction industry as a whole. This equates to sole traders and small business making up over 99 per cent of the businesses operating in the entire industry.

The construction industry's linkages with the economy

The ABS Multiplier for Construction

In 2008/09, Australia's Housing and Renovation Industries directly contributed approximately \$64 billion to Australia's Economy. While this strong result accounted for 5.3 per cent of Australia's Gross Domestic Product (GDP), when combined with those primary and secondary businesses that indirectly supply to the construction industry, the overall effect is far stronger in terms of both employment and output.

Over and above the direct contribution to the economy, construction industry activity has 'flow-on' impacts on the activities of other industries. The possible size of these impacts can be illustrated using the ABS multiplier for construction² based on inter-industry flows. The total multiplier for output and employment in the construction industry is estimated by the ABS to be 2.866. So, for every \$1 million increase in construction output, there is an increase in output elsewhere in the economy of \$2.9 million. In output terms, an extra \$1 million of construction expenditure also involves \$217,000 of employee earnings and \$241,000 of corporate and small business profits.



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¹ See: ABS catalogue 8155.0

² See:

<http://www.abs.gov.au/AUSSTATS/ABS@.NSF/94713ad445ff1425ca25682000192af2/ed6220072793785eca256b360003228f!OpenDocument>

In terms of employment, an extra \$1 million of construction expenditure generates 9 construction jobs. The initial effect of the additional \$1 million worth of construction is 9 positions in construction-related fields, such as carpenters, brick layers, plasterers, etc. In addition to this initial effect there are also production induced effects generating 7 jobs across those businesses manufacturing the materials needed for the additional construction, such as concrete and steel frames, and those businesses supplying and servicing the concrete and steel frame businesses, such as aggregate quarrying and raw steel production. Not all these jobs are necessarily going to be full time, but clearly the employment multiplier effect across businesses involved in construction or closely aligned to construction is considerable.

More generally, as activity increases in the construction industry, as well as in the suppliers to that industry and the ‘suppliers to the suppliers’, there is an increase in wages and salaries to employees throughout this chain. The spending component of these wages and salaries induces a further round of consumption effects in other areas of the economy.

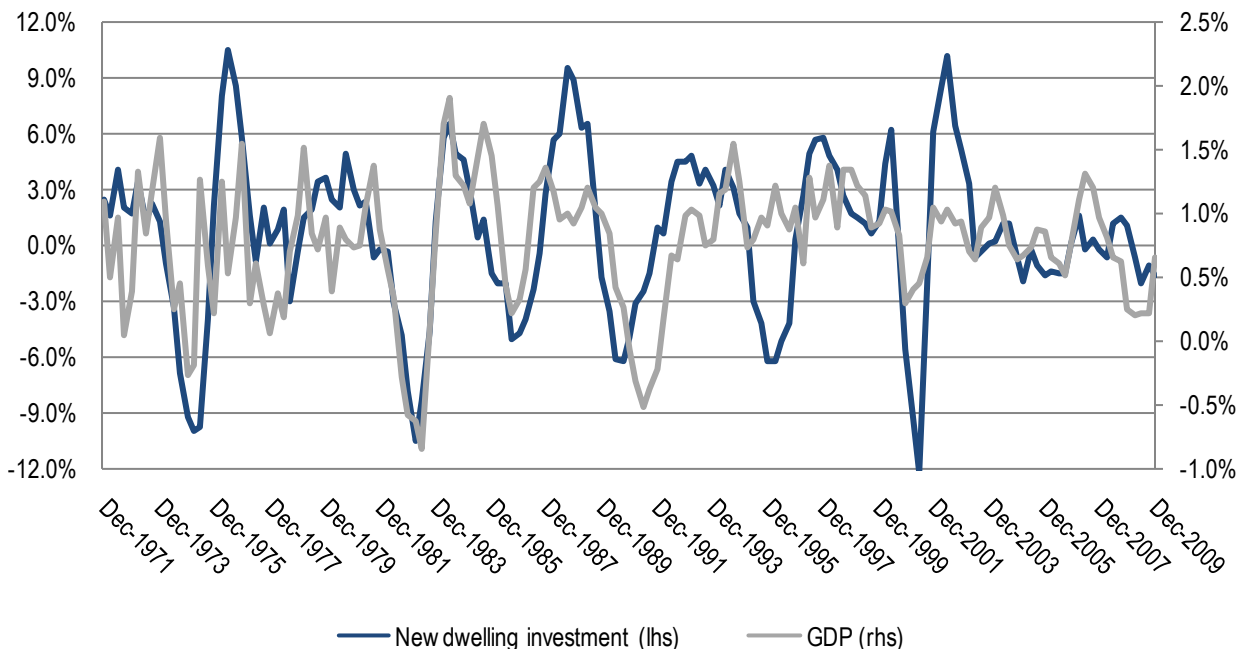
Housing as a lead indicator for economy activity

New home building is a lead indicator of economic activity. Empirical evidence suggests that, in many instances, cyclical movements in aggregate economic growth are preceded by a movement in new home building. This fact was clearly demonstrated most recently when housing indicators provided the early signals to a stronger than expected recovery in Australia’s economic growth amidst the global recession. The figure below provides further historical evidence of this correlation between housing and the economic cycle:

Figure 1:

Annual Percentage Change in New Dwelling Investment vs. GDP

Source: ABS 5206.3



The chart above demonstrates the capacity of new home building activity to act as a lead indicator. For example, the 1974/75 economic downturn was clearly preceded by a significant fall in the level of new home building in Australia. Another example can be seen in the downturn and subsequent upswing in economic activity between 1988 and 1991, which was foreshadowed by a strong dive in new dwelling investment followed by a substantial increase.

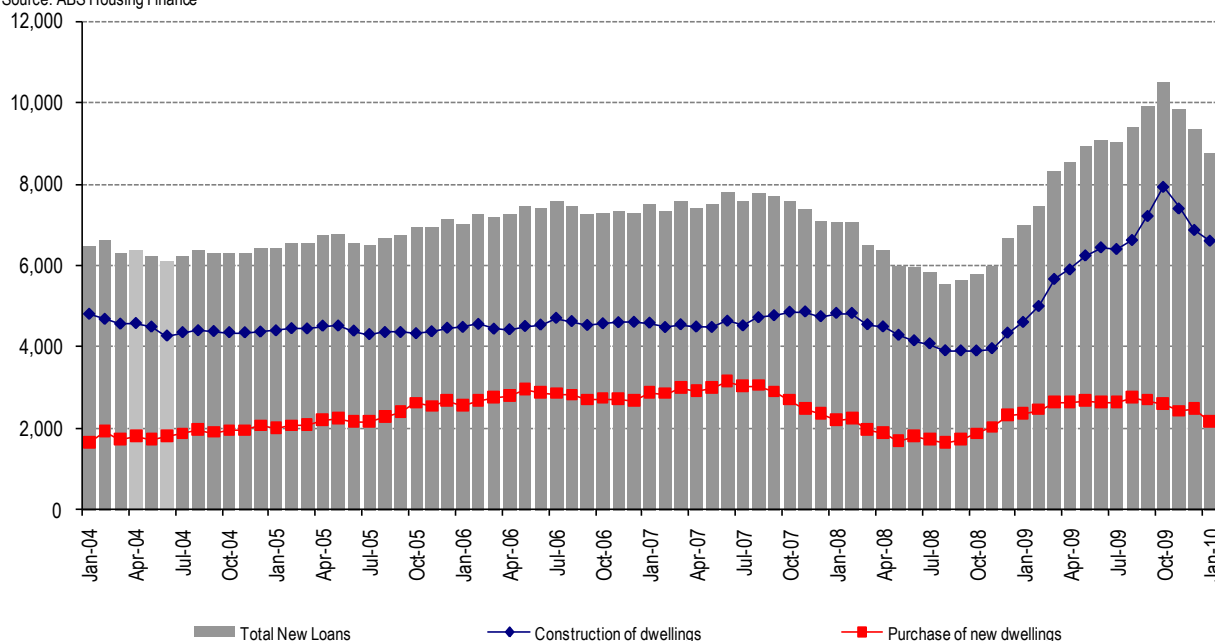
Very recent evidence suggests that new home building, and its own lead indicators, correlate strongly with economic growth in Australia. The major prior signals to a rise or fall in new home construction are housing finance, building approvals, and new home sales. Housing finance and building approvals data is collated and disseminated by the ABS, while HIA conducts its own monthly survey of new home sales activity. Movements across these indicators will point to ensuing activity in the new home building industry, and therefore in turn they will foreshadow economic activity in the short to medium term.

After three consecutive quarters of decreases in the rate of economic growth from the June 2008 quarter, Australia began to recover from the most recent downturn in the March 2009 quarter with a seasonally adjusted GDP growth result of 0.8 per cent (ABS). The commencement of this recovery was preceded by definitive gains in the number of loans issued for both construction and the purchase of new dwellings. As demonstrated by Figure 2 below, the level of housing finance issued in Australia started to rally in November 2008:

Figure 2:

AUST New Home Lending - Number of Loans

Source: ABS Housing Finance



Housing finance signalled that a new home building recovery was set to commence in 2009, despite the grim economic outlook at the time. Total new loans troughed in September 2008, before emerging with nine consecutive months of gains in the number of loans issued. Loans for construction of new dwellings troughed in October 2008, before posting eleven monthly gains from the next twelve months.

Building approval statistics are also viewed by economists as a leading indicator of the general level of residential building activity and economic growth. The most recent downturn in the number of building approvals issued by local government authorities occurred over the December 2008-January 2009 period. This two month period was followed by increases in the number of building approvals in nine out of the next eleven months. Building approvals in the detached house segment of the market rose for nine consecutive months from January 2009.

New home sales also pointed to a recovery in the broader economy, beginning with stabilisation in December 2008 after five large consecutive falls in the number of sales. According to the HIA New Home Sales Survey, total new home sales increased by 8.3 per cent in January 2009. New homes sales then proceeded to increase in nine out of the next eleven months of 2009.

It is evident that some of the earliest signs of economic activity in the short to medium term can be gained from analysis of housing industry indicators such as housing finance, building approvals, and new home sales.

Housing and the economy

Australia has experienced a boom in population growth due mainly to very strong immigration. Federal Treasury projects that Australia's population will reach 36 million by 2050, providing enormous challenges and opportunities. Key to the success or otherwise in adapting to any increase in population is the provision of adequate, affordable, and appropriate housing. In addition to this, Australia's long term growth prospects are interconnected with the nation's capacity to meet the dwelling requirements.

HIA estimates that over the next 10 years alone, taking account of current population projections Australia will need to build 1.92 million dwellings, well ahead of the 1.5 million dwellings completed over the last 10 years.

While Australia's population has been growing at a fast rate in recent years, new home building has stalled in alarming fashion. In addition to this, the Reserve Bank of Australia (RBA) estimates that between 2001 and 2006, approximately 15 per cent of new houses built replaced houses that had been demolished. The culmination of these issues is an imbalance in the supply and demand for housing. A national housing shortage has now emerged, leaving many people either homeless or forced into inadequate housing in terms of size and/or location.

Current population trends imply underlying demand was over 200,000 dwellings for 2009 alone, well ahead of the nearly 138,000 dwellings completed in 2009. Following a particularly weak half a decade for new home building, Australia's housing shortage currently stands at 109,200 dwellings. If current building trends were to persist, it is projected that Australia's cumulated housing shortage would reach 466,000 dwellings by 2020.

It is critical that Australia's long term growth prospects be solidified through an appropriate rate of dwelling construction. Failure to adequately address a national housing shortage will carry both social and economic consequences. From an economic perspective, the capacity of the economy to grow at a comparable rate with the population growth will be hindered. Productivity gains will be stifled by an inadequate allocation of labour. In many cases, people will be unable to dwell a suitable distance from employment opportunities.

The housing shortage means that property prices will remain out of reach for many first home buyers. Those locked out of the property market in the rental market face very low vacancy rates, skyrocketing rents, and often unsuitable housing options in terms of size and proximity to employment opportunities. Added pressure will be placed on Australia's transport network and system, which will add further to economic capacity constraints.

Overall, failure to address the nation's critical housing shortage will constrict the capacity of the economy to grow sustainably at a reasonable rate and will reduce the nation's living standards.