Costing us the house: Reforming policy for affordability

Overview:

Current taxation policy in relation to housing is creating a have and have not scenario when it comes to home ownership, while facilitating speculative as opposed to productive investment. Compounding this problem is bank dependence on offshore borrowings to feed the housing debt appetite. This has contributed significantly to our foreign debt position which has grown from 38 per cent of GDP in 1996, or just under $200 billion, to 60 per cent of GDP, or $666 billion.

Academic Biography:

- Bachelor of Arts (Economics, Politics and History) from La Trobe University.
- Graduate Certificate in Human Resource Management and Industrial Relations from Victoria University.

In 2007 Associate Professor of Economics and Finance at the University of Western Sydney, Steve Keen, wrote a paper for the Centre for Policy Development, *Deeper in Debt: Australia's Addiction to Borrowed Money,* where he warned that Australia's current borrowing trends cannot go on forever (Keen 2007).

According to the Reserve Bank:

- Australians now owe financial institutions more than $1 trillion in housing mortgages, almost 15 times as much as 20 years ago.
- Reserve Bank figures reveal that people paying off their own homes now owe banks and other lenders $763 billion - almost 12 times more than the $65 billion owed in January 1990 (Colebatch 2010).

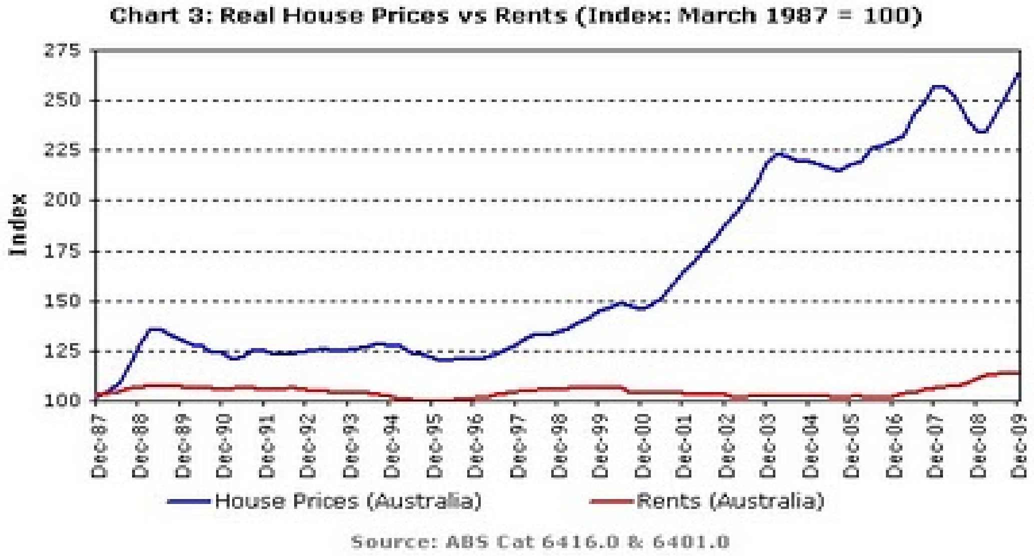
Rental investors have increased their mortgage debt even more substantially:

- In January 1990, landlords owed banks $10.5 billion, but by January 2010 the figure had grown to $324 billion.
- Tax Office figures show 1.1 million Australians declared negatively geared property investments in 2006-07.
- In the 13 years to 2006-07, landlords as a group went from declaring net profits of $399 million to net losses of $6.4 billion.
- Those reporting profits grew by 36,000. Those reporting losses grew by 594,000.
- Last financial year alone investors used negative gearing concessions to claim $8.6 billion in losses (Colebatch 2010).

In economic theory they speak about government spending crowding out private investment. In the housing market what we see now is investors crowding out genuine homebuyers, aided and abetted by generous taxation arrangements, with the likelihood future generations will not be able to afford their own home.

- From 1995 to 2007, the Bureau of Statistics reports, home ownership among people aged 25 to 34 shrank from 52 per cent to 43 per cent.
- Among people aged 35 to 44, it shrank from 73 per cent to 65 per cent.
- 40 per cent of lending to people buying established homes now goes to investors (Ibid).

The impact of the increase in property investment on Australia's house prices can be seen in the following chart.



As the Chart illustrates, despite flat rental growth, house prices surged from 2000 as investors piled into investment property on the back of the new tax rules that enabled them to partly socialise income losses from holding investment properties via negative gearing, whilst privatising more of the gains achieved through capital appreciation via the capital gains tax concession (Onselen 2010).

It is important to note that the new tax rules for capital gains abolished indexation which means that over one year, say, the capital gains tax is indeed halved, but over the longer term it can even be higher. At 3.0% annual inflation, over 25 years an asset with no real capital gain doubles in nominal value, wiping out the 50% reduction. From then on, the capital gains tax take is actually higher than it was under the previous regime, because it is taxing nominal gains. What this does is enhance the distortionary incentives for short-term speculation (McAuley 2009).

The Henry Tax Review addresses the issue of negative gearing and discounted capital gains and proposes a 40 per cent discount. Those declaring a loss from a rented property would receive a deduction from their tax bills 40 per cent smaller than at present. The present 50 per cent discount for capital gains would be reduced to the same 40 per cent figure. According to Henry the current system for taxing assets that yield capital gains and which allow for interest to be deductible at the full marginal tax rate encourages households to take on too much debt and risk when undertaking these investments (Australia’s Future Tax System 2010).

The last government to reform negative gearing was the Hawke government in 1985 which, as a part of a broader tax reform package, quarantined losses from negative gearing by stopping them from being deducted against other income. After strong lobbying from the property industry, however, which claimed investment in rental accommodation had declined significantly and rents had risen as a result of the changes, the old rules were restored in 1987.

The claim by the property industry that the abolition of negative gearing had such a significant impact was not reflected in ABS data at the time. Rents rose in both Sydney and Perth, were flat in Melbourne and Adelaide, and fell in Brisbane. If the abolition of negative gearing caused rents to rise, rents should have risen Australia-wide since negative gearing affects all rental markets. Clearly, based on this evidence, the property industry claim about the impact of negative gearing on rents was exaggerated (Onselen 2010).

This conclusion is supported by Saul Eslake, former Chief Economist at the ANZ, using different rental data. According to Mr Eslake:

"It's true, according to Real Estate Institute data, that rents went up in Sydney and Perth. But the same data doesn't show any discernable increase in the other State capitals. I would say that, if negative gearing had been responsible for a surge in rents, then you should have observed it everywhere, not just two capitals."

The claim that negative gearing increases the supply and availability of rental accommodation has not occurred. According to Reserve Bank data the share of investment in new construction has fallen for the past 25 years, from around 60% in the mid-1980s to around 5% currently. So despite the favourable tax treatment provided to property investors in Australia, for every 20 investment homes purchased in 2010, only one is a new dwelling that has actually added to housing supply and rental availability (Ibid).

The data on new home construction by investors is even more revealing. It shows a significant increase in investor loans for existing properties from around 2000 onwards, at the same time as the reduction in capital gains tax. By contrast, loans for new construction have remained relatively flat for the past 25 years. As a comparison, the ratio of investor lending for existing dwellings to new dwellings was around 2:3 in 1985; 7:1 in 2000; and 15:1 in 2010 (Ibid).

Based on this evidence Leith van Onselen, former economist from the Australian Treasury and currently working for a leading investment bank, concludes:

“There is clearly little merit in Australia's tax concessions for property investment. Negative gearing and the capital gains tax concession do not provide any incentive to invest in new housing because they are available for both existing homes as well as new ones. And since these concessions do not increase housing supply, they also do not put downward pressure on rents.

Rather, the increase of investment in existing dwellings has merely significantly added to housing demand, reduced housing affordability, and displaced potential owner-occupiers, forcing them onto the rental market. While the cost to the taxpayer is immense, the costs to younger Australians, in particular, from reduced housing affordability and increased debt levels is even greater.”

The Henry Review provides a sensible policy direction that would begin to address the impact of negative gearing and capital gains tax concessions on housing affordability. There is also Steve Keen’s recommendation of abolishing negative gearing on existing houses, along with the beneficial treatment of capital gains, and allowing it only on new buildings. This would address supply side issues and discourage speculation on existing dwellings (Keen 2007). Ian McAuley from the University of Canberra believes it would be far better public policy to re-introduce indexation of capital gains without any discount which would also address the issue of speculation (McAuley 2009).

It is the politics, however, moderate reforms like this can be difficult. Grandfathering existing provisions so that pre-existing investment property owners are not disadvantaged would make the political sell easier, or in the case of capital gains, the case could be argued of the advantages of indexation over the 50 per cent discount. Negative gearing's cost to the Government and impact on house prices would be greatly reduced if, from a certain date in the future, it was retained on newly constructed dwellings but abolished where an investor purchases an existing dwelling. Tax deductible interest would over time begin to fulfil its economic purpose of encouraging investment in new housing supply. Such an approach would most likely be supported by the home building and property development industry because it promotes higher building levels. Moreover, the increased housing supply would be likely to increase the availability of rental properties and lower rents (Onselen 2010).

The Economist has reported that Australia's housing market is overvalued. Reforms to tax concessions on housing would actually address the issue of an inflated real estate market. More importantly, however, if governments are serious about addressing housing affordability it's not just about running a tight budgetary policy in order to influence monetary policy decisions. It's about taxation reform that will facilitate better access to affordable housing for first homebuyers and owner-occupiers.

Short-termism in policy has dominated the political landscape over the last decade as successive Australian Governments seek to indulge segments of the electorate and vested interests rather than provide visionary policies that may be difficult politically, but are necessary to promote sustainability. Generous taxation policies in housing are an example of unsustainable policy and have created an inequitable market whereby genuine aspiration for home ownership is dashed on the rocks of exorbitant house prices.

References:

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