The Australia Institute
Research that matters.

Submission to the Inquiry into Home Ownership

Submission
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Matt Grudnoff

TAI

Submission

About TAI

The Australia Institute is an independent public policy think tank based in Canberra. It is funded by donations from philanthropic trusts and individuals, memberships and commissioned research. Since its launch in 1994, the Institute has carried out highly influential research on a broad range of economic, social and environmental issues.

Our philosophy

As we begin the 21st century, new dilemmas confront our society and our planet. Unprecedented levels of consumption co-exist with extreme poverty. Through new technology we are more connected than we have ever been, yet civic engagement is declining. Environmental neglect continues despite heightened ecological awareness. A better balance is urgently needed.

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Our purpose—'Research that matters'

The Institute aims to foster informed debate about our culture, our economy and our environment and bring greater accountability to the democratic process. Our goal is to gather, interpret and communicate evidence in order to both diagnose the problems we face and propose new solutions to tackle them.

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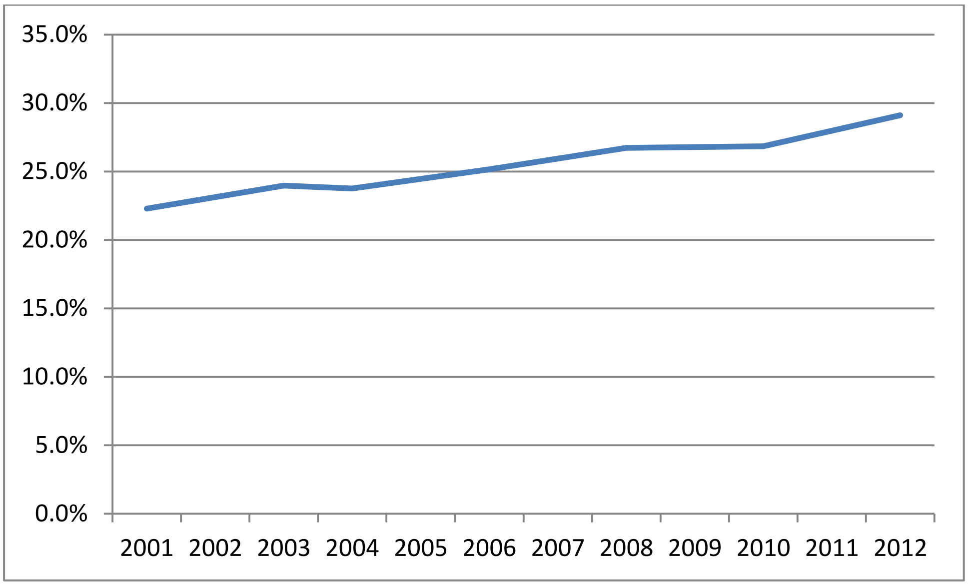
Unit 1, Level 5, 131 City Walk
Canberra City, ACT 2601
Tel: (02) 6130 0530
Email: mail@tai.org.au
Website: www.tai.org.au

Housing affordability

Housing affordability is a complex issue with many moving parts. While some parts of the problem are beyond the domain of the federal government, in particular the supply of land, the federal government can play an important role in helping make housing more affordable.

Loans for residential rental property have expanded rapidly, increasing from 16 per cent in 1992 to 40 per cent in 2014.[1] Rapidly increasing numbers of rental properties has led to rising rental rates as the increasing number of rental properties will come out of the available pool of housing, and mist increase the number of renters. Rental rates have risen from just over 22 per cent in 2001 to 29 per cent in 2012.

Figure 1 – Proportion of households renting 2001 - 2012



Source: ABS (2013) 6523.0 - Household Income and Income Distribution, Australia, 2011-12

From 2002 to 2012 middle and low income households have been increasingly locked out of the market with their home ownership rates in decline. They have fallen 19 per cent for middle income households and 15 per cent for low income households.[2]

The role of taxation

The increase in rental houses and rental rates is being driven in significant part by the federal government's tax treatment of housing. Not only is this tax treatment putting upward pressure on house prices but are also encouraging speculative behaviour and increasing the chances of property bubbles and financial instability. Two tax treatments in particular are in need of reform: negative gearing and the capital gains tax (CGT) discount.

The way in which negative gearing and the CGT discount interact is of particular concern. Negative gearing has been a part of the Australian tax system from early last century. In the context of residential housing investment it allows property investors to write off any losses

[1] ABS (2015) 5609.0 - Housing Finance, Australia, Apr 2015

[2] Johnson M & Baker D (2015) The great Australian lockout: Inequality in the housing market, The Australia Institute

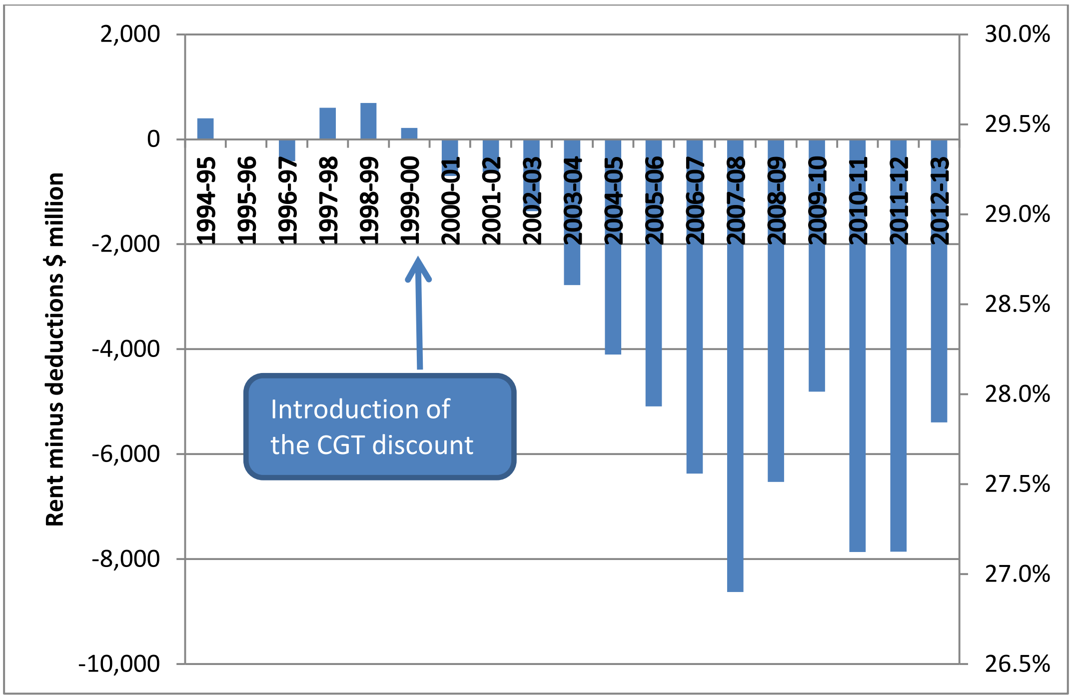
against their taxable income from other sources. This effectively means that the tax payer is paying for some of the loss.

Even with tax payers picking up some of the loss, this should not encourage people to deliberately make a loss since the investor still has to pay most of the loss from their own pocket. The investor makes another form of gain through capital gain on the property. After the property is sold, if the capital gain after tax is greater than the loss paid by the investor then the investor is ahead.

This is where the CGT discount is important. The CGT discount was introduced in 1999 and means that for assets held for more than a year only 50 per cent of the capital gain is taxed. This decreased the amount of CGT paid, and means capital gains become increasingly important to property investment.

The effect of the GCT discount can be seen in figure 2 which shows net rental income.

Figure 2 – Net rental income 1995 - 2013



Source: ATO (2015) Taxation statistics 2012-13

After the introduction of the CGT discount net rental income collapsed. Investors were willing to take on significantly larger losses at a time when they could keep a larger slice of the capital gain.

Speculative investment

The CGT change had another effect. The CGT discount means that if a property was going up in price then the rental return was less important as the capital gain was much more lucrative. A focus on capital gain at the expense of return is speculative investment.

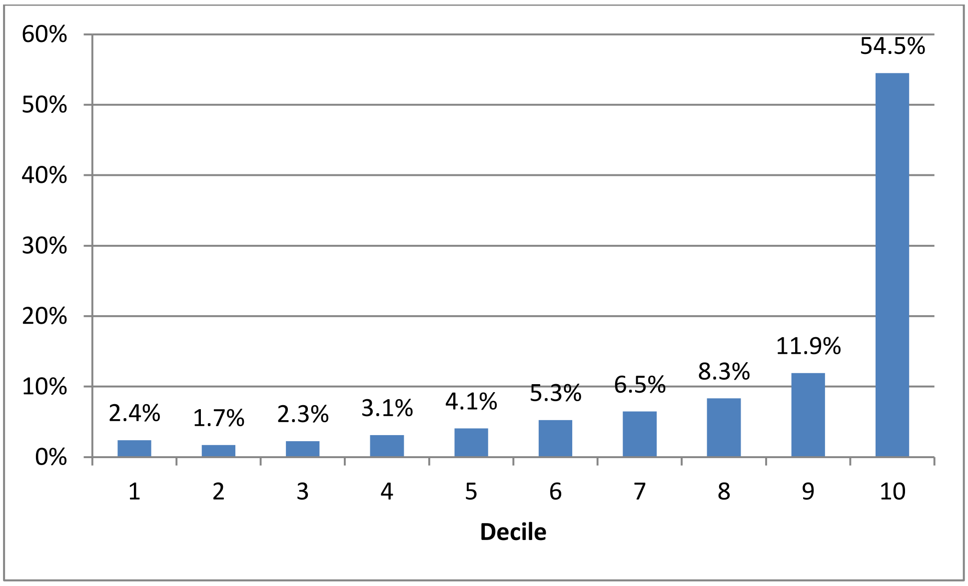
For example, in a normal investment market if the return on the asset was going down because the price of the asset was rising then this would be a signal to investors that it could be overvalued and would decrease the interest in investing. But an interest in capital gain means that a rising price is a signal to enter the market because future capital gain is likely.

Such a situation makes speculative bubbles more likely. This is why David Murray, the former head of the Commonwealth Bank, wrote in his report on the financial system that negative gearing and the capital gains tax discount were encouraging speculative behaviour.[3]

Distribution of benefit

While middle and lower income households are being increasingly shut out of home ownership, most of the benefits of negative gearing and the CGT discount flow to high income households. Modelling done by NATSEM for the Australia Institute shows that 55 per cent of the benefits of negative gearing and the CGT discount flow to high income households, while 50 per cent of families only get 13 per cent of the benefit.[4] Figure 3 shows the income distribution of the negative gearing and CGT discount benefits.

Figure 3 – Income distribution of negative gearing and CGT discount



Source: Grudnoff (2015) *Top Gears: How negative gearing and the capital gains tax discount benefit drive up house prices*, The Australia Institute

Investment in new housing

It is claimed that encouraging investment in residential property brings new housing stock to the market and therefore puts downward pressure on housing prices. Changing negative gearing, it is claimed, will decrease the amount of investment in residential property, decrease the amount of new housing, and therefore put upward pressure on house prices.

This argument is weak because there is little property investment in new housing, with just six per cent of investment finance going to new housing.[5] The other 94 per cent is spent on

[3] Murray D (2015) Financial System Inquiry

[4] Grudnoff (2015) *Top Gears: How negative gearing and the capital gains tax discount benefit drive up house prices*, The Australia Institute

[5] ABS (2015) 5609.0 - Housing Finance, Australia, Apr 2015

existing stock. If the objective of negative gearing is to encourage new housing then this can could be achieved by restricting negative gearing to apply only to new housing.

By restricting negative gearing to new housing it will not only allow the six per cent who are buying new housing stock to continue investing, it will also encourage those who want to invest in housing to do so with new houses rather than second hand housing stock.

Proposed reform

The Australia Institute proposes that negative gearing is restricted to new housing stock and only for a period of 10 years.

The CGT discount replaced a system where capital gains were discounted by the inflation rate. The argument for the CGT discount is that it is a simpler method for calculating and taxing the real capital gain. The broader question that should be considered is why we tax real capital gains but level all other taxes on the nominal gain. For example, interest earned on money is taxed at the nominal interest rate rather than the real interest rate.

Given that all other taxes are levelled on the nominal gain and not the real gain there is little justification that capital gains should be taxed differently. The Australia Institute proposes that the CGT discount should be abolished.

Impact of reform

These changes will have a number of effects. It will decrease demand for housing and hence put downward pressure on house prices as potential investors pick other investment opportunities. It creates a bigger incentive for new housing. It reduces the speculation in the residential housing market, making property bubbles and financial instability less likely. Finally it will raise $7.4 billion a year in revenue at a time when the government is trying to decrease the budget deficit.[6]

While the federal government has little influence over the supply of housing, it can still make a significant impact on housing affordability.

[6] Grudnoff (2015) *Top Gears: How negative gearing and the capital gains tax discount benefit drive up house prices*, The Australia Institute