Submission to the Inquiry into foreign investment in residential real estate

The Terms of Reference of the Inquiry are –

• the economic benefits of foreign investment in residential property;

• whether such foreign investment is directly increasing the supply of new housing and bringing benefits to the local building industry and its suppliers;

• how Australia's foreign investment framework compares with international experience; and

• whether the administration of Australia's foreign investment policy relating to residential property can be enhanced.

Executive Summary

The views contained in this submission are my personal perspectives – as a concerned Australian citizen.

1. While there may be economic benefits of foreign investment in residential property to the local building industry and its suppliers, the research in this submission will show that the perceived economic benefits are likely to be outweighed by the negatives effects.
2. The research shows that foreign purchasers of residential property are creating unprecedented price pressure on residential property.
3. This has in effect priced out (economists call it "*crowding out*") the average Australian home buyer with the consequence that –

"A generation of Australians are being priced out of the property market. Many face a life time of renting. Others are considering a move to the cheaper city fringes, areas which are notorious for their considerable infrastructure deficit."[3]

4. Rents should be lower if the foreign buyers are adding to the supply of new housing in a meaningful way. The high rents do not support this proposition.

5. By substituting the foreign purchaser with the local buyer, through greater affordability, the same building activity could be achieved with benefits to the whole economy. The foreign purchaser typically does not obtain finance from Australian financial institutions. By comparison, the local purchaser borrows from Australian financial institutions – thereby providing economic benefits to the Australian economy through the credit multiplier effect.
6. The traditional measure of the ratio of house prices to annual household income which tend to put a lid on house prices, break down when foreign purchasers arrive with foreign capital and bid up property prices to levels unrelated to annual Australian household incomes.
7. High property prices are shown to be directly associated with the high Australian labour costs. This has caused significant companies laying-off staff which historically had good well paying jobs eg. Caltex, Shell, Ford, Holden, Toyota, Alcoa and Boeing – just to name a few.
8. Compared to other countries facing large investment inflows from foreign purchasers of residential property such Singapore, Hong Kong and Canada, Australia's framework of foreign investment in residential property can be described as *laissez-faire*.
9. Australia's policy on foreign purchasers of residential property could be enhanced by –

i. improving compliance of reporting of foreigners purchasing residential property, and

ii. reducing foreign demand by introducing additional taxes or levies to fund aging and inadequate infrastructure which was previously funded by past generations of tax paying Australian citizens.

<u>Main body of the Submission</u>

The Terms of reference will be dealt sequentially in this submission as follows –

1. **The economic benefits of foreign investment in residential property, and**

2. **Whether such foreign investment is directly increasing the supply of new housing and bringing benefits to the local building industry and its suppliers**

The above 2 terms of reference are related to a high degree as new residential property development is a major driver of economic growth. As such, this submission will deal with them together.

While there may be economic benefits of foreign investment in residential property to the local building industry and its suppliers, the research in this submission will show that the perceived economic benefits are likely to be outweighed by the negative effects. The research shows that foreign purchasers of residential property are creating unprecedented price pressure on residential property. This can potentially cause property prices to deviate from the fundamentals of debt servicing and income growth, thereby creating a risk of a destabilising correction later on.

1.1. High residential property prices ➔ high labour costs

Land and residential property values are key factor inputs to the economy. To a large extent, it determines the labour costs which affect the economy and social equity. Businesses complain that Australia has a high cost structure and it is easy to see that this is a consequence of high residential property price *ceteris paribus*.

I will demonstrate this with two simplified illustrations –

i. **Renters**

Take the Sydney median unit (apartment) value of $552,500 as at 31 March 2014[1]. Say two young workers share accommodation in a 2 bedroom rental unit. With Sydney unit rental yields at 4.6%[1], these two young workers will have to pay $489/week ie. $244/week each. This equates to $12,707 per year in rent alone. As a rough guide, these workers will need to be paid a pre-tax income of $38,122

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[1] Source : RP Data-Rismark March Hedonic Home Value Index Results
Released: Tuesday 1 April 2014

just to live on – this is barely above the minimum wage of $622.20/week or $32,354 per year for Financial Year 2013/14.

ii. <u>Mortgage Payers</u>

Take a family of four living in Sydney – mum and dad with 2 primary school children. Say this family buys a $1M house[2] with a 20% equity ($200,000 – which is a lot of money). The husband borrows $800,000 to buy the house. At say a 5% mortgage rate, interest repayment alone is $40,000 (post-tax) – without repaying any of the owed principal.

The family will very likely require a family pre-tax income of $120,000 just to live on and make the interest repayment.

The husband could be your average "Joe" tradesman (electrician, plumber, carpenter, builder, garage mechanic), and therefore anecdotally charge you $60-70 for a call out fee. Anecdotally, the local garage mechanic charges $100/hour, while the exercise treadmill technician charges $120/hour for the first hour on site. These are examples of the high labour costs.

Therefore, high property values drive up the cost of labour, and make Australia uncompetitive. It is often cited that our labour costs (from waiter/waitresses to computer IT staff) are high compared to the other developed OECD countries. A major contributing factor is the result of high property prices in Australia, for example, versus the often cited United States. Australia high labour costs have caused, in part, the termination of many good high paid jobs in the oil refining industry (Caltex and Shell), Alcoa, the car manufacturers (Ford, Holden, and Toyota), and Boeing to name a high profile names. There are many other businesses struggling with the high cost structure.

1.2. <u>Undesirable Social Outcomes for future generations of Australians</u>

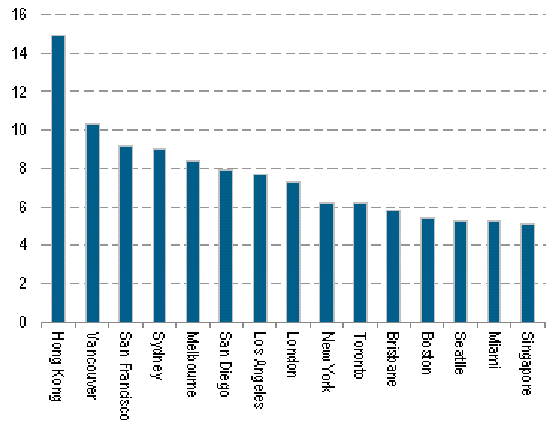
The effects of social equity of high residential property prices are also negative. In a recent report by the investment bank Credit Suisse[3] which concluded that –

[2] The Sydney median house value was $713,000 as at 31 March 2014[1]
[3] Credit Suisse ***"The Chinese Property Boom Down Under"*** *4 March 2014*

"A generation of Australians are being priced out of the property market. Many face a life time of renting. Others are considering a move to the cheaper city fringes, areas which are notorious for their considerable infrastructure deficit."

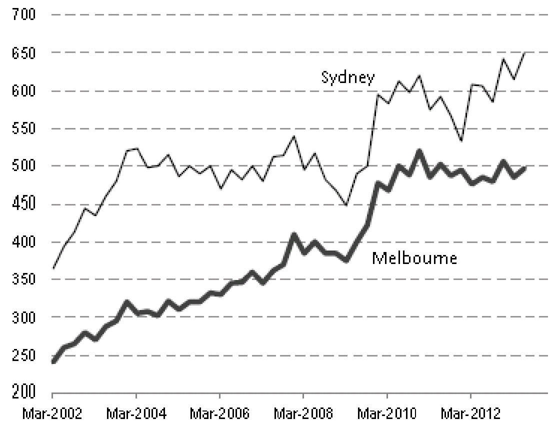
As Figure 2 below contained in the Credit Suisse report show, the three Australian East coast cities (Sydney, Melbourne and Brisbane) are in the top most expensive global 15 cities with populations of more than 2M.

Figure 2: **The Aussie east coast is expensive**
Highest House Price to Income Ratio. Cities More than 2m People*



** Income per adult. Source: Demographia Int. Housing Survey*

Figure 3: **Sydney & Melbourne home owners are happy**
Median Established House Price in Sydney and Melbourne ($000)



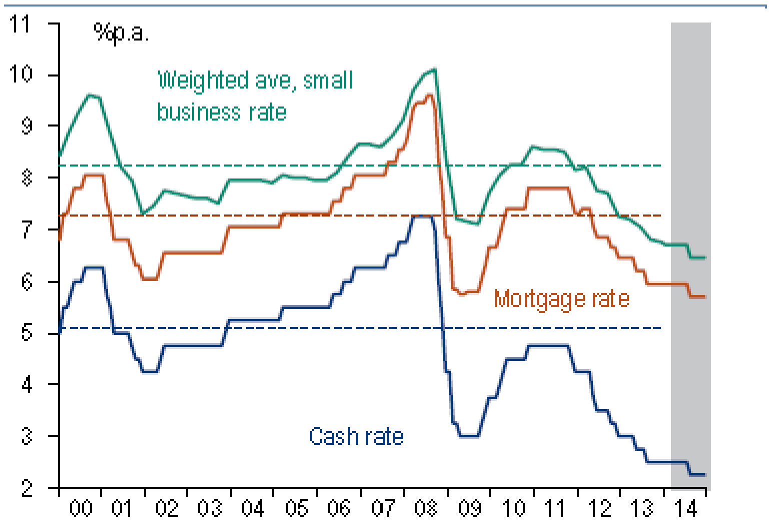
Source: Australian Bureau of Statistics

Figure 3 above show the value of house prices in Sydney and Melbourne from the Australian Bureau of Statistics over the last 12 years since 2002. What is striking is the rate of growth in the prices.

1.3. <u>Are foreign purchasers of residential property increasing the supply of new housing?</u>

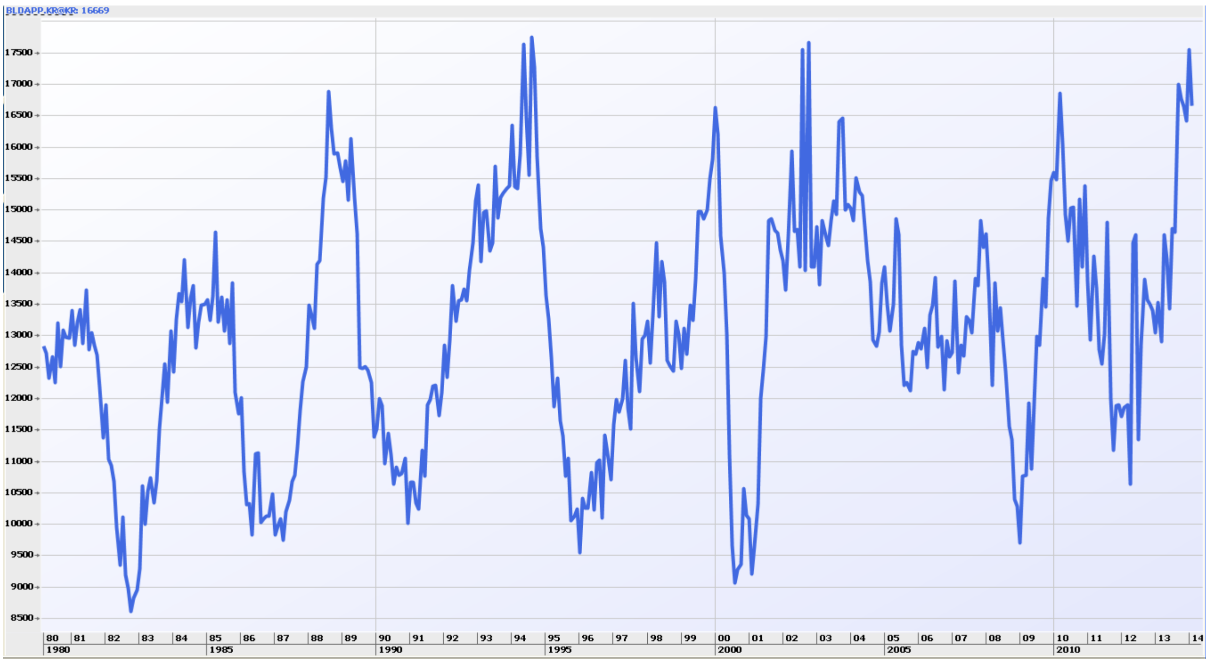
With record low mortgage rates as shown in the Chart 5 below, and building approvals close to thirty year highs as shown in Chart 6 below, there should be evidence of stabilisation (or moderate increase) of house prices if there were no external demand from foreign purchasers of residential property.

Chart 5: Official and effective interest rates



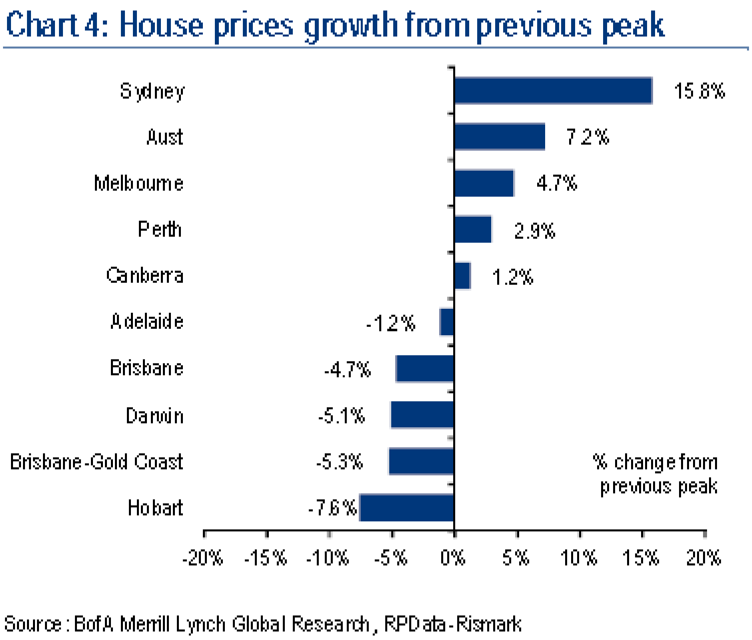
Source: BofA Merrill Lynch Global Research, RBA

<u>Chart 6 : AUSTRALIAN MONTHLY BUILDING APPROVALS – March 1980 – February 2014</u>



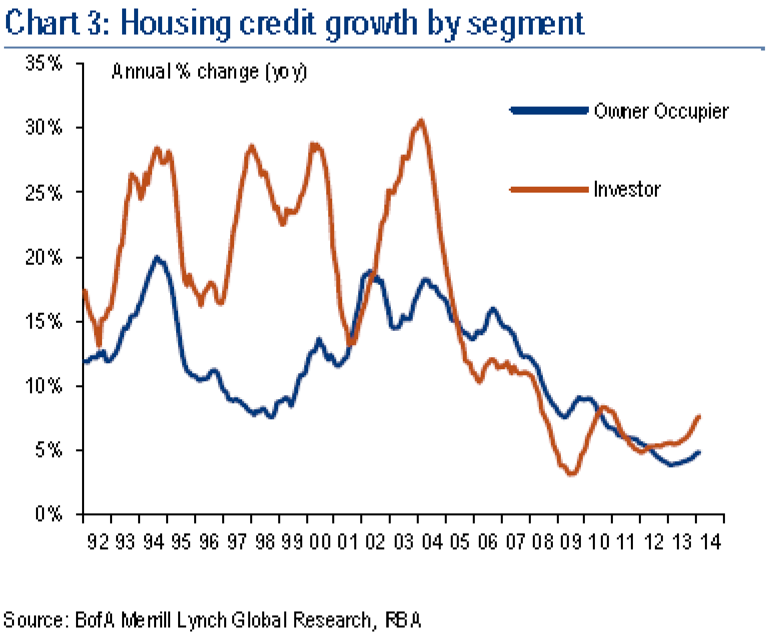
Source : IRESS

However, the evidence shows that prices have increased at an alarming rate. Chart 4 below from the investment bank - Bank of America Merrill Lynch[4] - show Australian house prices measured from their previous peak are 7.2% higher, with larger increases particularly in Sydney (15.8%) and Melbourne (4.7%).



In addition, housing credit growth particularly to first home buyers is low – indicating that they are priced out of the residential property market – refer to Chart 3 below.

[4] Bank of America Merrill Lynch ***"Australia Economic Weekly"*** *4 April 2014*



The above chart also show that despite foreign interest in the property market, credit growth from investors is relatively benign, indicating that foreign purchasers do not borrow from Australian financial institutions but source their finances offshore thus providing limited benefit to the demand for credit from local Australian banks.

Furthermore, in Figures 4 and 6 below from investment bank Barclays[5], the ratio of house prices to annual income is close to an all-time high, while gearing as measured by household debt as a % of income is at a record 177% of income.

This is a significant social burden inflicted on younger Australians due to foreign buyers of residential property pushing up prices for the locals.

Moreover rents (as reflected in the rental yields stated earlier of 4.6%[1]) have also not declined to make the cost of living more affordable for the lower paid employees such that these individuals have a higher disposable income to consume more to generate a greater growth in the economy. ***Rents should be***

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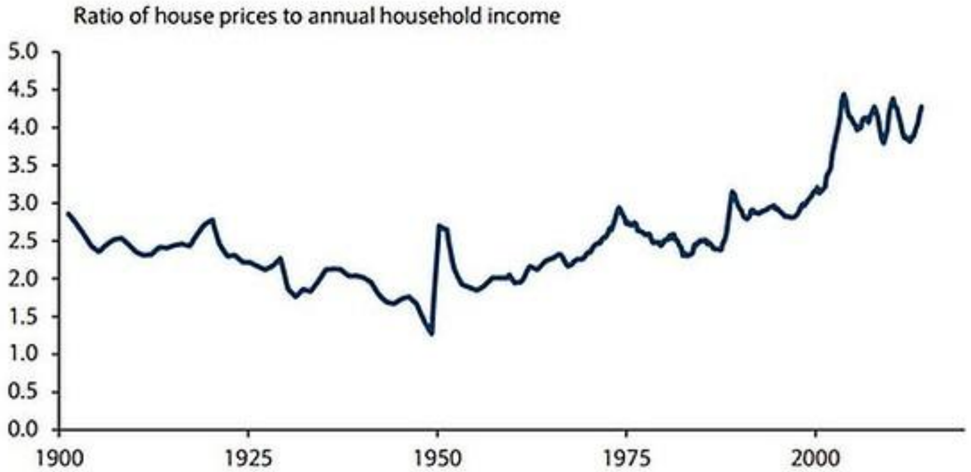
[5] Sydney Morning Herald (SMH) **"Australia's house prices 'flashing red', debt to income ratio at record levels"** *4 April 2014*

lower if the foreign buyers are adding to housing stock in a meaningful way. The high rents do not support this proposition.

FIGURE 4

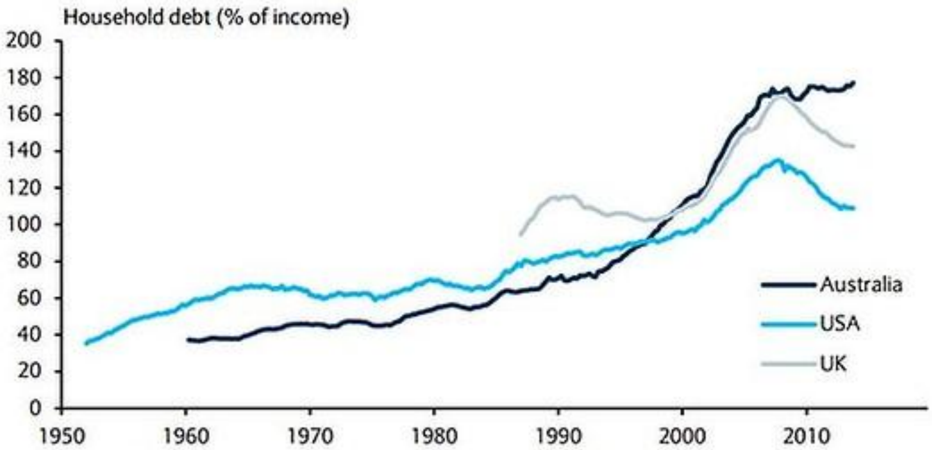
Home prices are almost back at their all-time high as a share of household income



Source: Australian Bureau of Statistics, Real Estate Institute of Australia, RP Data-Rismark, Stapledon, Barclays Research

FIGURE 6

Gearing has started to increase again and is now at a record 177% of income



Source: Australian Bureau of Statistics, Bloomberg, Reserve Bank of Australia, Barclays Research

1.4 ***High residential property prices are crowding out demand from first home buyers***

The growth rate of residential property prices in Australia is the highest among the Anglo World since 2007[6] (refer to the following chart), despite the expectation that foreign buyers increases the supply of new homes, and therefore price increases should be more moderate. From the research presented so far, it can be concluded that residential property prices are driven upwards due to the demand from foreign buyers setting the high prices, which subsequently affects the rest of the residential property market.

The economic benefits to the building industry would still accrue to the Australian economy if we substitute foreign buyers with local buyers, especially from the first home buyers who are currently priced out of the residential property market despite record low mortgage interest rates.

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[6] SMH "**Housing bubble fears: property prices could fall 10 to 20 per cent"** *1 April 2014*

3. How Australia's foreign investment framework compares with international experience

3.1 Over-representation by Chinese investors in Australian Real Estate

Using data from the 2012-13 Foreign Investment Review Board (FIRB) Annual Report in Table 2.11 below, across all industries, it shows that a total of 13,421 approvals were given by the FIRB in that year. China alone received 6,102 approvals representing 45.5% of the total approvals.

Real Estate received the largest approval by value at $51.9Bn. Of this value, China received the largest approval to invest $5.9Bn in Real Estate (an increase of 41% from 2011-2012[7]). This $5.932Bn approved for China represented 11.4% of the Real Estate industry's approval.

Table 2.11: Approvals by country of investor in 2012-13 — industry sector

Country(a)	Number of approvals(e)	Agriculture forestry & fishing $m	Finance & insurance $m	Manufacturing $m	Mineral exploration & development $m	Real estate $m	Resource processing $m	Services $m	Tourism $m	Total $m
USA	264	880	1,647	1,563	5,381	4,406	60	6,666	25	20,627
Switzerland	51	-	-	12	15,763	346	-	2,266	-	18,387
China(b)	6,102	328	23	957	8,273	5,932	-	291	-	15,803
Canada	218	553	-	355	1,545	4,926	25	6,987	-	14,392
UK	1,197	-	159	494	3,198	1,671	-	1,318	-	6,849
Japan	111	-	129	-	2,906	895	-	654	-	4,589
Qatar	26	11	-	-	3,461	-	-	-	-	3,482
Singapore	675	380	-	-	189	2,008	-	563	-	3,145
Malaysia	894	-	-	826	147	1,600	-	198	-	2,785
Germany	113	-	129	253	-	769	330	635	-	2,117
NZ	34	-	-	82	60	644	-	1,116	-	1,903
United Arab Emirates	45	-	-	-	15	885	-	809	-	1,709
Sth Korea	114	-	11	643	19	903	-	-	-	1,579
Hong Kong	251	14	18	350	386	649	-	74	-	1,491
South Africa	223	-	-	-	31	953	-	306	-	1,290
France	122	-	69	36	730	100	-	333	-	1,273
Spain	15	-	-	-	32	325	-	830	-	1,187
Netherlands	56	-	-	-	22	229	-	858	-	1,109
Other(c)	2,332	205	79	725	1,570	10,216	-	767	-	13,561
Sub-total	*12,843*	*2,396*	*2,279*	*6,299*	*43,728*	*37,457*	*422*	*24,669*	*25*	*117,279*
Australia(d)	578	461	645	210	1,414	14,450	-	1,241	-	18,420
Total	**13,421**	**2,858**	**2,924**	**6,509**	**45,142**	**51,907**	**422**	**25,909**	**25**	**135,699**

Note: Totals may not add due to rounding.
'-' indicates a figure of $10 million or less.

[7] In the 2011-2012 FIRB report Table 2.11, China received approval to invest $4.187Bn in Real Estate.

Due to the lack of timeliness of the FIRB annual report (the 2012-13 report was only issued on 28 February 2014), media reports indicate that Chinese buyers continue to be over-represented in Australian residential purchases in 2013/14. A listing of the media reports are given below, and are attached for easy reference.

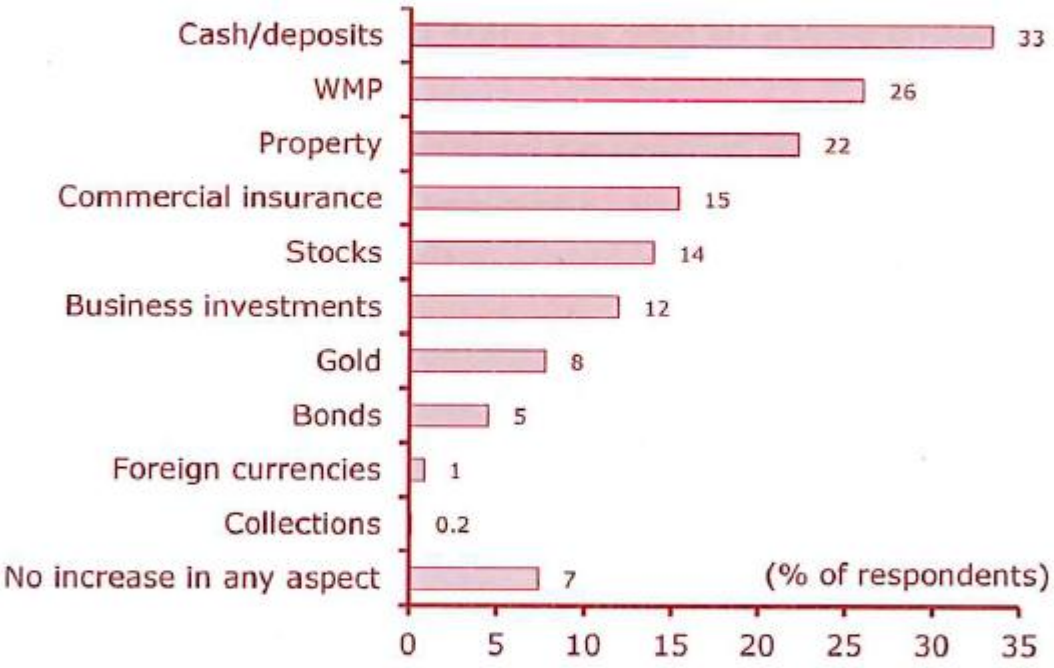
In summary, all the media reports highlight the upward pressure on residential property prices by foreign buyers in Australia, Hong Kong, Singapore, Canada and the United Kingdom. In Australia, this has priced out many local buyers, especially the first home buyers, from the residential property market potentially creating generations of social inequity.

Number	Date	Source	Title
1	29-Oct-2012	World Property Channel Asia-Pacific Edition	**Hong Kong Slaps New 15% Property Tax on Foreign Buyers to Cool Market**
2	10-Dec-2013	Sydney Morning Herald	**First home buyers squeezed as investor borrowing hits record levels**
3	14-Dec-2013	Sydney Morning Herald	**Squeezed at home, wealthy Chinese are sold on Sydney**
4	17-Jan-2014	Macrobusiness	**Foreign property investment and the Chinese factor**
5	2-Feb-2014	The Observer (UK)	**Stop rich overseas investors from buying up UK homes, report urges**
6	24-Feb-2014	Sydney Morning Herald	**Shunned Chinese buyers to turn from Canada to Australia**
7	25-Feb-2014	Global Property Guide	**Singapore's foreign real estate investment curbs won't be relaxed anytime soon**
8	5-Mar-2014	Australian Broadcasting Corporation	**Chinese buyers to invest $44b in Australian real estate: analysts**
9	21-Mar-2014	Australian Broadcasting Corporation	**Insider: Foreign property investor rorts "prevalent"**
10	1-Apr-2014	Sydney Morning Herald	**Housing bubble fears: property prices could fall 10 to 20 per cent**

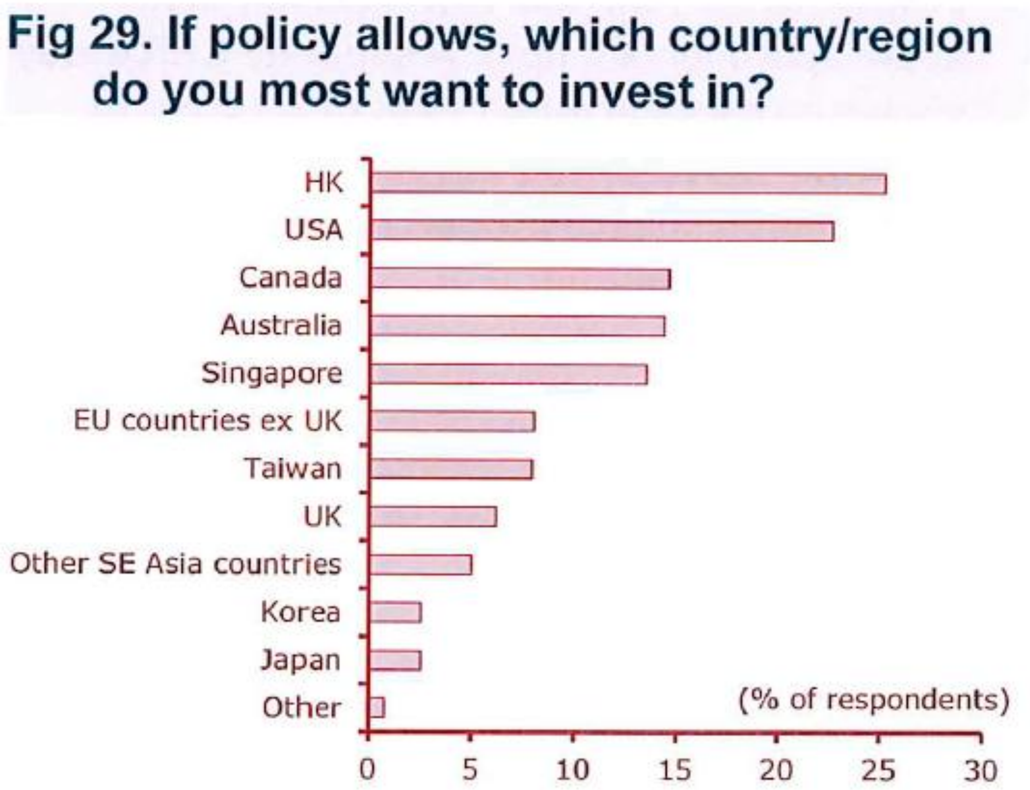
11	4-Apr-2014	Bloomberg/Sydney Morning Herald	**Struggling London home buyers blame foreigners for price surge**
12	4-Apr-2014	Sydney Morning Herald	**Australia's house prices 'flashing red', debt to income ratio at record levels**
13	5-Apr-2014	Sydney Morning Herald	**Boom threatens the great Australian dream of a home**

The Chinese demand reflects a report by the investment bank Credit Lyonnais SA (CLSA) of investment intentions over the next three years[8]. The report indicates that Property Investment is the third highest preference after cash/deposits and wealth management products. It also reports that Australia is the fourth most desirable destination for investment. Refer to Figures 28 and 29 below.

Fig 28. Over the next three years, you plan to increase your investment in:



[8] Credit Lyonnais SA ***"Mr and Mrs China dare to dream"*** *September 2013*



Taken together with Credit Suisse's report[3] which states –

"There are currently 1.1mn US-dollar millionaires in China, according to the Credit Suisse Global Wealth Report. These individuals can easily afford to buy an apartment in say Chatswood — an upper-middle class area of Sydney renowned to be popular with the Chinese. The median apartment in Chatswood currently sells for $700,000 and has risen by 15% over the past 12 months. If we assume growth in the number of Chinese millionaires slows to 5% p.a. for the next seven years, down from 12% over the past three, then there will be more than 1.5mn wealthy individuals by 2020 or 30% more than current. The IMF forecasts nominal GDP in China will double over the same period. This additional demand should support a further $44bn of Australian residential property purchases over the next seven years. They purchased $24bn over the past seven"

- abnormally high property prices are inevitable without government policy, taken in the national interest, to curb foreign demand.

This investment intention identified in the CSLA report is over and above the Chinese President Xi JinPing's pronouncement on identifying and prosecuting corrupt officials within China – causing a potential outflow of funds seeking a home to hide any ill-gotten proceeds.

3.2 ***Effectiveness of existing FIRB framework in relation to Real Estate purchases by foreigners***

Compliance by foreign investors in the residential property market is difficult to verify. Media reports have suggested that there are loop holes being exploited by some foreign investors. The ABC reported[9] and I quote in part –

"Foreign investors can only buy newly-built properties, which is the Government's way of boosting construction.

But there is scepticism with some real estate agents suspecting that rules are being bent.

Ballard Property Group's Bill Bridges sells multi-million-dollar established homes in Sydney's eastern suburbs and says he has seen a big jump in interest.

He says he always asks whether paperwork is in order and "the main answer to that is they say 'Well, we'll take care of that, that's not a problem'".

Mr Fuggle [of global law firm Baker MacKenzie] says buyers can easily circumvent the rules by getting a resident to buy property on their behalf.

"And that would be very difficult to detect and I think it would be quite difficult to police … anecdotally it seems to be a relatively prevalent activity," he said.

Australian banks are also allowed to offer products which facilitate foreign nationals to circumvent the rules.

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[9] **ABC Insider: *Foreign property investor rorts "prevalent"*** *19 March 2014* **- *ABC: http://www.abc.net.au/news/2014-03-19/insiders-warn-property-rules-rorted/5332338***

To qualify for residency under the Significant Investor Visa program, $5 million must be invested in Australian Government approved products for four years.

Real estate is not an approved product.

But Macquarie Bank is lending the $5 million back to investors, which Mr Fuggle says can then be legitimately put into real estate.

"Proceeds of that loan are essentially unregulated money so they invest that wherever they like," he said.

…Banking analyst Martin North says this shows regulation is weak.

"I'm not sure that the policing is that real. It's a process that everybody goes through but if you think about the 6,000 applications they receive every year, are they really going to look at every one?" he said".

Therefore, given the above environment, it is not difficult to conclude that foreign purchasers, particularly the Chinese, exert an unhealthy upward pressure on residential property prices.

3.3 ***Overseas Government policies in curbing foreign investment in residential property***

To curb the upward pressure of property prices as "beneficiaries" of Chinese foreign property investments[7], overseas countries such as Singapore[10] (initially in December 2011) introduced an additional buyer's stamp duty (ABSD) for foreign investors of 10% which was further increased to 15% in January 2013; Hong Kong[11] (in 2012) introduced a 15% property tax on foreign buyers; and Canada[12] (in 2014) has changed their visa programme to dampen foreign buyer demand.

Singapore has gone even further to limit speculation on residential property by applying the ABSD (at the lower rate of 7%) to Singaporeans purchasing a second

[10] Global Property Guide ***"Singapore's foreign real estate investment curbs won't be relaxed anytime soon"*** *25 February 2014*
[11] World Property Channel Asia-Pacific Edition "**Hong Kong Slaps New 15% Property Tax on Foreign Buyers to Cool Market"** *29 October 2012*
[12] SMH "**Shunned Chinese buyers to turn from Canada to Australia"** *24 February 2014*

home. The Australian Government should also reconsider the merits of allowing Self Managed Superannuation Funds (SMSFs) to invest in property, and therefore creating a demand that is not historically relevant to residential property prices. This additional demand from SMSFs has also added to the high residential property prices in recent years. I submit that an additional levy/tax should be applied to SMSFs property investments.

In the United Kingdom, Bloomberg[13] reported that –

"The UK government has taken steps to increase the tax burden for luxury homes and properties owned by foreign buyers through companies. The Treasury has to be "vigilant" as prices rise, Chancellor George Osborne said today".

Despite the FIRB rules that foreign purchasers can only buy new residential properties, it has already been discussed above that there are ways to circumvent the rules. Compliance is difficult, and the FIRB annual reports are extremely out of date to obtain a good handle of the dynamics of foreign buyers in the residential property market.

An example is provided below where FIRB approval is sometimes not required, and therefore it is difficult to determine how many buyers are foreign, and also when they use their family members or friends who are Australian citizens or permanent residents to make residential property purchases on their behalf. When this occurs, these foreigners are able to purchase established homes through the third parties.

A company called Exfin based in South Australia prepared a Guide for Foreign Citizens Buying Australian Properties[14] and states in part –

• *You* ***do not need FIRB approval if you purchase a new dwelling from a developer who has already received preapproval to sell them to foreign residents.*** *If you are in any doubt, contact the FIRB to confirm that approval is not required.*

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[13] Bloomberg **"Struggling London home buyers blame foreigners for price surge"** *4 April 2014*

[14] Exfin International "**A guide for Foreign Citizens buying Australian Residential property"** *2013*

• For those considering purchasing property through an Australian company or trust, note that "Australian incorporated companies or trusts where 15 per cent or more of the shares or units are beneficially held by a foreign person are themselves considered to be 'foreign' and require approval." They may however be situations where, because of recent changes to the tax law which we will cover later, <u>it may be more beneficial or effective to now purchase property through a trust or corporate structure rather than directly as an individual.</u>
• Some foreign investors in Australian real estate have the incorrect impression that only "off the plan "properties are available for foreign citizens. This is a consequence of Australian property developers constantly running offshore seminars focussed on the sale of these sorts of properties. Developers often trumpet stamp duty savings on the sorts of sales, and we will cover these later, but <u>potential purchasers are not just limited to this relatively narrow part of the market.</u>

From the research provided so far, Australia's framework on residential property can be considered *laissez-faire* compared to Hong Kong, Singapore and Canada.

As discussed above, Australian residential property should not be a globally traded good as it has a direct impact on the economic factor cost of production ie. labour costs. There are significant flow-on effects to the broader economy causing in part the high Australian labour costs.

4. Whether the administration of Australia's foreign investment policy relating to residential property can be enhanced

For the benefit of Australian citizens and its permanent residents, foreign purchasers of residential property should make a more substantial contribution to the Australian society via additional property taxes eg. Stamp duties or transactional taxes or levies for infrastructure.

These foreign purchasers do not live here to pay on-going Australian taxes which fund infrastructure – they are essentially getting a free ride vis-à-vis the Australian citizens and permanent residents. Our infrastructure funded by previous generations of tax paying Australians is now grossly inadequate and <u>**old**</u> requiring upgrading or replacement.

It is recommended that the Federal government -

i. Introduce additional taxes or levies on foreigners purchasing residential property to fund infrastructure
ii. Make reporting of foreign purchasers more transparent through working with the States' Land Title Offices to determine ownership.
iii. Reduce non-compliance and develop with industry the means to track foreign purchases using third parties more effectively
iv. Ensure that the FIRB data is timelier.

Submitted by : David Wong

Date : 29 April 2014