

# Chapter 4

## Factors influencing the demand for housing

4.1 There are a number of factors which have driven up the demand for housing, and in particular for home ownership, in recent years.

### Higher incomes

4.2 As Australia has lifted its productivity, and benefited from the higher prices for its commodity exports due to the 'resources boom', average incomes and household wealth have increased.<sup>1</sup> It is unsurprising that households have wanted to spend some of this increased income and wealth on improving the quality of their housing. At the upper end there has also been increased demand for second 'holiday' homes, particularly in coastal regions.<sup>2</sup> To the extent that supply responses are limited (see next chapter), this increased demand leads to higher prices.<sup>3</sup>

4.3 For many couples, household incomes are higher because both partners now work (as indicated by rising labour force participation rates). However, as Professor Julian Disney notes:

By fuelling competitive bidding-up of house prices it has led many couples into taking on excessive workloads to pay their mortgage.<sup>4</sup>

4.4 Incomes have increased at a similar pace across most income quintiles in the past decade.<sup>5</sup> But there are likely to be some groups whose capacity to save and bid

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1 Goldbloom and Craston (2008) show that since 2000 household net worth has risen more than 10 per cent a year, while inflation has been averaging only 2½ per cent.

2 Some press reports have suggested as many as 8 per cent of Australian households own a holiday home; *Australian Financial Review*, 30 May 2008, p. 9.

3 Productivity Commission (2004, p. 60) cite studies suggesting that real house prices in Australia might increase by around 1½ per cent for every 1 per cent increase in real income, but note these estimates seem well above those from other countries. Tu (1999) suggests that house prices rise more than proportionately with income in both Australia and the United Kingdom. Sutton's (2002, p. 49) study concluded 'a 1% increase in the growth rate of GNP is associated with a rise in real house prices in the range of 1–4% after three years' in advanced economies, with Australia at the lower end of the range. For Australia, he suggests income increases and interest rate declines explain most of the rise in house prices from 1995 to 2002.

4 Disney (2008, p. 253).

5 ABS data show that between 1995–96 and 2005–06, mean disposable household income grew by 33 per cent for the lowest income quintile, 34 per cent for the second lowest and middle quintiles, 31 per cent for the second-highest quintile and 40 per cent for the highest quintile.

for homes has improved less than others. For example, around 300 000 people have accumulated HECS/HELP debt, which may be an impediment to buying a home.<sup>6</sup>

## Demographics

4.5 The average household size has decreased for a number of reasons, such as later marriage, fewer children and increased incidence of separation and divorce.<sup>7</sup> This increases the demand for housing for a given population. Demographic projections are for this to continue, with lone person households expected to increase at a much faster rate than family and group households.<sup>8</sup>

4.6 Australia has relatively strong population growth for an advanced economy. A large component of this reflects relatively high immigration compared to comparable countries. Higher immigration rates have added to demand for housing, especially as immigrants tend to be disproportionately young adults.<sup>9</sup> Immigrants have also tended to head for areas where housing is already short, such as Sydney, rather than to country regions. This partly reflects a perception of where the best job opportunities are located. It has a self-reinforcing aspect as new arrivals prefer to locate in areas where friends or relatives have already gone or where there are shops and cultural facilities catering to people from their ethnic background.

4.7 An eminent demographer points out that:

About half the growth in households in Melbourne is attributable to overseas migration. When you push out the 30-year projection, as you get near the end of it, about 80 per cent of the growth is attributable to migration...in Sydney, all the growth in households is attributable to overseas migration.<sup>10</sup>

4.8 This has led some witnesses to suggest restricting immigration, even of skilled workers, as a means of curbing rises in house prices:

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6 Australian Institute of Health and Welfare (2008a, p. 8); Professor T Burke and K Hulse, *Submission 33*, p. 3. Total HECS/HELP debt was around \$800 million in 2006.

7 Divorce in particular raises the demand for housing where both parents need to have sufficient accommodation for children; Queensland Community Housing Coalition, *Submission 18*, p.3.

8 Australian Institute of Health and Welfare (2008, p. 7).

9 Dr R Silverberg from the Housing Industry Association describes immigration as 'a very significant influence on the demand for housing'; *Committee Hansard*, 1 April 2008, p. 94. Its importance was also highlighted by a number of academics: Professor P Troy, *Committee Hansard*, 1 April 2008, pp 107–8; Professor T Burke, *Committee Hansard*, 24 April 2008, p. 26; and Professor T Sorensen, *Submission 50*, p. 7. Others to emphasise the impact of immigration included Sustainable Population Australia's Tasmanian branch, *Submission 12*; Mr P Pollard, *Proof Committee Hansard*, 7 May 2008, pp 59–60; and Mr G Holman, *Submission 10*.

10 Dr B Birrell, *Committee Hansard*, 24 April 2008, p. 31.

One of the key drivers of the housing crisis, we believe, is the continued rapid population growth in Australia, which is a continent of very low carrying capacity, and most of the development is around the edges of the continent...[we recommend] that we train our own skilled workers and that we cease poaching skilled workers from other countries.<sup>11</sup>

4.9 In this context, the committee also notes concerns that in the current environment of skill shortages in the construction industry, the net impact of immigration is inflationary:

We do not have the trades to build the housing stock that we need. Immigration into the country is fuelling demand at a much faster rate than immigration is helping our industry build that extra demand.<sup>12</sup>

4.10 There are also alternative arguments:

I am all for increasing immigration....I think that, to support infrastructure in this country with the landmass we have, we need a lot more people to use those facilities.<sup>13</sup>

4.11 The Government has made it clear it sees substantial net economic benefits from continued high rates of immigration:

The Australian labour market is the tightest it has been in a generation, with skill and labour shortages pushing up labour costs and contributing to inflationary pressures. Immigration will continue to be an important contributor to labour supply, with skilled migration in particular helping to address Australia's skill needs in the short-term while also delivering fiscal benefits.<sup>14</sup>

4.12 The committee regards population growth policy as an important issue, but one outside the terms of reference of this inquiry.

4.13 The relationship between the overall number of skilled migrant workers and the number with particular skills in the construction industry is discussed in more detail in chapter 5 (paragraphs 5.60–5.64).

## High rents

4.14 The increase in rents in recent years has increased the *desire* of many renters to buy a home instead of renting. However, having to pay higher rents has reduced the *ability* of these households to save a deposit. The net impact on the effective demand for house purchases is therefore ambiguous.

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11 Ms S Davis, Gecko-Gold Coast and Hinterland Environment Council Association Inc, *Committee Hansard*, 14 April 2008, p. 24.

12 Mr S Chamberlain, *Committee Hansard*, 1 April 2008, p. 99.

13 Mr J Symond, Aussie Home Loans, *Proof Committee Hansard*, 7 May 2008, p. 67.

14 *2008–09 Budget Statement No. 1*, p. 1-29. See also box 7 on p. 2-27 of the same document.

## Lower interest rates

4.15 The decline in the standard home loan interest rates from the mid-1990s to early 2002 increased the amount that households could borrow and so gave them the ability to bid up house prices. For example, the repayments on a 30-year mortgage of \$100 000 at an interest rate of 14 per cent are \$1185 per month. When interest rates are instead 7 per cent, the same repayments can service a loan of \$178 000.

4.16 The main reason for the drop in housing loan interest rates had been the lowering of the Reserve Bank's policy interest rate as a low inflation environment has become established. But increased competition has also seen a reduction in the margin between the policy interest rate and the housing loan rate.

4.17 If this mechanism were the only driver of prices, then prices would have fallen back again as interest rates have since risen. However, there may be inertia in the system, or prices may be 'sticky', as vendors are reluctant to accept low bids. This would imply that affordability will only be restored by the gradual rise in incomes rather than a fall in nominal house prices.

4.18 Given that underlying inflation has recently risen above the Reserve Bank's 2-3 per cent medium-term target band, it could be argued that aggregate demand in the economy has been allowed to grow faster than aggregate supply. A loose fiscal and/or monetary policy is likely to result in rises in asset prices, including house prices, as well as generalised inflationary pressures.

4.19 When the Reserve Bank Governor was asked what the central bank could do about housing affordability he replied:

the best thing that we can do is keep inflation rates controlled, because if we do not do that then interest rates will end up much higher than otherwise. I think the biggest problem for housing affordability is that basically, particularly if you are a first home buyer, the level of house prices is too high. The policies to address that are mainly not in our preserve, except that, if we run monetary policy too loose, house prices tend to inflate more than they need to and that would not be good.<sup>15</sup>

4.20 The committee received comment from one submitter who criticised the Reserve Bank's approach to monetary policy. Mr Phil Williams highlighted in his submission that the RBA's inflation target is set solely in terms of *consumer* prices, not *asset* prices. The cost of land is not included in the CPI. As a result, Mr Williams argued that the RBA's monetary policy failed to respond to the sharp spike in house prices in 2002–2003.<sup>16</sup> He claimed that the underlying cause of house price inflation is

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15 Mr G Stevens, Transcript of appearance before House of Representatives Economics Committee, 17 August 2007, p. 19.

16 There are also arguments that central banks should be concerned about increases in asset prices because of the potential damage that can be wrought when overpriced assets suddenly fall in value. These matters are, however, outside the scope of this inquiry.

the conduct of monetary policy which should aim for house price stability, not just the 2–3 per cent CPI band.<sup>17</sup>

4.21 The committee does note that the RBA has been vigilant in seeking to restrain the CPI to within its target band. There have been several increases in the official cash rate over the past three years which 'is helping to produce a moderation in demand'.<sup>18</sup>

**Table 4.1: Housing finance markets**

	Typical term of mortgage (years)	Typical loan-to-value ratio for new mortgages (%)	Variable rate mortgages (% of total)	Owner-occupiers with mortgage (% of total)	Home equity withdrawals	Mortgage market index#	Use of mortgage-backed securities
Australia	25	80	85	45	yes	0.69	extensive
Austria	25	60			no	0.31	
Belgium	20	83	25	56	no	0.34	limited
Canada	25	75	30	54	yes	0.57	extensive
Denmark	30	80	32		yes	0.82	no
France	15	75	20	38	no	0.23	limited
Germany	25	70	30		no	0.28	yes
Hong Kong	20	70*	most				yes
Ireland	20	70	most		limited	0.39	limited
Japan	25	80	21		no	0.39	limited
Netherlands	30	90	26	85	yes	0.71	extensive
NZ	25-30	95	16				limited
Norway	17	70	most		yes	0.59	no
Singapore	30-35*	80*	most				yes
S. Korea	20*	56	most		yes		limited
Sweden	25	80	98		yes	0.66	limited
Switzerland	15-20	80*	35		no		limited
UK	25	75	97	60	yes	0.58	yes
USA	30	80	22	65	yes	0.98	extensive

\*maximum # IMF (2008) measure: higher values indicates easier household access to mortgage credit. Sources: BIS (2006, pp 12–4); Ellis (2006, p. 14); IMF (2008); Lawson and Milligan (2007, p.46); Tsatsoranis and Zhu (2004, p. 69); Zhu (2006, p. 60).

17 Mr P Williams, *Submission 61*, pp 10–11.

18 Mr G Stevens, 'Statement on Monetary Policy', Reserve Bank of Australia, *Media Release*, 3 June 2008.

## Greater credit availability

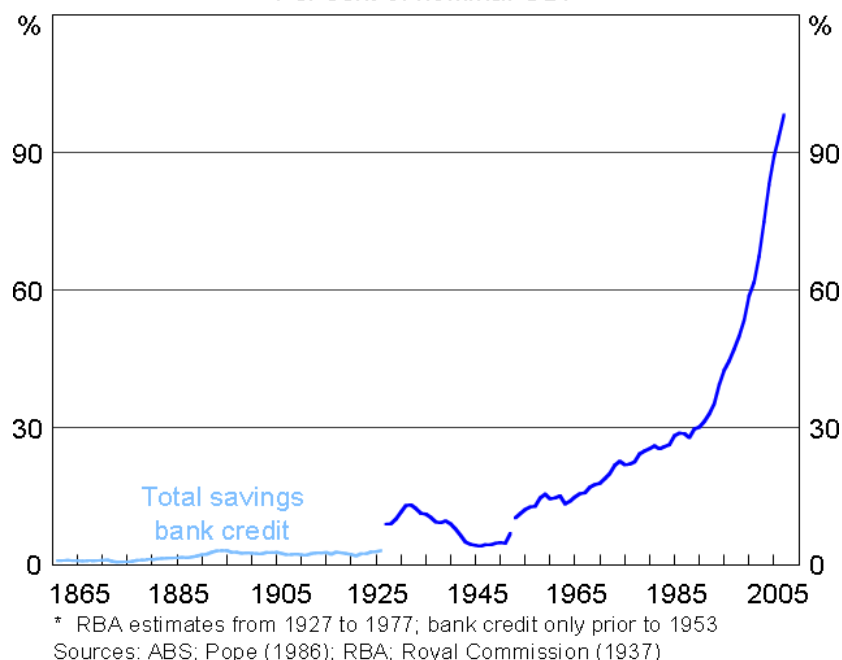
4.22 In addition to interest rates being lower, loans have become easier to obtain. In the longer term this has been a welcome result of financial deregulation. Non-bank lenders have increased the availability of credit for housing, tapping into securitisation markets. Since deregulation, the Australian housing finance market has developed a wide range of products and credit is available to all potential borrowers who can afford the repayments (Table 4.1).

4.23 In this brave new financial world, banks no longer 'ration' credit only to customers with a long record of placing money in low-interest deposit accounts with them. As the Reserve Bank's deputy governor noted:

...if you go back just 30 years it was very hard for households to get access to finance. Basically, to get a housing loan you had to save for years at the bank and then you had to plead with the bank to give you some money and then they only gave you some of the money. You had to go to a finance company, a building society or someone else and borrow at much higher rates to get the rest of the money to buy a house...and if you were a woman you had no chance.<sup>19</sup>

4.24 Looking back further, the increase in the availability of credit is even starker.

**Chart 4.1**  
**Household Credit – Australia\***  
Per cent of nominal GDP



Source: Battellino (2007).

4.25 However, there is evidence that recently credit standards have been loosened excessively. This was been most noticeable in the United States where the prevalence of 'sub-prime' loans is now causing serious problems in financial markets. While Australian lenders have not gone as far as their counterparts in the US, the Reserve Bank has referred to 'the general lowering of credit standards that has occurred since the mid 1990s' and the Australian Prudential Regulation Authority has referred to lenders having 'been willing to move out the risk spectrum by loosening their credit standards'.<sup>20</sup>

4.26 Housing lenders are now much more likely to allow customers to borrow amounts that require more than 30 per cent of income to service and will lend a higher proportion of the value of a property.<sup>21</sup> There is considerable variation among lenders in how much they will lend, as noted by the Australian Prudential Regulation Authority: 'The most aggressive ADI will typically be willing to lend more than twice as much as the most conservative'.<sup>22</sup>

4.27 There are disadvantages in moving away from the old model where banks required people to save a deposit with them before granting a loan. As Dr Judith Yates commented: 'having a savings history is not a bad idea in that it indicates that people do have the capacity to save'.<sup>23</sup> Households unable to save regularly may struggle to meet loan repayments.

4.28 The greater availability of credit has fuelled the aspirations of first home buyers. A Queensland developer gave this example:

When we first started developing land out there [Ipswich], in 1992, we noticed that people would buy a block of land and spend probably the next 12 months building their house. They would spend every weekend out in the front yard landscaping, doing all those things that they could not afford to do when they first built the house. It probably took them almost two years to come up with a house in the form that they actually wanted. Now we do not see any of that. Now we see people shifting into a house with everything done up-front—swimming pool, landscaping, everything. My point is: I think people want everything straightaway these days.<sup>24</sup>

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20 Reserve Bank of Australia, *Financial Stability Review*, March 2007, p. 17 and Mr J Laker, APRA chair, 'Credit standards in housing lending—some further insights', address to Institute of Chartered Accountants in Australia, 20 June 2007, p. 1.

21 For more information, see House of Representatives Standing Committee on Economics, Finance and Public Administration (2007, pp 4–10).

22 Laker (2007, p. 5).

23 Dr J Yates, *Committee Hansard*, 2 April 2008, p. 45. This is one of the arguments for the new First Home Saver Accounts scheme, discussed in Chapter 9.

24 Mr R Sharpless, Urban Development Institute of Australia (Ipswich), *Committee Hansard*, 14 April 2008, p. 3.

4.29 As lenders moved from rationing credit to marketing it, some households were offered larger amounts of credit than they could readily repay:

Deregulation of the financial institutions in the eighties had a significant impact on low-income people. Not only do those people sign up for things they cannot afford but also they often do not understand the paperwork they are signing.<sup>25</sup>

4.30 A similar view was put by John Symond of Aussie Home Loans:

money has been too free. Instead of looking at getting their ultimate home step-by-step, young people expect and want a new home with all the mod cons. They go off to a department store and borrow \$20,000 for a plasma TV, new lounges and everything else in the belief that it is interest-free and the latest and the greatest. They then find out that they have been stung with a 28 per cent interest rate. So clearly credit tightening would be a good thing.<sup>26</sup>

4.31 Regretting some of the excesses associated with financial deregulation might be regarded as wishing the stable door had been shut before the horse had bolted. But the committee did hear some suggestions for some mild forms of regulation to address these concerns:

Options for consideration may include mandatory minimum credit checks, minimum loan-to-value ratios for property purchases, restrictions on advertising targeting persons with a poor credit history, or public disclosure of the level of credit risk held or on-sold by lending institutions.<sup>27</sup>

### **Speculative demand**

4.32 In addition to the demand from people wanting a house in which to live, there is a speculative element to the demand for housing. As one witness put it, 'houses are being valued as speculative assets, not as homes for Australians anymore'.<sup>28</sup> (See the discussion in Chapter 2 on 'changing aspirations').

4.33 As well as encouraging home ownership, this attitude has led many households to borrow to purchase a second investment property.<sup>29</sup> Investors now account for about a third of new home loans. The Reserve Bank (2003, p. 48) has referred to the role of unregulated property investment seminars in promoting the purchase of investment properties.

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25 Ms McIvor, Macarthur Community Forum, *Committee Hansard*, 3 April 2008, p. 11.

26 Mr J Symond, Aussie Home Loans, *Proof Committee Hansard*, 7 May 2008, p. 66.

27 Mr M Munro, Real Estate Institute of Australia, *Proof Committee Hansard*, 7 May 2008, p. 37.

28 Dr B Edgerton, *Committee Hansard*, 14 April 2008, p. 14. Yates (2007, p. 6) refers to 'an obsession with the role of home ownership in contributing to wealth accumulation'.

29 Productivity Commission (2004, p. 22) comments that a much higher proportion of Australian households own investment properties than do households in Canada, the UK and the US.

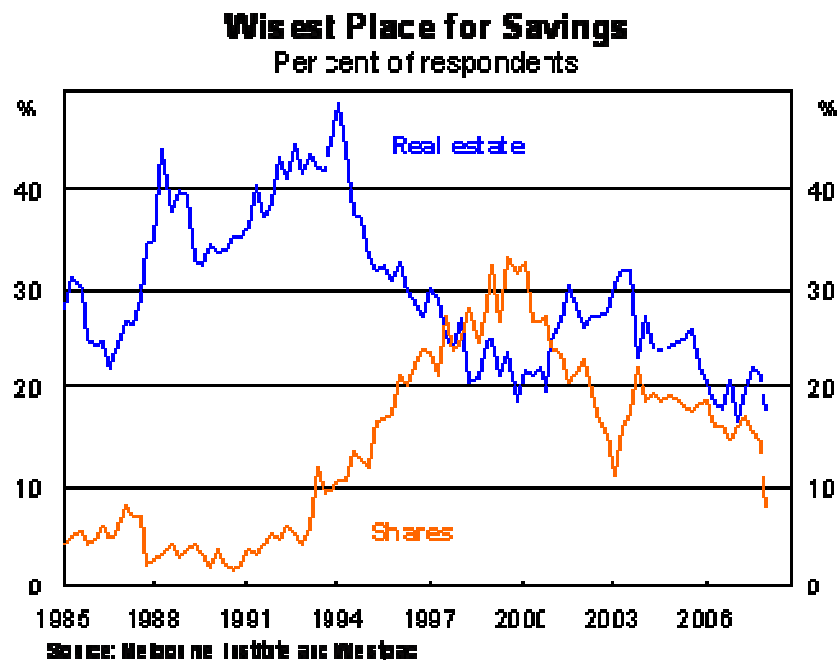


4.34 Except for the brief period of 'irrational exuberance' about hi-tech stocks around 2000, Australians have generally regarded property as a better investment destination than equities, although they are less attracted to it now than in the 1980s.

4.35 There is a self-reinforcing aspect to speculative booms:

Related to this boom period is the self-generating nature of house price rises. Most finance for housing arises from the high price already of existing housing, because people upgrading build on the increased value of their housing, and investors are then drawn in by rising prices. So you have a self-generating effect until they hit something like much higher interest rates or a recession or something.<sup>30</sup>

**Chart 4.2**



Source: Reserve Bank (2003, p. 41)

## Taxation influences

4.36 This speculative demand for housing may be encouraged by some aspects of the taxation system, which makes investing in housing (and sometimes other assets yielding capital gains) more attractive than alternative investments. A blunt assessment is provided by Professor Julian Disney:

...a major cause of our problems is that we have excessive exemptions for owner-occupiers from capital gains tax, land tax and the pension assets test. They are so generous that they have driven up housing prices. They have

30 Mr P Pollard, economist and town planner, *Proof Committee Hansard*, 7 May 2008, p. 58.

ended up being not in favour of homeownership; they are in favour of current homeowners but they are not in favour of homeownership.<sup>31</sup>

4.37 In similar vein, the economics journalist Ross Gittins has commented:

Do you see what the special tax-free status of housing does? By pushing up the price of homes it makes it that much harder to attain the state of being a home owner, but makes the benefits of home ownership even greater if you manage to make it. The jackpot's bigger, but harder to win. And a system that is biased in favour of owner-occupiers is a system that is biased against renters. That's unfair to people who spend all their lives as renters, as well as making it harder for would-be home owners to make the leap.<sup>32</sup>

4.38 Significant tax concessions are currently provided for housing. It is not easy to find hard data on the costs of most of these concessions<sup>33</sup>, but the secretariat has put together in Table 4.2 some approximate numbers from the sources indicated, based on the assumptions listed. In addition to the tax expenditures listed, the exemption of owner-occupied housing from the asset test for the age pension costs around \$10 billion.<sup>34</sup>

4.39 The combined total of capital gains tax arrangements, land tax exemption and negative gearing arrangements is estimated to be in the order of \$50 billion per year. That reflects against the \$1½ billion in the Commonwealth–State Housing Agreement and the \$1 billion spread over four to five years proposed for the new National Rental Affordability Scheme and the Housing Affordability Fund. These tax concessions also mean that the overall support to wealthy homeowners is greater than that to low income renters.<sup>35</sup>

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31 Professor J Disney, *Committee Hansard*, 2 April 2008, p. 29.

32 R Gittins, 'Renters can't home in on jackpot', *Sydney Morning Herald*, 19 September 2007, p. 13 reprinted in Australia Institute, *Submission 56*.

33 The Industry Commission (1993, p. xv) noted 'the full costs of housing assistance are not recorded and governments do not know whether assistance is well targeted or delivered efficiently'.

34 The Productivity Commission (2004, p. 109) estimated the cost at about \$8 billion in 2003.

35 The Industry Commission (1993, p. 21) cite estimates that in 1990-91 subsidies to homeowners in the top quintile of income earners averaged \$3 180 while those to private renters in the bottom quintile were less than half as much, at \$1 440.

**Table 4.2: Taxation expenditures pertaining to housing (\$ billion in 2007-08)**

Capital gains tax exemption for owner-occupied housing <sup>36</sup>	20
Discount on capital gains on investor housing <sup>37</sup>	6
Land tax exemption for owner-occupied housing <sup>38</sup>	10
Negative gearing for rental housing <sup>39</sup>	2
Non-taxation of imputed rent for owner-occupied housing <sup>40</sup>	15

Sources: Secretariat estimates, see footnotes.

- 36 This is reported as costing 'over \$1 billion' in *Tax Expenditures Statement 2007*, Treasury, p. 161. Australian National Audit Office (2008, pgs 19 and 115) says 'approximately \$13 billion' but this appears to just repeat the estimate of \$13 billion in 2001, given in Yates (2003) and cited by Productivity Commission (2004, p. 109). Scaling this \$13 billion up for the doubling in the value of the housing stock since 2001 would give an estimate of \$26 billion. Alternatively, taking the \$3,300 billion value of the housing stock, allowing for two-thirds being owner-occupied, assuming conservatively that over the long term houses prices grow four per cent a year (sum of inflation and productivity growth), and an average marginal tax rate of 30 per cent, also gives an estimate of \$26 billion. Alternatively, as the Australian Tax Office's *Taxation Statistics 2005–06* reports total capital gains tax discount claimed by individuals for real estate was \$14.3 billion in 2005–06, in the absence of the discount they would have paid \$28.6 billion. As there are twice as many owner-occupied homes as investor properties, capital gains on them may have been around \$57 billion, which if taxed at a marginal tax of 30 per cent would have raised \$17 billion in 2005–06, which would likely have increased in subsequent years.
- 37 The capital gains tax discount claimed by individuals was \$14.3 billion in 2005–06 (ATO *Taxation Statistics 2005–06*, p.80). As real estate accounts for about 1/3 of capital gains of individuals (p. 77), the discount for investor property was \$5 billion in 2005–06 and it is likely to have grown since. Alternatively, taking the \$3,300 billion value of the housing stock, of which two-thirds is owner-occupied, conservatively assuming that over the longer term houses prices grow at an annual rate of 4 per cent (sum of inflation and productivity growth), and assuming an average marginal tax rate of 30 per cent, gives an estimate of \$6.6 billion.
- 38 The Productivity Commission (2004, p. 109) estimated the cost at about \$7 billion in 2003. Scaling up on the conservative assumption that land prices grew at the same rate as house prices would give an estimate of over \$10 billion. Alternatively, land taxes raised \$4.4 billion in 2006–07 (ABS cat. No, 5506.0). As two-thirds of homes are owner-occupied, adding them into the net would at least triple the revenue, implying revenue foregone is well over \$8.8 billion.
- 39 The ATO's *Taxation Statistics 2005–06* reports 1.6 million taxpayers had rental income in 2005–06 with an aggregate net loss of \$5.1 billion. A conservative assumption of a 30 per cent marginal tax rate would cost negative gearing at \$1.5 billion. Since 2005–06, both rents and interest rates have increased. This estimate is below those provided by witnesses; \$2½ billion (Mr M Myers, Queensland Community Housing Coalition, *Committee Hansard*, 14 April 2008, p. 51); \$3½ billion (Mr A Pisarski, National Shelter, *Proof Committee Hansard*, 7 May 2008, p. 74) and \$5 billion (Mr M Munro, Real Estate Institute of Australia, *Committee Hansard*, 7 May 2008, p. 41).
- 40 Imputed rent for owner-occupied housing was \$74 billion in 2006–07 (ABS 5204.0). As a significant proportion is owned by retirees, a conservative assumption of an average marginal tax rate of 20 per cent is applied to generate an estimate of revenue foregone of \$15 billion.

**Table 4.3: International comparison of taxation regimes**

	Interest tax deductibility		Capital gains tax		Land tax		Investor		Tax on imputed	Indirect tax rate
	Owner	Investor	Owner	Investor	Owner	Investor	Negative gearing	Depreciation	rent	on new houses (%)
Australia	no	yes	no	half rate	no	yes	yes	yes*	no	10
Canada	no	yes	no	half rate	yes	yes	yes*	yes		
France	no	yes	no	no*	limited	limited	limited	yes	no	20
Germany	no	no	no*	no*	limited	limited	yes	yes	no	16
Neth'nds	yes	na	na	na	yes	yes	na	no	yes*	19
NZ	no	yes	no	no	limited	limited	yes	yes	no	0
Sweden	yes	yes	limited	limited	yes	yes	yes	no		
Switz.	yes	yes	yes	yes	yes	yes	no	yes*	yes	
UK	no	no	limited	yes	limited	yes	yes	no	no	0
USA	yes	yes	no	yes	yes	yes	limited	yes	no	

Sources: Ellis (2006, p. 11); Lawson and Milligan (2007, p.46). \*under some conditions

4.40 The tax treatment of housing in Australia is compared with that in comparable countries in the above table.

### **Recommendation 4.1**

**4.41 In the interests of more informed discussion of arrangements to encourage affordable housing, the Treasury be asked to publish current estimates of various taxation and related measures affecting the housing market.**

#### ***Discount on capital gains on investor housing***

4.42 Capital gains on investor housing held for over a year are taxed at half the marginal tax rate applied to other income.<sup>41</sup> A common argument for this discount is that it also applies to holdings of shares.<sup>42</sup> Some would contend that the logic of not discriminating between different types of income would mean that all capital gains should be taxed at the same rate as other income. (In some tax regimes, capital gains are regarded as 'unearned income' and taxed at a *higher* rate than other income.) The current arrangements do not apply to alternative investments, such as bank deposits (and education and training), which generate income that is not in the form of capital gains.

41 According to the Productivity Commission (2004, p. 78), this discount was introduced in 1999 with the goal of 'promoting investment in innovative and high growth companies'.

42 This argument is put by Mr Harnisch, MBA, *Committee Hansard*, 1 April 2008, p. 29.

4.43 A number of witnesses argued that capital gains should be taxed like other income. Apart from fairness concerns, it was argued that the concession encourages investors to focus on investment in that type of housing where capital gains are expected to be largest and this may be more expensive rather than affordable housing:

...we should not have the discount on capital gains tax, because it is crucial that we do not encourage investment to go where the capital gain is the greatest. We need it to go to the bottom end.<sup>43</sup>

4.44 Another suggestion was that the concession be more focused:

Australians would be better served if the incentives were based entirely on newly constructed houses rather than established houses so it led to an increase in supply.<sup>44</sup>

4.45 In contrast, the construction industry argues that the tax rate on capital gains should be lowered further:

...governments need to introduce a stepped-rate capital gains tax where after, say, 10 years there is no capital gains tax applicable. This will mean you will get investment into the rental market.<sup>45</sup>

### ***Capital gains tax exemption for owner-occupied housing***

4.46 Capital gains on owner-occupied housing (the 'family home') are exempt from income tax. This is another aspect of the taxation system which favours housing as an asset class and increases demand for it.

4.47 Master Builders Australia argue that the exemption should be retained, on the grounds that:

There is no empirical evidence to support the proposition that the tax exempt status of home ownership undermines the equity or efficiency of the tax system.<sup>46</sup>

4.48 Others witnesses expressed reservations. Professor Sorensen commented:

...the tax breaks afforded to housing—for example, the absence of capital gains tax for owner-occupied housing...just simply tend to feed in to higher prices for housing.<sup>47</sup>

4.49 The exemption may also lead to households demanding larger homes than they require at the time for accommodation, to increase their prospective capital gains:

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43 Mr A Farrar, NSW Federation of Housing Associations, *Committee Hansard*, 2 April 2008, p. 8. See also, for example, Professors Burke and Hulse, *Submission 33*, p. 5.

44 Dr B Edgerton, *Committee Hansard*, 14 April 2008, p. 14.

45 Mr W Harnisch, Master Builders Australia, *Committee Hansard*, 1 April 2008, p. 29.

46 Master Builders Australia, *Submission 30*, p. 10.

47 Professor A Sorensen, *Proof Committee Hansard*, 7 May 2008, p. 54.

Owner-occupiers were encouraged to over-invest in housing producing the so-called 'McMansions' in the outer suburbs. This was, in part, a logical response to the fact that capital gains are not paid on the family home. The family home was thus seen by middle income households as an opportunity to maximise their savings.<sup>48</sup>

4.50 Another fault with this tax concession is its regressive nature:

...the capital gains tax exemption for owner-occupied housing is vastly regressive in a social sense, with nearly all the gain from that exemption going to high-income households.<sup>49</sup>

### ***Land tax exemption for owner-occupied housing***

4.51 All states, and the ACT, impose land taxes but exempt almost all owner-occupied housing (Table 7.6). This impacts on what in principle would be an efficient and equitable tax and can encourage some people to hold wealth in the form of housing in excess of their requirements for accommodation.<sup>50</sup>

4.52 Shelter WA recommends capping this exemption to a level 10 per cent above the median house price for the region.<sup>51</sup>

4.53 A problem in taxing the land value of owner-occupied housing is that asset-rich but income-poor households, such as retirees, may need to incur debt to pay it. This is easier to do now that 'reverse mortgages' are more readily available, but older households are likely to be wary of increasing their debt. Professor Disney suggests addressing this problem by making the land tax at least partially deferrable until sale.<sup>52</sup>

### ***Negative gearing***

4.54 'Negative gearing' refers to allowing investors to deduct losses on rental property from their other income (not just other property income) and so lower their tax liabilities. In aggregate, landlords received gross rental income of \$19 billion in 2005–06, from which they were allowed to deduct \$14 billion in interest, \$1 billion in capital works deductions and \$9 billion of other deductions (including letting agents'

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48 Professor P Troy, *Submission 11*, p. 4.

49 Professor A Sorensen, *Proof Committee Hansard*, 7 May 2008, p. 55. A similar view is put by National Shelter, *Submission 57*, p. 3.

50 Land tax was most famously advocated by Henry George (1879). It has a number of advantages over stamp duty, such as not discouraging labour mobility; Stilwell and English (2004). The head of Tasmania's Treasury praises it as one of the best state taxes; Tasmanian Legislative Council Select Committee on Housing Affordability in Tasmania (2008, p. 88).

51 Shelter WA, *Submission 42*, p.2. Similar views are expressed by their national body; National Shelter, *Submission 57*, p. 3.

52 Disney (2008, p. 261).

fees, body corporate levies and council rates), giving an overall 'loss' of \$5 billion which they could offset against other income.<sup>53</sup>

4.55 Included among the deductions is a depreciation allowance of 2½ per cent on new buildings. This had been introduced at 4 per cent in 1985 when the scope of negative gearing was reduced by quarantining the interest cost offset to rental income.<sup>54</sup> The rate was lowered to 2½ per cent in 1987 when the quarantining was removed and full negative gearing restored. It could be argued that houses are an appreciating rather than depreciating asset, or that 2½ per cent overstates any physical depreciation (ie that the average house will last more than forty years).

4.56 Negative gearing is criticised on equity grounds:

We have argued that it is iniquitous. It is not spread fairly and it really represents one of the starkest contrasts in the Australian taxation system.<sup>55</sup>

4.57 This leads to suggestions to cap it.

...there should be caps. There should not be unlimited access. Millionaires and billionaires should not be able to access it, and you should not be able to access it on your 20th investment property. There should be limits to it.<sup>56</sup>

4.58 Master Builders Australia defend negative gearing as 'part of a modern tax system'.<sup>57</sup> Table 4.3 shows that tax systems in a number of modern economies do not allow, or restrict, negative gearing.

4.59 The Real Estate Institute of Tasmania claimed that 60 per cent of those using negative gearing 'are your mum and dad investors—normal Australians—not the rich and wealthy'.<sup>58</sup> While investors owning rental properties may be 'normal', they may also be more affluent than the average taxpayer.

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53 ATO Taxation Statistics 2005–06.

54 Reserve Bank of Australia (2002, p. 3).

55 Mr A Pisarski, National Shelter, *Proof Committee Hansard*, 7 May 2008, p. 74.

56 Mr J Sutton, *Proof Committee Hansard*, 24 April 2008, p. 4. Shelter WA recommend it be limited to those in the lower three quintiles of the income distribution; *Submission 42*, p. 2.

57 Mr W Harnisch, Master Builders Australia, *Committee Hansard*, 1 April 2008, p. 29.

58 Mr P Bushby, Real Estate Institute of Tasmania, *Proof Committee Hansard*, 5 May 2008, p. 17. The Australian Tax Office's data show that, in 2005–06, three-quarters of individuals claiming net rental losses had taxable incomes below \$63,000 (after claiming the deduction!). About two-thirds of investors with a rental property have only one. On the other hand, those using negative gearing planned to recoup their losses from capital gains, and over 80 per cent of the tax on capital gains comes from individuals earning over \$95 000; *Taxation Statistics 2005–06*, pgs 12, 13 and 75.

4.60 A number of witnesses point out, correctly, that negative gearing also applies to other investments such as purchases of shares.<sup>59</sup> However negative gearing seems to be used a lot more for housing than for investment in other assets, with some recent estimates suggesting that a third of investors in housing claim they are making losses. In many cases, when the rental property is initially bought, the investor expects to make such a loss but hopes that (concessionally taxed) capital gains will mean the undertaking becomes profitable. As noted above, in Australia housing investors routinely make an aggregate loss, while in other countries they generally make an aggregate profit.<sup>60</sup>

4.61 The most common argument by supporters of negative gearing (and capital gains tax concessions) is that it increases the supply of rental accommodation and keeps rents lower than they otherwise might be.<sup>61</sup> FaHCSIA stated that 'the taxation provision for negative gearing has demonstrably increased the amount of rental housing that is available in the broader market', but under later questioning, acknowledged that 'we do not have any information from our own sources' to support this and made references to work by the Australian Housing and Urban Research Institute.<sup>62</sup>

4.62 It does seem to be the case that rental yields (ie rent as a proportion of the property price) on their own could be unattractive without the tax advantages. A common rule of thumb in the Australian real estate market is that a property that costs X thousand dollars will rent for about X dollars per week. This implies a gross yield of about 5 per cent. After deducting expenses such as maintenance, letting agents' fees and so on, net yields are lower, currently around 3 per cent. This is well below interest rates being paid by banks.

4.63 But a further reason advanced as to why these yields are low is that the tax advantages given to housing have led to house prices being bid up. On this argument, without these tax breaks, house prices would be lower, making rental yields attractive to investors without the tax breaks being required.

4.64 As noted above, negative gearing was restricted in July 1985 and restored in October 1987. Rents rose around the time it was restricted and its restoration was followed by an increase in the supply of rental housing. However, some argue this may have had more to do with the global stockmarket boom and crash occurring at the

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59 Mr W Harnisch, Master Builders Australia, *Committee Hansard*, 1 April 2008, p. 29; Mr M Munro, Real Estate Institute of Australia, *Proof Committee Hansard*, 7 May 2008, p. 41.

60 Reserve Bank of Australia (2003, p. 45).

61 Mr P Bushby, Real Estate Institute of Tasmania, *Proof Committee Hansard*, 5 May 2008, p. 17.

62 Ms P Winzar, Department of Families, Housing, Community Services and Indigenous Affairs, *Committee Hansard*, 1 April 2008, pp 18–19 and Ms C Wall, *Proof Committee Hansard*, 7 May, p. 4.



same times, initially attracting and then scaring investors away from shares – the main alternative investment asset to rental housing.<sup>63</sup>

4.65 Negative gearing is also seen as advantaging investors over owner-occupiers. One witness claimed it 'amounts in essence to much cheaper finance for investors versus home buyers'.<sup>64</sup>

4.66 Even if negative gearing encourages investment in rental property, many witnesses agreed 'the funds that go into negative gearing housing for rental do not go to modest or low-income rental'.<sup>65</sup> Two examples of this argument are:

...there is a major need...for some changes in our taxation system that are going to support investment in long-term, low-cost rental accommodation. ...We have seen negative gearing have a positive impact on the willingness of people to invest in rental property as part of their investment profile and strategy. But that is very selective and it is not long term. If we are to deal with the rental accommodation side of housing affordability, we are going to need to see superannuation funds, infrastructure funds and the like being prepared to take a long-term view of developing and holding that accommodation, to provide low-cost rental alternatives for our society.<sup>66</sup>

At the moment the only good that comes out of the use of negative gearing is the creation of rental property but, unfortunately, very little of it is at an affordable level.<sup>67</sup>

4.67 To the extent that negative gearing changes the tenure arrangements of some housing, it is not regarded as particularly beneficial by some:

...with a given block of housing, if an investor simply turns a house over from owner-occupation to investment, that on the face of it means there is more housing for renting, but they are obviously displacing one household net from owner-occupation to renting. On the face of it, investment in housing simply does not assist the renting situation.<sup>68</sup>

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63 Reserve Bank of Australia (2002, p. 5) note that after the 1987 share market decline there was a surge in lending to property investors. Mr P Pollard claims 'the only real studies on the effect of the partial removal of negative gearing in 1985 show that the claims that it forced up rents and dropped building and so on are completely unfounded.'; *Proof Committee Hansard*, 7 May 2008, p. 62.

64 Mr P Pollard, *Proof Committee Hansard*, 7 May 2008, p. 58.

65 Professor P Troy, *Committee Hansard*, 1 April 2008, p. 114.

66 Mr Jackson, UDIA (South Australia), *Proof Committee Hansard*, 28 April 2008, p. 13.

67 Mr A Pisarski, National Shelter, *Proof Committee Hansard*, 7 May 2008, p. 74. Similarly, the Queensland Community Housing Coalition (*Submission 18*) argue that even if negative gearing results in some additional rental property, it is not the most cost-effective means of doing so.

68 Mr P Pollard, *Proof Committee Hansard*, 7 May 2008, p. 60.

4.68 There are differing views about whether negative gearing leads to construction of new housing or a bidding up of the prices of existing homes. The Real Estate Institute of Australia argues:

Negative gearing as it is certainly encourages the building of new property. Given that a major component in the tax offset—or write-down, if you like—of negative gearing comes from the depreciation component, that component is obviously a lot higher and a lot more attractive for new properties. So a lot of money from investors using negative gearing as it stands actually goes into new property.<sup>69</sup>

4.69 Professor Sorensen by contrast believes:

...the tax breaks afforded to housing—for example...negative gearing for rental property...just simply tend to feed in to higher prices for housing...We would have lower rentals combined with better returns for owners of rental accommodation, were negative gearing to be abolished.<sup>70</sup>

4.70 This has led to some suggestions to modify it in ways that would encourage construction of new and affordable housing. Mr Pollard suggests:

negative gearing be applied only in the case where investors buy new houses and that it not apply to the buying of established houses. The effects of this would be that investor interest in established houses would fall significantly and so we could expect that prices in future would rise much less than prices of housing generally otherwise, because the vast majority of investor finance is used on established houses.<sup>71</sup>

4.71 National Shelter suggests:

to taper it to ensure that you can only maximise the level of investment on it if you are building affordable housing.<sup>72</sup>

4.72 Along similar lines, Professor Burke suggests restructuring it:

...in a way which encourages greater investment in new supply and lesser investment in existing stock, which only puts investors in competition with first home buyers. ...Instead of having 100 per cent allowable for all expenses, you have a higher deductibility—we recommend up to 125 per cent—for investment in new construction and the purchase of the new rental property. It reduces to only 75 per cent deductibility for investment in an established property. That 125 per cent deduction only applies for a benchmark affordability property—in other words one that is probably

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69 Mr M Munro, Real Estate Institute of Australia, *Proof Committee Hansard*, 7 May 2008, p. 40.

70 Professor A Sorensen, *Proof Committee Hansard*, 7 May 2008, pgs 54 and 56.

71 Mr P Pollard, *Proof Committee Hansard*, 7 May 2008, p. 60. A similar position is put by Mr D van der Klauw, *Submission 80*.

72 Mr A Pisarski, National Shelter, *Proof Committee Hansard*, 7 May 2008, p. 75. This was also advocated in a supplementary personal submission from Robin Spragg, the social planner from Tweed Shire Council, *Submission 76*.

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around \$300,000, which could be indexed annually. But then the 125 per cent reduces as prices go up. So over some cut-off point like \$500,000 or \$600,000 you are back to the 75 per cent.<sup>73</sup>

4.73 Only a few submissions wanted to abolish negative gearing totally.<sup>74</sup> But there were other suggestions to restrict or quarantine it:

The loss would be available in future years as the rent income exceeded the expenses, but in the early years it can't be used to reduce overall taxable income. This would have an effect without being a massive change.<sup>75</sup>

4.74 The attractiveness of negative gearing would be greatly diminished if the tax discount on capital gains on investor rental housing was removed.

## **Recommendation 4.2**

**The committee recommends that Australia's Future Tax System Review Panel consider the implications for housing affordability, as well as the overall fairness of the tax system, of the:**

- (a) tax discount for capital gains on investor housing;**
- (b) exemption from land taxation of owner-occupied housing; and**
- (c) current negative gearing provisions.**

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73 Professor T Burke, *Committee Hansard*, 24 April 2008, p. 22.

74 Professor P Troy, *Submission 11*, p. 6 and Mr C Geyde, *Submission 78*, are among those favouring its elimination.

75 Mr C Simpson, *Submission 1*, p. 2.

