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# Notes on Housing - No.2 April 2016

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## The Great Housing Tax Debate – Will Rents Rise? Of Course They Will.

- When the Henry Tax Review reported it readily acknowledged that its proposals would mean higher rents. But the Grattan Institute and others seek to play down this prospect.
- The Henry Tax Review proposed quite modest changes: it proposed a cut in taxes on saving, notably interest and rental income, of 40% which carried with it a 40% reduction in the benefits of negative gearing. And the discount on capital gains would be aligned taking it from 50% to 40%. The impact on the cost of capital of investors of the Henry proposal was much less than the Grattan proposal with no cut in tax on rental income, a 100% cut in the benefits of negative gearing and a larger increase in capital gains (or the very similar proposal by the Labor Party). But the Henry report was upfront that it would mean higher rents and higher rental yields (rent-price ratios). The Henry report was not trying to scare the punters.

## What Changes Will It Bring?

- There will be short term ructions if the US experience is anything to go by but in the long term, the market will adjust. But the market will be changed.
- The Henry Report expected that one might see a change in the mix of landlords as higher yields (rents up) would attract more long term investors which was seen as perhaps a desirable thing for renters looking for longer term leases. The Grattan Institute has also been pushing this line of argument which is OK as long as you acknowledge the trade-off of higher rents.

## Which Investors Will Leave The Market?

- It is accepted by all that there are a large number of low/middle income investors accruing a small benefit from negative gearing, and a small number of high income investors accruing a large benefit.
- What the Tax Office statistics also show (Table 1) is that in aggregate those high income investors also have substantial other investment income. A negatively geared house can quite rightly be offset against that income under the Grattan/Labor proposals. Hence, while some high income investors will be affected by the change, a substantial but number will not and higher rents will make some winners.
- By contrast, the low/middle income investors have significantly less other investment income and a greater proportion of this group will be affected by the changes.
- That is, small/middle income investors are the segment that is most likely to exit the market.

## First Homebuyers – Winners or Losers?

- The NAB Survey, which is probably the best guide on the make-up of investors, suggests that over 30% of first home buyers are enter the market as investors rather than going directly into owner-occupation. No doubt some of these first home buyers are on high incomes. But a good number would be low-middle income earners trying to build equity, hedge against future rises in property prices, and retain some mobility as they establish their careers.
- An unintended consequence might be that this avenue is cut off.

## Housing affordability – Improved or Worsened?

- If you look at housing affordability from the perspective of owner-occupation, lower prices would improve affordability.

**'For the record'**

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- But the chief beneficiaries would be buyers (first time and established) with substantial equity, particularly high income households. For those first home buyers with minimal equity, in the absence of very sharp falls (unlikely), the hurdle of high interest rates will remain.
- Moreover, if you look at affordability in terms of renters, affordability will decline. That matters for the 28% of mostly low and middle income households that rent.
- The Henry Tax review recognised this outcome but suggested that fiscal measures (other than maintaining 100% negative gearing) might be more efficient in dealing with higher rents. The Henry Tax review also emphasised that if people are really concerned about the high price of housing, then the real culprit is supply side issues, not tax.

### The 1999 Tax Changes Caused the Price Boom – I Don't Think So!

- The Grattan Institute report has argued that the changes to capital gains in 1999, in conjunction with negative gearing, was a major contributing factor to the rise in prices after 1999. But in proposing to increase capital gains and end negative gearing it then wishes to play down any impact on prices. Where is the logic in that?
- In truth, the big rise in prices which actually started circa 1996 in the Sydney market was primarily drive by the lagged response to a big decline in nominal and real interest rates. While inflation and mortgage interest rates fell in the early 1990s sharply from their 1980s levels due to the recession, borrowers were not convinced that inflation was beaten and that interest rates would not return to the 1980s levels of 17%+, until the mid-1990s when the then interest rate cycle peaked at 10.5%. By 1999 they had dropped to 6.5%. With the economy on the rise, buyers (BOTH owner-occupiers and investors) were prepared to borrow more, leverage up, and jump into the housing market. And so began the big rise which ran out of steam when the lower rates were fully factored into prices. In the Sydney and Melbourne markets the decline in rent-price ratios (as prices rose) almost exactly matched the decline in real interest rates, i.e. it is an interest rate story.
- Taking an international perspective, the declines in interest rates and rises in prices are hardly unique to Australia. Did the change in tax policy in Australia cause the very similar rise in prices in NZ, California and Canada?
- When the change in capital gains tax was introduced in 1999, it was on the basis of it being neutral with the inflation-indexed regime. Indeed, given the long-term (1955-2015) rise in house prices in Australia's capital cities to then had been more like 2% per annum in real terms (3% but subtracting 1% pa for improvements as per Abelson and Chung (2005)), the new regime would have represented a slight penalty not a discount. Only in hindsight has the 4% real appreciation (5% less 1% pa) proved more favourable tax-wise to investors.
- Looking forward, with the substantial decline in real interest rates which generated the period of abnormally high capital gains largely in the past, lower capital gains are more likely in the future. Investors would be wise to factor in lower capital gains in their investment decisions.
- And policymakers would be wise to predicate capital gains tax changes on more realistic expectations of likely capital gains, not on a unique period in history.

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## Some More Detailed Analysis

In the balance of the Report, I look at a number of specific issues in a bit more detail. Firstly I look at some of the taxation statistics to see who the winners and loser might be from changes in policy. I look at the US experience when it made very big changes to taxation affecting housing in the 1980s. What does it tell us about what might lie ahead?

In the first housing report I discussed the user cost framework established by James Poterba for analysing the impact of tax on housing. A question put to me was how does this translate to prices and rents, so I look at this issue in more depth here. Particularly since the Grattan Institute report has quoted me in support of their contention that rents will not do much. I beg to differ.

There is old saying about "lies, damn lies and statistics". Well, one of the casualties of the debate has been the facts about the role of domestic investors in the new and established housing markets, and the role of foreign investors. Domestic investors play a much bigger role in the new housing market than suggested by the "only invest 5% in new housing" headlines, and fortunately foreign buyers are playing a much lesser role than some of the inflated figures floating around. Nonetheless, the RBA's concern that foreign buyers are bringing an unpredictable element to the housing market is well founded.

In my next report, I will look at the question of whether, as ANZ Bank argues, there is really a shortfall of 250,000 houses in the Australian market. Just briefly for now, I would caution investors, developers and all businesses in the housing sector to not rely on this "shortage" as any sort of prop for the market, when making investment decisions.

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## 1. Some Taxation Statistics of Interest

| Table 1: Australian Tax Office: Rental Loss By Age and Income Groups and as a % of Other Investment Income 2012/13 | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Age Group | 18-29 | | 30-39 | | 40-54 | | 55-64 | | 65+ | |
| Taxable Income | Rental Loss $mn | % Other Income | Rental Loss $mn | % Other Income | Rental Loss $mn | % Other Income | Rental Loss $mn | % Other Income | Rental Loss $mn | % Other Income |
| $30-80,000 | 427 | 98.3 | 981 | 164.1 | 1837 | 85.5 | 829 | 35.4 | 113 | 2.9 |
| $80-180,000 | 223 | 98.5 | 945 | 126.9 | 1779 | 69.4 | 645 | 33.8 | 81 | 2.8 |
| $180,000+ | 36 | 50.3 | 320 | 50.3 | 1044 | 29.5 | 343 | 15.3 | 71 | 1.7 |

Table 1 presents aggregate figures for rental loss by age groups and income groups for 2012/13 and the percentage of that rental loss to other investment income. Aggregate figures will not tell the individual stories. That is with groups those with rental losses may not match up with those with other investment income. But the comparative figures indicate the likely pattern across the groups. Investment income is interest and share income.

What the data suggests is that higher income groups generally have more investment income relative to rental losses and hence there is a higher probability that within that group taxpayers are offsetting rental losses against that other investment income, rather than against labour income. It is in the younger age groups (18-39) that rental losses are more likely to be offset against labour income.

Tax and investment are not static in response to tax changes. High income groups with investment assets are going to be in stronger position to adjust to changes in the tax system. With higher rents and prospective returns, and investment income to match against rental losses, they can actually do well out of the changes. But the low/middle income groups with minimal investment assets (apart from that locked up in superannuation) do not have that flexibility and will be the ones more likely to exit the investor housing market.

That is, the ownership structure of the rental stock will gradually change. A greater share of it will be owned by high income/high wealth individuals and perhaps in time by corporations.

In the US, corporations own 18% of the rental apartment stock. In Australia it is negligible because rents/returns are too low. But that can change.

As the Henry Tax Report observed, there are some who would see this change as desirable given these investors are more likely to be interested in long-term tenure to renters, but there will be a trade-off here in higher rents.

## 2. The US experience in the 1980s – What does it Tell Us?

In 1981, the US Government introduced accelerated depreciation (which shortened the tax lifetime from 32 to 15 years) to stimulate investment in the housing sector. This led to, or at least contributed to, a boom in housing.

In 1986 there were major tax reforms in the US which reduced the tax benefits attached to housing. In the case of owner-occupiers, the reduction in marginal tax rates reduced the value of the exemption of imputed rental income from taxation and the value of tax deductibility of mortgage interest and land tax payments. This loss of tax benefits caused the user cost of owner-occupation to rise. For investors, the changes in 1986 saw the accelerated depreciation rates cut back (tax lifetime increased to 27.5 years), negative gearing was capped, and the capital gains tax was increased from 20% to 28%.

The boom in the first half of the 1980s (Figure 1 over) meant that oversupply was starting to emerge, putting downward pressure on rents, just at the time the tax changes came in. That is cyclical factors were weighing heavily on rents in the short run. Those cycles muddied the waters in judging the long term impact of tax changes. Poterba (1990, 1992) estimated that rents would rise 10-15% in the long term but that in the short term most of the impact would be on prices. He also noted that at the time declines in interest rates were working in the other direction, to lower rents and required returns and encourage investors into the market. In terms of activity, Poterba observed a sustained decline in the unit market in the US (which persisted well after his observation). This could be seen as a response to the lower rents/oversupply but it went beyond that. The contrast between detached housing/owner-occupied vs unit/rental market was evidence of investors leaving the market.

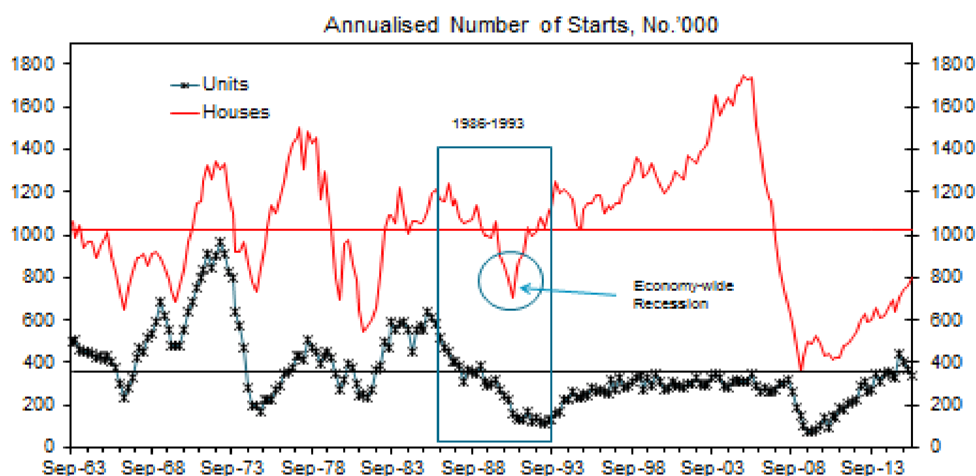
Subsequent studies used various models to empirically measure the effect all suffer from the specific difficulty of measuring expected capital gains in user cost, data problems and the general problem of disentangling all the factors that impact on prices and rents. For example, Blakely and Follain (1996) find that rents only respond over a long time period but then confess that this more likely reflects the problems inherent in their modeling of complex relationships and severe data issues. While protagonists will give them such studies varying weight, it is not evident that these studies actually add anything to Poterba's analysis.

Now of course the US rental market has since adjusted – even if it was painful for a few years - so it was not by any means terminal.

What does this tell us about Australia? What should be clear is that casual empirical observations on what happened to rents in the two year period 1987-88 in Australia are fraught. The honest answer should be that we can infer nothing from the empirical analysis. But theory still provides us with a fairly clear view what will happen.

What is similar to the US story is that in the lead up to these possible changes (depending on outcome of 2016 election), the housing and particularly the unit/investor market in Australia is experiencing a sizable boom. Booms end and tax shocks can accentuate the downturns that come with the end of the boom, as was the case in the US.

Figure 1: US Dwelling Market Starts 1963-2016



## 3. Why Changes in User Cost Impact on BOTH Prices and Rents

In Note No. 1 I discussed user cost framework set out by James Poterba in 1984 to assess the economic effects of taxes on housing.

The user cost framework has the following (simplified) formulae for rents and prices:

For rent: $Rent \; = \alpha . R_L + (1 - \alpha). uc_S . S$ [1]

For price: $Price = \alpha . \frac{RL}{UC_L} + (1 - \alpha). S$ [2]

(S = value of structure, $R_L$ = rent on land, α = shares of land, $(1 - a)$ is share of structure, and $uc$ = user cost or cost of capital. User cost discussed in detail in first report,)

The first thing to note is that land here refers to the component that is location premium. At the urban fringe, the value of land contains a high component of structure (infrastructure and cost of conversion to urban use). So, while the ABS statistics have land more broadly defined representing about 66% of the value of residential property in Australia and structures just over 33%, allowing for infrastructure in land, the truer measure of structure is about 60%.

The important thing to note in equation is that rent on land is set independently of interest rates/user cost. The second point is that user cost for land and structure will differ. Land does not depreciate so depreciation is not a relevant expense, which lowers user cost on land. More significantly, land is the source of capital gains, so expected capital growth also lowers user cost for land. (To the extent that building costs rise faster than general inflation, there is some capital gain in the structure! But it is small.) In short, user cost is lower for the land component than the structure component of a house.

By itself what this says is that if the proportion of the value of housing represented by land is high, the impact of changes in interest rates or changes in tax which lift user cost, will predominantly affect prices. Conversely, for housing with a high proportion of structure, the effect will mostly be on rents.

Particularly in the inner parts of say Sydney, land is a high proportion of the value of low density housing. On the other hand, units in inner areas (high density housing) have a higher share of structure. And in the outer areas, the share of structure rises. So this helps us understand the observed variation in rent-price ratios within urban areas.

The temptation then is to think that in a city such as Sydney with a high share of land, most of the impact of increases in tax or interest rates will feed into lower prices and the effect on rents will be negligible. The problem with that is that the supply side of the market in Australian cities is very rigid which has historically limited the downside to prices.

So that if higher user cost requires a higher rent-price ratio, the limit to the downside to prices will shift more of the long term adjustment onto higher rents. Hence, the Henry Tax Review's view that rents would rise. In the short term, that scenario still allows for volatility in prices.

In Note 1 (March 2016) , I indicated that the BIS Shrapnel estimates of 6% (average) rent rise in the longterm, while entirely plausible, might be a touch on the high side. Further number crunching the almost endless permutations possible, suggests that rent-price ratios will be pushed up from 3-4% in the Sydney and Melbourne markets to 3.5-4.5% (up +/- 0.5) in the long term, with rents up in the ball park of 5-10%. (I say long term because the current state of the market is one of downward pressure on rents and these pressures will persist for some time.)

## 4. NAB Survey - the “second best” but best guide on the role of domestic and foreign investors in the new dwelling market in Australia

One casualty of the tax debate has been the truth about the relative role of domestic investors and the foreign investors in the new housing market. Domestic investors purportedly invest 95% in the established housing market and a miserable 5% in new housing.

Conversely, foreign investors have been claimed to be putting three to four times as much as domestic investors and nearly as much as owner-occupiers into the new housing market in Australia. And that false analysis was based on the 2013/14 FIRB data, before the substantial 40% lift in the value of foreign investment approvals for 2014/15. If that analysis were correct, the Reserve Bank, which has expressed concern at the impact of foreign buyers in adding to peakiness in the housing cycle, would have reason to be truly alarmed.

Both are WRONG for the reasons I outline below.

While there are no precise estimates, the NAB Residential Market surveys for 2015 provide some numbers that at least look roughly credible. For 2015 they show:

- foreign investors taking (an historic high) 15% of new dwellings;
- domestic investors 35%, with the latter including 12% first home buyers entering the market by the investment route; and
- owner-occupiers accounted for the balance of 48% (existing 33%; first home buyers 15%)

The owner-occupier share looks a bit low compared with their 65% share of the total dwelling stock and the 50% plus share indicated by the ABS data (see below) while the investor share is high compares with its 27% share of stock but given the prominence of units in this cycle, for which typically own a larger share, it is largely explainable.

The good news from the NAB survey in the March quarter 2016 was that it showed that the foreign investor interest in the new dwelling market was cooling.

- Foreign investors share of new dwellings dropped to 12%,
- Domestic investors share rose to 38%, including 14% first home buyer investors
- Owner-occupiers were steady at 47% but first homebuyers up to 19%.

In the established market, the NAB survey also gives a guide on the relative share of buyer types for 2015:

- Owner-occupiers accounted for 60% (existing 42%; first home buyers 18%)
- Domestic investors accounted for 31% (existing 21%; first home buyers 10%)

What it says is that domestic investors’ share of the established and new markets is about equal at over 30% in 2015 and that about 30-40% of first home buyers are entering the market as investors in the established and new markets.

## 5. Domestic Investors and the New Housing Market

The ABS gives us data on the number and value of approved loans for owner-occupiers in the new and established dwelling markets. So for example in 2015, there were 103,650 loans worth $34.5bn approved for the purchase of new dwellings which comprised 69,800 loans for construction of new dwellings and 33,800 loans for the purchase of completed dwellings. In aggregate, new dwellings were 31% of loans and established dwellings 69%. If we compare the 103,650 loans when compared with the number of new dwellings completed in 2015 (191,000), represents about 54% of the new dwelling market.

In the case of domestic investors, less data is available. The ABS gives only a dollar figure for loans (not numbers) by domestic investors, and the category split gives loans for construction of new dwellings BUT NOT for purchase of completed dwellings. That is, there is not a figure for new dwellings comparable with that for owner-occupiers. Loans for the purchase of newly completed dwellings are aggregated with all other loans, which includes for the purchase of established dwellings and for the refinancing of loans. Assuming half the rate of refinancing as in the owner-occupied market but otherwise similar shares of established and new purchases and same size loans, estimates are that investors loans for all new dwellings were about 54,000 in 2015, representing about 28% of the new dwelling market. This is slightly below the NAB survey estimate of 35%. As a share of investor borrowing, new dwellings account for 16-20% and established dwellings 80-84%. The NAB estimate

would push the new dwelling share up over 20% which would compare with the 31% share of owner-occupier's loans being for new dwellings.

An important point to note is that these figures exclude the equity investment by owner-occupiers and also exclude the indirect financing as change-over owners sell an established property and use proceeds to part or fully finance either another established dwelling or a new dwelling. Hence, that the two figures (54% + 28%) add up to an 82% share does not mean that other (i.e. foreign) buyers accounted for the balance. More likely there are a portion of buyers (much more likely owner-occupiers) purchasing new dwellings with 100% equity, while it could be that the assumptions for investors are perhaps understating the investor share. The NAB survey might suggest some of the latter.

## 6. Foreign Investors – Big but Not So Big?

The principal source of data for foreign investors cited is the FIRB. The FIRB data is for the full purchase price which is necessarily not comparable with lending figures. For end –investors, the three components are vacant land for construction (making some allowance for developers), individual purchases, and developer's off-the plan approvals.

In the case of developer's off-the plan approvals (for end-investors to purchase), using the average value of individual approvals ($700,000) as a benchmark the $28.7bn approved in 2014/15 would translate to 41, 000 potential approvals which would make foreign investors a big part of the market. But foreign buyers are more risky than domestic buyers (harder to chase down) and if developers need bank funding for a development, the bulk of pre-sales will need to be to domestic investors and owner-occupiers, e.g. some banks will only allow 20% of off-the-plan purchases to be foreign buyers. A Treasury Report (2014) noted that typically only about 35% of these off-the-plan projects were sold to foreigners and with the banks tightening up on their risk assessment, that proportion could well be less than that with more recent projects. In short, these blanket approvals need to be heavily discounted. The estimates in Table 2 assume a low-high range of 20%- 35% foreign take-up.

In respect of individual approvals, the estimates assume 80-90% translation to purchase and the low assumption (80%) may be too high: an RBA paper by Gauder et al (2014) noted that a reasonable but unknown number would not turn into actual purchases. On these stated assumptions for individual and off-the-plan approvals, foreign buyers would have accounted for 17,850 new dwellings in 2013/14 and 29,368 in 2014/15, representing 10-12% and 15-19% respectively of the market.

Now the RBA in its April 2016 Financial Stability Review expressed some concern about foreign investors which in 2016 is predominantly about investors from China. In the 1980s it was investors from Japan and in the 1880s it was investors from the UK – in both cases they did very badly. But back to 2016, the RBA is not particularly concerned about how well or badly the investors do. It was more concerned about the impact on banks and the economy/ housing sector and the risk to these that "a substantial reduction in Chinese demand would likely weigh most heavily on the apartment markets of inner-city Melbourne and parts of Sydney, not only because Chinese buyers are particularly prevalent in these segments but also because other factors would reinforce any initial fall in prices."

That is, even if foreign investors are still well behind domestic investors and owner-occupiers in an absolute sense, what happens at the margin is important. In the 1980s, investors from Japan were not important overall but they were significant in the Gold Coast market which at the time was much more cyclical than other markets, as those investors found out to their cost. The inner city markets of Sydney and Melbourne in 2016 are much deeper markets but nonetheless have parallels to the Gold Coast markets of earlier years in terms of the euphoria about them (or was about them). Certainly these are markets to watch and be wary of.

| Table 2: Foreign Investment Review Board Statistics on Purchases of New Dwellings | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | | | Number of Purchases (3) | | Share of Completions (%) (4) | |
| Fiscal Year | Value of approvals $bn (1) | Individual mean value $'000 | Number of approvals (2) | Low Estimate | High Estimate | Low Estimate | High Estimate |
| 2007/08 | 14.1 | 633 | 17707 | 5167 | 7688 | 3.6 | 5.3 |
| 2008/09 | 8.8 | 629 | 10655 | 3296 | 4797 | 2.4 | 3.4 |
| 2009/10 | 4.9 | 620 | 6660 | 3294 | 4137 | 2.1 | 2.7 |
| 2010/11 | 14.9 | 629 | 19938 | 6276 | 9931 | 4.6 | 6.8 |
| 2011/12 | 14.1 | 632 | 22831 | 8444 | 11038 | 5.8 | 8.2 |
| 2012/13 | 10.0 | 647 | 15179 | 7460 | 9232 | 4.8 | 5.9 |
| 2013/14 | 25.8 | 681 | 38545 | 17850 | 21459 | 9.7 | 11.7 |
| 2014/15 | 45.6 | 700 | 67461 | 29368 | 38164 | 14.8 | 18.9 |

(1) Value of approvals is sum off vacant land, individual, and off-the-plan approvals.
(2) Number of approvals is the dollar value of approvals divided by the average value of individual approvals for that year.
(3) High Estimate assumes 35% of off the plan approvals translate to purchases, and 90% of individual and vacant land purchases translate to purchases. Low estimate assumes 20% of off-the-plan and 80% of individual and vacant land approvals translate to purchases.
(4) Shares are numbers as a % of commencements/completions for the overlapping calendar year to allow some lag, e.g. for 2014/15 compares with 2015 commencements/completions.

Source: FIRB Annual Reports, ABS Building Activity

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