



AUSTRALIAN HOUSING

A Case for Reform



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Introduction

Australia is facing housing affordability problem, particularly in its large metropolises. The median house prices have trebled leading up to the year 2015 and the gap between median income and median house prices has doubled during this period (Yates, 2016). One manifestation of the problem is through decreasing home ownership rate among younger adults which has dropped from 60 percent in mid-1980s to below 40 percent in 2016 (Daley et al., 2016; Yates, 2016). The housing affordability continues to worsen and borders on becoming Australian housing affordability crises (Ryan-Collins, 2019; Yates, 2008; Wyatt et al., 2005) despite significant government investments in the housing sector over the years. This draws attention to the impact of governmental measures on ground. However, given the multidimensionality and complexity of the housing problem, foregoing a holistic analysis of all governmental measures is this manuscript explores interface of only two federal tax measures, negative gearing, and the capital gains tax discount (CGT), with the housing affordability in Australia to understand their impacts on ground. Drawing on the literature review, it is argued that the negative gearing and CGT discount promote financialization of housing and contribute to making housing less affordable. These tax arrangements enhance the treatment of housing as a vehicle for accumulation of wealth by investor landlords¹ and push the first home buyers at a competitive disadvantage. It is also argued that the negative gearing must be done away with altogether and phased reduction in the CGT discount be introduced. Also, a broad-based land tax may be gradually introduced to ease the housing stress. Implementing these recommendations is important if housing is to be treated as a social good rather than a speculative investment strategy.

The manuscript is organized as follows. The introduction is followed by a broad overview of the housing in Australian context which is followed by introduction, rationale, and effects of negative gearing and CGT discount on housing affordability. The next section aims to understand difficulties in changing the status quo around these taxes due to political implications of such moves. This is followed by a section on recommendations to increase housing affordability from a normative standpoint before concluding the essay.

Context

The mandate for provision of housing is split across federal and state jurisdictions. The Commonwealth has control over most of the demand side levers in the shape of federal taxes and control over interest rates while the state and local governments have a predominant control over supply side measures through provision of social housing and land use regulations (Daley et al., 2018; Pawson et al., 2020). These arrangements are not mutually exclusive as Commonwealth has engaged in supply of houses for homeless and aboriginals while state governments levy stamp duty and land taxes which might have bearing on the housing affordability (Jacobs, 2015a). Though the split of the housing mandate across Commonwealth and States is itself a major factor explaining lack of strategic voice in housing policy in

¹ Investor landlords are small scale investors in the property market colloquially known as ‘mum and dad investors’ in Australian context. Pawson et al., (2020) report that two thirds of the private rental properties are owned by the investor landlords in Australia.

Australia (Pawson et al., 2020), yet, comparatively, the macroeconomic instruments available with the Commonwealth remain crucial in determining housing affordability (Pawson et al., 2020). Two of these tax measures, negative gearing, and CGT discount, has increasingly attracted attention of academics since the turn of the century as a factor in exacerbating the housing affordability problem in Australia (Blunden, 2016; Daley et al., 2018, 2016; Pawson et al., 2020; Wyatt et al., 2005). These measures, therefore, merit attention for their impacts on housing affordability.

Negative Gearing

Negative gearing is a tax rule whereby losses on rental property can be deducted from personal income tax liability. It allows investors to write off business related expenses including loan interest payments and other holding costs against their entire income including incomes that are unrelated to the assets (Daley et al., 2016; Pawson et al., 2020; Yates, 2016). This unique Australian practice (Blunden, 2016) found its widespread use during 1980s though it was available during most of the last century (Pawson et al., 2020). Negative gearing, coupled with general substitutability between owner-occupied housing stock and private rental stock (PRS) in Australia has offered investors with a lucrative investment opportunity in the real estate business (Hulse et al., 2018; Hulse and Reynolds, 2018). However, due to unavailability of such treatment to institutional investors, small scale investors or the 'mum and dad' investors have increasingly dominated the PRS market in Australia (Hulse et al., 2018). Accordingly, there has been consistent increase in the bank lending to investors which saw a 42% increase in the lending to investor landlords from 2006-2016, resultantly there are, currently, 1.135 million small scale investor landlords in Australia who own 80% of PRS with 38% owning one property while the rest own up to three properties (Hulse et al., 2018; Hulse et al., 2020). The rest of 20% include investors who own four or more than four properties including institutional investors, real estate companies and overseas based individuals.

Capital Gains Tax Discount

CGT is also a Commonwealth tax arrangement levied on income derived from the appreciation of assets when the asset changes hand. Levied in 1985 to recover part of unearned income accrued from appreciation in the value of the assets, CGT was originally levied on taxpayer's marginal rate of income tax (Pawson et al., 2020). However, since 1999, CGT is liable to a 50% discount if the transaction is carried out after a year of the purchase of an asset, real estate property in our case (Pawson et al., 2020; Wyatt et al., 2005). In addition to offering a net discount, this tax arrangement allows investors to offset the capital gains against other capital losses that the real estate investor might be holding (Wyatt et al., 2005). The financial impact of the CGT discount can be measured from the fact that it alone cost \$55 billion to the national exchequer in 2015-16 and comprised almost half of the Commonwealth tax concessions (The Treasury, 2016).

Impact of negative gearing and CGT discount

The operation of negative gearing and CGT is not without its consequence for housing affordability. The annual financial impact of the two tax concessions has been estimated at \$11.7 by Grattan Institute (Daley et al., 2016). However, in addition to losses to exchequer, these tax arrangements and the structure of

housing subsidies impact the intragenerational home ownership by placing first home buyers at a competitive disadvantage. The distributional aspect of the negative gearing and CGT discount coupled with other housing subsidies, therefore, requires attention. Yates (2011) estimate that the federal government's tax expenditures on housing is around \$53 billion a year from which \$45 billion flows to existing owners in the shape of imputed tax subsidies. According to her estimates, individual homeowners are subsidized \$8000 a year, investors get \$4000, private renters get \$1300 while residents of public housing get \$1000 a year in the shape of subsidies. The consistent flow of annual subsidies to owner-occupiers and investor landlords gets capitalized into the housing and places the new home entrants at a comparative disadvantage as manifest in the declining home ownership rate among young adults (Pawson et al., 2020; Yates, 2016). Yates (2016) shows that how the deposit gap for younger adults is increasing over the years who must save double the annual median incomes for securing mortgage finance to enter the housing market. Wyatt et al. (2005) does a statistical modelling based on the interest rates, median house prices and available finance to show that the net deposit requirement for the first home buyers are increasing over the years due to effect of persistently falling interest rates and tax subsidies (negative gearing and CGT discount) that flow to rich investor landlords. Daley et al. (2016) show that in addition to depressing taxable income, negatively geared properties offer a proposition where an investor can reduce his/her income tax bill from a possible taxable threshold had he/she did not own a negatively geared property (Daley et al., 2016). Such an arrangement offers rewards to investors for negative gearing. Yates (2016) argue that the situation, if left unattended, might be potentially detrimental to the economic stability and competitiveness of the economy due to distortion of the investment decisions in favour of real estate properties against more productive investment decisions.

For a holistic understanding of the issue, arguments in favour of status quo also merit attention. Sloan (2014) argues that abrogation of negative gearing provisions in the tax code might reduce the investment in PRS, especially the new homes. Similarly, he argues that ownership of investment properties is distributed across the national income spectrum and any disturbance in it would impact the working class. However, as earlier shown, the ownership of the properties is not distributed equitably across national lines (Daley et al., 2016; Pawson et al., 2020; Wyatt et al., 2005). Moreover, statistical calculations based on the tax-assessable rather than the taxable income show that the negative gearing disproportionately favours the already wealthy (Grudnoff, 2019). Analysed as such, 80% of the CGT discount flows to the top 10% of the income earners (Mather, 2018). Another argument in favour of the status quo cites the progressively decreasing interest rates as a reason behind housing unaffordability (Guest, 2014). However, as shown by Wyatt et al. (2005), the decreasing interest rates negatively impact the first home buyers than the owner-occupants or the investor landlords. Though seemingly counter intuitive, yet Wyatt et al. (2005) shows that in the face of lower interest rates, the first home buyers must save over a longer period to gather deposit money for entering the mortgage market for housing. Similarly, an argument is made that CGT discount is not available to investor landlords, therefore, it has no impact on housing affordability. However, the fact remains that this potential disadvantage to investors occurs only if they decide to sell the assets which they could do when their marginal income tax rate is lowest (Wyatt et al., 2005). They can also sell after realizing capital loss from other property thus offsetting the gain against loss and paying zero CGT. Consequently, the tax arrangements continue to be lucrative instruments of

wealth accumulation. But the worrisome feature is the lack of political will to change the status quo even with its dire implications for housing affordability.

Impediments to reform

There seems to be a political inertia in changing the status quo. It seems that the political pragmatism of the governments and concerns for re-election in office have defeated the goals of strategic thinking in housing particularly after 1980s. Short termism in policy making might fear voters' erosion of wealth if the house prices were to fall, after all, the investor landlords were 12% of Australian taxpayers in 2015 and they continue to grow (Blunden, 2016). Jacobs (2015) show how powerful industry lobbyists in Australia shape and use market efficiency narrative in Australia to maintain status quo in housing policy. Similarly, Gurrán and Phibbs (2015) use policy capture theories to argue that housing policy in Australia is largely influenced by the home-owning electorates and industry sponsors who portray monetary interests of the few as the wider public interest to resist the change. Such is the power of the lobbyists that the government's decision to rescind negative gearing in 1985 had to be reversed in 1987 due to pressure from housing industry associations who worked through media and behind the scenes to achieve their objectives (Jacobs, 2015a). The welfare lobbyists, on the other hand, do try to get heard in the power corridors but they remain less effective than their influential and well-resourced industry counterparts who are considered as partners in policy making while welfare lobbies are considered dependent clients (Jacobs, 2015a). Resultantly, governments continue to look busy in fixing the housing problem (Gurrán and Phibbs, 2015) while more houses are built for speculative purposes and even left vacant for reaping windfall capital gains at opportune times (Rahardjo, 2018). However, the potential first home buyers continue to be marginalized from realizing the great Australian dream of owning a house in this setting (Pawson et al., 2020). Jacobs (2015b, p.1) terms the situation a 'reverse form of welfarism' wherein government continues to favour the already privileged at the cost of denying shelter to underprivileged who are left at a competitive disadvantage with each passing day.

A case for change

Though difficult to change yet the status quo must change. The normative considerations of equity and rights-based approaches deem housing as a social good and a basic human right rather a commodity to be exchanged in the speculative investment market. It seems that a phased withdrawal of negative gearing and reducing the CGT discount to 25% is necessary if investor landlordism is to be discouraged. The current 50% CGT seems to have overcompensated the investors against the overall inflationary pressures over the years and, therefore, needs correction. Increase in tax bill for property investors might decrease the rate of return on property which in turn might reduce the effective demand for investment properties. Though seemingly difficult to implement, calls for changing the status quo are gaining momentum (Blunden, 2016; Daley et al., 2018, 2016; Grudnoff, 2019; Wood et al., 2010; Wyatt et al., 2005). The Grattan Institute estimates that phased abolition of negative gearing and gradual reduction in CGT discount might lower property prices by at least 2% without significantly impacting the rents and the supply of new housing units (Daley et al., 2016). In addition, they also estimate that treasury can benefit by at least \$5 billion a year because of reduction of CGT discount and abolition of negative gearing (Daley et al., 2016). These savings can be used to shore up stock of public housing which is dwindling with each

passing year due to government's reliance on market mechanisms for delivery of housing. Consequently, the private investors might switch to other more productive investment options such as shares and mutual funds etc. or reconcile to lower rates of return in the property market. Additionally, the denial of negative gearing and CGT discount might also attract institutional investors to the PRS who are competitively disadvantaged in the current scheme of taxation against the investor landlords (Hulse and Reynolds, 2018; Nethercote, 2020). The entry of institutional investors might diversify the PRS market and promote it as an alternative tenure against current domination of owner-occupation.

Another avenue of reform is through a uniform and broad-based levy of land tax. The land tax is a state level tax arrangement whereby taxable land values are progressively taxed by the state governments. In the current arrangement owner-occupied houses and land uses for some other purposes such as education are exempt from land tax while the commercial uses such as rental housing are subject to land tax (Wood et al., 2012). Together with the exemptions on CGT, the exemption on land tax can serve as a powerful attraction for home ownership as a tenure of choice. However, this preferential treatment to owner-occupiers and investor landlords can be corrected by levying of a flat land tax across the board for all lands. Such arrangements, combined with the withdrawal of negative gearing and reduction in CGT discount, might increase the tax expenditure of the property owners making it a less attractive option. The net effect of these arrangements might manifest itself in lower prices of lands which might make housing a less feasible option for investment (Daley et al., 2016; Wood et al., 2012). Wood et al. (2012), in addition to levying land tax, also argue for phased withdrawal of stamp duty to increase supply of rental housing and decrease investors' appeal for speculative investment. There theoretical statistical modelling based on the median land values as per 2006 rates indicate that a plot with land value of \$335,000 will decline by \$24000 or approximately 5% if broad based land tax is applied to the land across the board. Such decrease might seem trivial, but it holds potential to discourage speculative investment in real estate business alongside increasing home ownership prospects for young adults who will be required to deposit less for entering the mortgage market.

Conclusion

In a nutshell, though the wicked problem of housing affordability cannot be holistically solved by changes in federal tax policy alone, yet these adjustments can pave way for discouraging speculative investment in housing. The essay has argued that in a neoliberal setting where the government has relied on market mechanisms for delivery of housing, the tax rules on negative gearing and CGT discount promote usage of housing as a vehicle for accumulation of wealth instead of a social good to be enjoyed by all. It has also been argued that the effects of these two tax rules have disproportionately favoured the existing rich investor landlords and diminished prospects for first homebuyers to share the Australian dream of owning a house. These tax arrangements distort the investment decisions in favour of real estate investments and discourage investments in more productive investment portfolios. Accordingly, a phased withdrawal of negative gearing along with reduction of CGT discount to 25% has been recommended to discourage treatment of housing as a speculative tool of wealth accumulation. In addition, a case for introduction of flat rate, broad based land tax has been argued to disincentivize speculation in housing and reduction in land prices due to increase in tax bill of the land holders. These changes might not deliver a holistic

solution to housing problems but might serve as a crucial first step towards treatment of housing as a social good by reducing the prices of land by approximately 5% through introduction of these measures.

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