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How would proposed reforms in the Henry Tax Review affect housing affordability for private renters and property owners?

MODELLING SHOWS THAT PROPOSED REFORMS IN THE HENRY TAX REVIEW CAN IMPROVE HOUSING AFFORDABILITY BY REDUCING PRIVATE RENTS AND ENTRY COSTS FOR PROPERTY PURCHASERS.

KEY POINTS

- The Henry Tax Review proposes that housing affordability can be improved through changes to negative gearing, as well as abolishing stamp duties and modifying current land tax arrangements.
- The introduction of a Savings Income Discount (SID) of 40 per cent for net rental income (including capital gains) would offer a more balanced tax treatment of rental income and capital gains, while curbing some of the tax shelter benefits from negative gearing. Despite fears of a 'flight' of investors from the market, such changes are unlikely to lead to an overall contraction in private rental housing stock.
- The abolition of stamp duty should reduce entry costs to home ownership. It is also expected there would be a boost to the supply (and affordability) of rental housing as the introduction of a broad based land tax places landlords and home owners on an equal footing.
- However, caution needs to be exercised by policy-makers to ensure the beneficiaries are current or prospective

This bulletin is based on research conducted by ***Dr Rachel Ong*** *and* ***Mr Clinton McMurray*** *at the AHURI Western Australia Research Centre,* ***Professor Gavin Wood*** *and* ***Dr Melek Cigdem*** *at the AHURI RMIT Research Centre. The research involved modelling two recommendations made in the Henry Review of Taxation (2010), and it modelled the impact of the recommendations on rents, rental supply and housing affordability.*

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house purchasers, who face the greatest difficulties in accessing markets, rather than accruing to those already well placed to access home ownership.

- The Henry Review also proposed changes to Commonwealth Rent Assistance (CRA) through better targeting of assistance, based on more accurate indexation of CRA to rents. This is expected to improve housing affordability in the lower priced section of the market and reduce the number of private renters experiencing housing stress. With fewer households therefore being eligible for assistance there is likely to be a reduction in CRA outlays.

CONTEXT

The tax treatment of housing has a bearing on housing affordability. The recent Henry Review identified three key areas to improve the supply and affordability of private rental:

- A Savings Income Discount (SID) of 40 per cent applied to the net income (including capital gains) from most non-business assets other than shares.
- Stamp duties on conveyance abolished and replaced by a broad based land tax, which is levied according to a progressive rate structure applied to the value of land per square metre.
- Commonwealth Rent Assistance reforms, to index maximum thresholds, refine the formulae governing determination of threshold amounts and redefine eligibility rules, including the extension of CRA to public housing tenants.

RESEARCH METHOD

Using data on landlords' wealth and private renters in the 2006 Household, Income and Labour Dynamics in Australia (HILDA) survey, the study simulated the Henry Tax recommendations for negative gearing and CRA using the AHURI-3M micro-simulation model. The modelling analysed the costs of supply of rental housing by landlords, as well as the housing affordability and housing tenure outcomes for private renters under current government policy parameters, and outcomes under alternative policy parameters based on reforms to negative gearing and CRA.

The Victorian Valuer General's data base, which comprises residential property transactions and imputed land values for all residential land plots in Melbourne in 2006, was used to analyse the effect of replacing stamp duties by a broad-based land tax. The study estimated the amount of revenue that would be lost through the abolition of stamp duties and designed a new land tax schedule that contains the features recommended in the Henry Review and fully compensates for the loss of revenue through abolition of stamp duty.

Please note that flats and apartments were omitted from the stamp duty and land tax calculations due to the absence of land area information on these dwellings.

KEY FINDINGS

Reforming negative gearing

The Henry Review recommended the introduction of a SID, designed to offer a balanced tax treatment of rental income and capital gains while curbing some of the tax shelter benefits provided by negative gearing. Instead of including 100 per cent of net income from property investments in assessable income, the investor would report 60 per cent as assessable income. At present 50 per cent of capital gains are taxed; under the reform, 60 per cent will be taxed so the application of the SID on capital gains tax would reduce incentives to 'chase' capital gains.

Negatively geared investors are adversely affected by the SID reforms, with their average after-tax economic cost (as a percentage of property value) rising from 8.0 to 8.5 per cent. However, the average after-tax economic cost for equity investors (i.e. those not negatively geared) falls from 8.0 to 7.5 per cent. The modelling shows that these lower costs for equity investors would result in a long-term decrease in average rents of 3.5 per cent (or $300) annually, all other factors being equal.

In absolute terms, this reduction in housing costs is greatest for tenants in the more expensive segments of the private rental market (where tenants typically have higher incomes); whereas the effects on housing affordability ratios (HARs) and rates of housing affordability stress (HAS) are more modest. In the more affordable segments this translates into a $285 reduction in housing costs annually.

The concern that investors are likely to leave the market due to the proposed reforms is likely to be unfounded. Unleveraged and equity oriented investors are more inclined to retain investments under the SID reforms, while negatively geared investors are likely to realise their investments. A 'flight of investors' from private rental housing would not occur as these supply responses would offset each other.

However, it must be noted that any contraction in the supply of rental housing would only occur if existing rental investors sell their properties to non-investors, that is owner occupiers. If existing rental investors sell their properties to other investors, the impacts of SID will be reflected in reduced prices paid by those new investors.

Reforming land tax and abolishing stamp duty

The Henry Review recommends a broad based land tax to avoid the distortionary effects of current tax arrangements which are not tenure neutral: at present owner occupiers do not pay land tax but investors do. Further, the determination of land tax thresholds by per square metre value would apply a higher tax rate to more expensive land.

Economic theory suggests that if a broad based land tax is shifted to landowners who receive lower after-tax rents these will in turn be capitalised into lower land values. The modelling found that the average plot, with a land value of $335 000 (at 2006 prices), would likely decline by $24 000 (or 5%). Suburbs located closer to the CBD are relatively affluent and have the most expensive land and will therefore bear the highest tax burdens under the reforms. The expected decline in land value is estimated at around 12 per cent. In suburbs further away from the CBD, the percentage decline in mean land value will be around 8 per cent or less.

The removal of stamp duty might affect the timing of development by aiding transfers of property from lower to higher value uses. The modelling also suggests efficiency gains as 'empty nesters' would find that trading down is a more effective method of releasing housing equity, with the result that housing stocks are more fully utilised.

Reforming Commonwealth Rent Assistance

The proposed changes to CRA in the Henry Review are likely to have a larger effect on housing affordability within the lower cost segment of the market.

The Henry Review's proposed CRA reforms seek to better target housing support, more accurately index CRA to rents and separate income support and family tax benefits from housing support payments. Under existing arrangements, over 1 million individuals (or one-third of private renters) receive CRA as eligibility is determined according to receipt of family tax benefits. Under the proposed reforms almost one-third of current CRA recipients (329 000) would be ineligible to receive CRA. Those affected would likely be younger families with at least one parent employed and incomes further up the income distribution than typical for CRA recipients.

The modelling suggests an improvement in housing affordability for those households who remain eligible for CRA. The proportion of private renters in housing stress is expected to drop from 37 to 29 per cent following changes to both thresholds and eligibility criteria. Overall, the proposed reforms would succeed in removing relatively better off families as clients of CRA, while targeting improved housing assistance to less well-off older singles and families. There is also likely to be a commensurate decrease in Commonwealth expenditure by around 20 per cent, from approximately $1.9 billion to $1.5 billion.

FUTURE RESEARCH

Longitudinal analysis of investor behaviour

At the time the research was conducted the most recent wealth data from the 2010 Hilda Survey (wave 10) was not yet released. Using the updated data AHURI-3M could generate a longitudinal analysis of investor behaviour during 2002, 2006 and 2010—a period of initial strong house price growth followed by a downturn in housing market conditions in the latter part of the decade. This will allow investigation of the entry of new landlords into the market over a nearly 10-year period. This is an opportunity to identify the factors shaping decisions to add rental property investments to wealth portfolios.

Extent of negative gearing

The proportion of negatively geared residential landlords is an important determinant of housing supply responses to the SID recommendation, and indeed any policy reforms to negative gearing. However, current surveys that contain information on negative gearing (HILDA Survey, ABS Rental Investors Survey and ABS Survey of Income and Housing) produce estimates that diverge quite significantly from the estimates of negative gearing by the Australian Tax Office. An updated survey that offers negative gearing data that aligns closely with the Australian Tax Office would provide more useful evidence about the forces shaping the supply of affordable rental housing and assist policy deliberations.

Land tax and stamp duty analysis

The analysis used in the report draws on 2006 stamp duty schedule and property transactions from metropolitan Melbourne. The availability of new data provides an opportunity to update the findings. The analysis would also be enriched if replicated on similar property data in other capital cities with different housing markets and urban forms.

FURTHER INFORMATION

This bulletin is based on AHURI project 80647, *Modelling the impacts of the Henry Review tax recommendations on housing supply and affordability.*

Reports from this project can be found on the AHURI website: www.ahuri.edu.au or by contacting AHURI Limited on +61 3 9660 2300.

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