

Increasing the supply of affordable private rental housing

THE SUPPLY OF AFFORDABLE HOUSING IN THE PRIVATE RENTAL MARKET COULD BE INCREASED IF THE AUSTRALIAN GOVERNMENT BUILDING WRITE-OFF ALLOWANCE WERE REPLACED BY A LOW INCOME HOUSING TAX CREDIT, AND BY AMENDMENTS TO STATE AND TERRITORY LAND TAX AND STAMP DUTY.

KEY FINDINGS

- On the supply-side of the housing market, AHURI-3M estimates that individual investors in the private rental market face high effective tax rates at low rates of capital gain. Existing Australian Government Building Write-Off allowances have only a marginal impact upon the tax burden of landlords. Furthermore, they are not targeted to the low rent end of the private rental market.
- A US-style Low Income Housing Tax Credit (LIHTC) is estimated to be far more effective in promoting the supply of low-rent dwellings.
- Estimates from AHURI-3M demonstrate that State and Territory Land Tax and Stamp Duty create disincentives for single property landlords who wish to add to their investments in rental housing, and thereby potentially limit the supply of dwellings in the private rental market.

CONTEXT

The AHURI Housing Market Microsimulation model (AHURI-3M) is the first comprehensive microsimulation policy tool designed for the Australian housing market. AHURI-3M takes into account both the demand side and the supply side of the housing market and is designed specifically to assess the quantitative impacts of housing policy measures.

By simulating the economic impact of policy measures, AHURI-3M is able to provide guidance to policy makers.

AHURI-3M analysis is the basis for the findings in this Bulletin.

The availability and cost of housing in the private rental market is affected by both supply and demand factors.

Based on research by Gavin Wood, Richard Watson and Paul Flatau of the AHURI Western Australia Research Centre. The research uses AHURI's Housing Market Microsimulation Model (AHURI-3M) to analyse the supply of dwellings in the private rental market. AHURI-3M is the first microsimulation model to be developed of the Australian housing market. This is one of three Bulletins based on this large-scale project



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The demand for housing in the private rental market is affected by growth in the number of households, movements in house prices, and the availability of public and community housing.

On the supply side, the private rental market has seen a recent surge of investors and average vacancy rates have increased as a result. Yet trend data through the 1990s identify an uneven pattern to these investments, with fewer investments directed to the low-rent end of the market. Whether this trend has continued in the most recent period needs to be established, as it is the low-rent end of the market that is of immediate concern to policy discussion about affordable housing.

One set of factors affecting whether any particular individual becomes a landlord, and thereby adds to the supply of dwellings in the private rental market, is the financial viability of such an investment.

A range of factors shapes this financial viability. They include mortgage interest rates, property prices, income tax rates and income tax deductions – for example, negative gearing which allows landlords to deduct the costs of supplying a dwelling from their annual taxable income. A similar measure is the Australian Government Building Write-Off (BWO) allowance, which enables a landlord to deduct from their annual taxable income an amount equal to 2.5% of the construction cost of a newly built dwelling or an extension.

Tax measures such as negative gearing and the BWO allowance can reduce the amount of tax paid by a landlord, making investing in the private rental market more financially viable. The more that rental property investments are financially viable, the more the supply of dwellings will increase, other things being equal.

But the combined effect of negative gearing, capital gains and BWO tax arrangements on financial returns is greatest at the high rent end of the market, for properties with a weekly rental of \$205 or more in 1996-97 dollars. The combined effect is small at the low-rent end of the market, for properties renting at \$140 a week or less. As a result, the pattern of rental housing financial returns is distorted, disadvantaging investments at the low-rent end of the market.

Two further measures that affect the tax burden of landlords are State and Territory Land Tax and Stamp Duty.

All jurisdictions, except the Northern Territory, impose land tax on the value of land (excluding the value of the dwelling). Land tax is payable annually (typically) on dwellings that are not a primary place of residence (rental properties, second homes).

Stamp duty is levied by all jurisdictions on contracts associated with the change of ownership of land and dwellings. Typically, the higher the value of the transaction, the higher is the rate of stamp duty.

AHURI-3M was used to estimate the impact that these various tax measures have upon the supply of dwellings in the private rental market.

FINDINGS

THE IMPACT OF THE BUILDING WRITE-OFF ALLOWANCE

A modelling analysis conducted with AHURI-3M examined how effective the BWO is in reducing the tax burden of landlords, and thus how effective it is in promoting the supply of dwellings in the private rental market.

The analysis finds that the BWO allowance has little effect on tax burdens, reducing the average effective tax rate by only one percentage point from 64% to 63%. The negligible impact arises because BWO allowances are recaptured on sale of the rental property, through the capital gains tax.

An alternative means of reducing the tax burden of landlords and of directing investment to the low-rent end of the market is the Low Income Housing Tax Credit (LIHTC). This credit, currently in operation in the United States, allows a landlord to deduct from their taxable income an amount equivalent to 70% of the present value of a newly constructed or substantially renovated dwelling, for ten years, providing the dwelling is let at a rent in the lowest gross weekly rent quartile. In AHURI-3M this corresponds to \$140 per week, in 1996-97 dollars.

AHURI-3M was used to model how effective a LIHTC would be in promoting the supply of

dwellings in the private rental market, particularly at the low-rent end of the market. The analysis found that average effective tax rates at the low-rent end of the market were reduced from 61% to 41% – a potentially powerful incentive effect.

Taking into account the full ramifications of the LIHTC on landlord behaviour and secondary effects on other tax receipts, AHURI-3M estimates that the annual cost in revenue foregone of the LIHTC would be \$88.1 million at 1996-97 prices. This is a modest cost compared to that of rent subsidies paid to private rental tenants, which in 1996-97 amounted to approximately \$1 billion.

THE IMPACT OF LAND TAX AND STAMP DUTY

AHURI-3M was also used to examine the impact of Land Tax and Stamp Duty on a landlord's effective tax burden when increasing his/her holdings from one property to multiple properties. The large number of single property landlords is a feature of the Australian market. If these landlords moved to become multiple property landlords, then the supply of dwellings in the private rental market would increase.

Land Tax is payable only above certain specified land value thresholds, but is payable on the *combined land value* of all property holdings. The multiple property landlord is thus far more likely to exceed such a threshold and to be liable to pay Land Tax.

AHURI-3M was used to estimate the rise in the effective tax burden for a landlord if they added an extra rental dwelling to their holdings. The modelling shows that the effective tax burden increases as the number of rental dwellings held by a landlord increases, and this increase can be a steep one. To illustrate, for a typical single property landlord in Sydney the effective tax burden increases by nine percentage points from 50% to 59% when they invest in one additional rental dwelling. This creates a financial disincentive for landlords to increase the supply of rental dwellings.

CAVEATS

The AHURI-3M simulations reported here are based on data on landlords who held 347 new dwellings as estimated from the detailed financial records in the 1997 ABS Rental Investors Survey. All modelling was conducted with 1996-97 prices.

More recently the private rental market in Australia has attracted a surge of new investment. Contemporary data on the sources of this new investment and to which parts of the market it is being targeted are required to ascertain whether the parameters of the modelling conducted on the 1997 data still hold. As yet such data are unavailable.

POLICY IMPLICATIONS

The government policies that affect housing outcomes can be, as illustrated here, beyond the direct portfolio concerns of housing policy makers. In this instance, the impact of tax expenditures and taxes, the responsibilities of Commonwealth, State and Territory Treasuries, are demonstrated to have a significant effect on the effective tax burdens and economic returns to landlords in the private rental market.

Existing Australian Government tax expenditures, such as the BWO allowance, are demonstrated to be less effective than a US-style LIHTC in stimulating the supply of dwellings at the low-rent end of the private rental market. State and Territory taxes, such as Land Tax and Stamp Duty, deter the emergence of multiple property landlords by increasing the effective tax burden on such landlords.

Addressing these tax measures to improve the supply of dwellings at the low-rent end of the private rental market could lead to lower rents. For some private tenants aiming to enter home ownership, this could improve their savings capacity. An increase in the supply of dwellings at the low-rent of the private rental market could also help to alleviate demand pressures upon social housing waiting lists, assisting other private tenants with severe housing affordability difficulties, who are seeking to enter public and community housing.

FURTHER INFORMATION

For more information about this research project, the following paper is available:

Final Report:
www.ahuri.edu.au/attachments/80088_final_microsimulation.pdf

See also the following Research and Policy Bulletins:

Bulletin 28, A model of the Australian housing market, November 2003.

Bulletin 30, Predicting the outcomes of home purchase assistance schemes, November 2003.

Or contact the AHURI National Office on +61 3 9660 2300.

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