

Fundamental tax reform and its impacts on alternative providers of rental housing

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Boarding house rents and caravan park fees have been a controversial topic in debates about the new tax system and its impacts on accommodation costs. This project models the impact of the new tax system on these forms of private rental accommodation, using data from sales of boarding houses and caravan parks before and after the introduction of the new system. It demonstrates that, in calculating the impact of the system, proprietors' financing costs and changes to the system of capital gains tax have been neglected – and these can have a substantial negative impact. This impact is not lessened by recent measures to simplify the Goods and Services Tax (GST) procedures for caravan park owners.

KEY POINTS

- The impacts of the new tax system on proprietors of boarding houses and caravan parks are important because these forms of lodging are significant sources of low income private rental housing. Other recent research has shown that low income private rental housing is becoming scarcer and that affordability of housing is a major issue for low income earners.
- During the introduction and transition to the new tax system, the Australian Government estimated the anticipated increase in rents to range between 2.3% and 3.6%.
- This research found however that average increases in rents and site fees required by proprietors, if they were to cover all after-tax economic costs of the new system, would be between 5% and 6%, if favourable assumptions about the economic environment were made. The impacts would be greater if those favourable assumptions were relaxed.
- There are likely to be significant differences in impacts across regions and cities. Proprietors in areas with sluggish property prices (eg Adelaide and Hobart) would be particularly adversely hit by the new tax system. Proprietors in areas with rapid property price appreciation rates (eg Sydney) might even gain, due to reductions in capital gains tax.
- Many boarding houses and caravan parks proprietors could find it difficult to pass on rent and site fee increases to long-term residents, making it more economic for them to exit the business.
- In the longer term, there is likely to be further contraction in the number of proprietors offering predominantly long term accommodation in boarding houses or caravan parks as a result of the impact of the tax changes.

CONTEXT

In July 2000, the Australian Government introduced a new tax system that aims to reduce the tax burden on ordinary incomes by shifting some of the tax burden onto consumption. The most prominent feature of the new tax system is the goods and services tax (GST). The introduction of a GST is to some extent balanced by the abolition of Wholesale Sales Tax (WST) and some State and Territory taxes.

Also helping to offset the GST are cuts to marginal income tax rates and changes to income tax brackets. However, there are other significant reforms to the tax regime that are relevant in this context. Changes to the capital gains tax (CGT) provisions introduced in September 1999, are also a key feature of the new tax system. Under the old system, capital gains were measured by indexing the cost of an asset to the inflation rate and taxing real gains at the investor's marginal tax rate. Under the new system, CGT liabilities are calculated by adding half of all capital gains to other sources of income, and treating this amount as the portion of income that is taxed at the investor's marginal tax rate.

In aggregate, these changes represent a fundamental reform of the tax system. The potential impacts on the housing sector are an important subject for research. Under the GST, private rental housing is input taxed, and this includes boarding houses and caravan park sites that offer predominantly long-term accommodation and which elect to be input taxed. 'Input taxed' means that proprietors of boarding houses and caravan parks are not required to charge tenants or residents a 10% GST on top of their rent. However, the proprietors are then not able to claim a credit for the GST they pay on inputs purchased in the course of carrying out their business. These inputs include, for example, repairs carried out to properties or sites, which are deemed a taxable supply. Taxable supplies include the GST in the price paid by the purchaser (in this case the boarding house or caravan park proprietors). Under the input tax system, the proprietors' costs will rise if the extra costs of GST on inputs to their business outweigh savings due to abolition of WST.

Referring to caravan parks and boarding houses, the Australian Competition and Consumer Commission (ACCC) claimed that, after taking into account the effects of abolishing WST, "long-term accommodation charges may increase slightly, as providers pass their increased costs on to residents by adjustments to accommodation charges". In an illustrative example offered by the ACCC for long-term residents of caravan parks, site fees increase by 2.1%. The Australian Government anticipated increases in private rents generally of between 2.3% and 3.6%.

This project models the impact of the new tax system on these forms of private rental accommodation, using data from sales of boarding houses and caravan parks before

and after the introduction of the new tax system.

Previous modelling has focused on providers' operating costs – implicitly assuming that rents are determined by operating costs. However, long-term survival of private proprietors is conditional on rents covering both operating costs and capital costs.

Therefore this project models the impact of the new tax system on both these cost components.

Models were constructed to find the "reservation rent" – that is the gross rental income that is just sufficient to cover all after-tax economic costs. These economic cost measures include operating and transaction costs (the costs of buying and selling), as well as capital costs and capital gains tax liabilities, all defined on an after-tax basis. We compare these rents under the old and new tax systems. The comparison is conducted under two scenarios.

- **Baseline** scenario assumes the continuation of interest rates and property price inflation rates at their pre-reform values.
- **Favourable** scenario assumes that the new tax system raises the long run growth potential of the economy so that interest rates can fall below pre-reform levels. It also assumes a higher property price appreciation rate.

The analyses also consider the impact of various marginal tax rates for proprietors and the variable lengths of time a proprietor is expected to own his or her business before disposing of the property.

FINDINGS

- Even under the favourable scenario, average increases in the rent levels proprietors require to cover costs are between 5% and 6%.
- The scale of the impacts depends on the proprietor's income (and thus marginal tax rate) and the holding period (the length of time the proprietor keeps the property before exiting the business) and there is significant variation when these factors are modelled at a range of different levels. It is therefore impossible to offer a precise single measure of impacts.
- For boarding house and caravan park proprietors, the greater the reduction in marginal tax rate under the new system, the more their after-tax cost of capital rises. This is because the after-tax return on alternative investment options increases when there is a reduction in marginal rates of tax.
- Reservation rent increases are lower the longer the holding period, because capital gains taxes are paid on asset realisation. If a proprietor delays realisation, payment of capital gains tax liabilities is postponed and their present value declines.

The table below summarises key findings.

MEAN PERCENTAGE INCREASE IN ANNUAL RESERVATION RENTS ¹		
	Base Scenario ²	Favourable Scenario ³
Boarding House – Existing	14.83	5.39
Boarding House – New	19.26	9.26
Caravan Park	14.84	5.59

(1) This mean is calculated across all income tax brackets where the Marginal Tax Rate is positive, and for a range of holding periods from 10 to 30 years.

(2) Base scenario values entail an interest rate of 7.8 percent, an inflation rate of 2.5 percent and a rate of capital appreciation of 3.5 percent.

(3) Favourable scenario values are an interest rate of 7.8 percent for the Old Tax System and 7.3 percent for the New Tax System, an inflation rate of 2.5 percent and a rate of capital appreciation of 4.0 percent. The reduced interest rate is not applied to the OTS estimates, as it is assumed that the reduction in interest rate is a direct result of the implementation of the New Tax System

- The impacts of the system also vary across regions and cities. This is due to the CGT changes. These changes, in essence, increase the CGT liabilities of proprietors owning properties whose rate of price appreciation is less than double the rate of inflation. In areas with sluggish property prices the new capital gains tax system will hit proprietors with higher tax bills as compared to the old tax system. On the other hand, proprietors in areas with rapid property price appreciation rates might even gain under the new CGT system.
- This study suggests that the CGT changes rival the GST reform package in terms of their impact on after-tax economic costs. For established boarding houses and caravan parks, for example, the CGT reforms account for 45% of the total increase in reservation rents.

Finally, the project also examined the extent to which proprietors of boarding houses and caravan parks can pass on increases in after-tax economic costs to residents. Proprietors are to some extent competing with other providers of long-term rental accommodation, and in particular private rental landlords. In the private rental housing market, rents are typically between 6% and 7% of capital values. If reservation rents were significantly higher as a percentage of capital values, proprietors would find it hard to pass on increases in after-tax economic costs.

- The ability to hold reservation rents to between 6-7% of capital value depends on the real rate of property price appreciation. The higher the rate of property price appreciation relative to the rate of inflation, the lower are the capital gains tax liabilities under the new tax system.

- Under the old tax system, average after-tax economic costs for boarding houses could be covered at market rental rates if real property prices appreciated by 1.5% per year. However, under the new tax system except for newly constructed boarding houses, real property price appreciation would have to be greater than 1.5%.
- In reality, there is significant variation between capital cities in real property price appreciation, with some capital cities experiencing rises of far greater than 1.5% per year. The annual real rate of appreciation (June 1986 – June 2000) for the eight capital cities was:

Darwin	3.7
Sydney	2.9
Brisbane	2.6
Perth	1.7
Melbourne	1.4
Canberra	0.9
Hobart	0.4
Adelaide	-0.7

- At these real rates of appreciation, proprietors in Darwin, Sydney and Brisbane would benefit from reduced capital gains liabilities, while proprietors in other states would have increased CGT liabilities.
- Our modelling estimates suggest that only proprietors from the highest income tax bracket could remain competitive and cover after-tax economic costs at the market rental rates of between 6 and 7%.

POLICY IMPLICATIONS

- If proprietors cannot cover their after-tax economic costs and remain competitive with other forms of accommodation, it is likely that they will move out of the business.
- This project offers firm evidence that, for most providers, this form of accommodation is uneconomic given current tax arrangements. The analysis suggests that proprietors from lower tax brackets will exit the market. Indeed it is possible that if a favourable scenario does not eventuate in the longer term, even proprietors from the highest tax bracket will struggle to pass on cost increases arising as a result of the new tax system.
- Further reduction in the supply of long-term boarding house and caravan park accommodation appears highly likely. This would continue a trend that has been apparent for some considerable time with respect to boarding houses.
- The supply of low-income rental housing has been identified as a key issue in a number of studies. The Australian Housing Policy Project, conducted by AHURI in late 2000-early 2001 found agreement among most key stakeholders that providing affordable and appropriate housing for low-income people was a major challenge facing Australia. Other studies have shown that affordable private rental housing for low income people is becoming scarcer in Australia.
- Another study by Dr Gavin Wood has found that tax factors are one reason for the dwindling supply of low income private rental accommodation.
- This suggests a policy response aimed at helping retain the stock of low-income housing.
- One such measure implemented in the USA in 1987 is a low-income housing tax credit. The tax

credit entitles the landlord to a one-dollar reduction in tax liability for each dollar of tax credit. For example, suppose a landlord invests in a \$100,000 building. He or she can claim a \$4000 tax credit each year for 10 years that will reduce their tax bill by \$4000 each year, provided his/her taxable income is high enough to make use of the credit. The tax credit can be targeted if it is conditional on the building being occupied by low-income tenants who receive rental subsidies, or being charged a rent below some threshold level.

- In a study funded by the Australia Research Council, Dr Gavin Wood conducted microsimulations of this scheme for private rental investors in Australia, assuming that eligibility is conditional on charging weekly rents of less than \$100 (at 1996 prices). The tax credit successfully reduces the after-tax economic costs of those landlords of housing that are likely to be receiving poor returns on their investment. Furthermore, the restriction on weekly rent targets assistance to low-income rental housing.

FURTHER INFORMATION

For more information about this project, the following documents are available:

- Report on Findings, April 2000
- Consultation Reports
- Papers presented at workshops
- Facts Sheets

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