Australian Institute for Progress

Housing investment – the last five years

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The Australian Institute for Progress exists to advance the discussion, development and implementation of public policy for Australia's future, from its base in Brisbane. The future does not look after itself.

Contents

1. Methodology

This study is based on a cash flow model which as much as possible uses Australian Bureau of Statistics figures to model housing returns for first home owners (owner occupiers) and investors, for the period 2011 to 2016.

The purpose was to assess how a hypothetical investor who purchased an average house at the beginning of the period, and sold it at the end, fared under current government tax policies, and how they would have fared if the ALP housing policy, as applied to existing, rather than new, properties, had been in place over that period.

It also allowed for comparison between investors and owner occupiers, to determine how much of a crowding effect there might be of first home buyers by investors.

Finally it allowed for comparison between the returns available from superannuation and housing over the same period. This is an important factor in the debate over whether first home buyers should be able to use their superannuation account to supplement their savings for a deposit on a first home.

The model was run on three scenarios at the three top marginal tax rates. One model assumed no borrowing, to provide an idea of the intrinsic return on the asset, after tax, but before financial engineering. The second model assumed a 80 per cent borrowing, and the third 100 per cent borrowing.

The assumptions underlying the model have been listed at the end of this study.

2. Summary and findings

Current Australian taxation policy heavily favours owner-occupiers over investors, although that is not the common view. Our study of the housing market over the last 5 years shows it's not negative gearing that is freezing first home buyers out of the market.

Rather, the evidence points towards the relative ease with which investors, who generally own their own home, can use that equity as a deposit, compared to the first home buyer who has to save a deposit from scratch, being the factor that makes affordability an issue in this country.

We have suggested in earlier research[1] this could be solved by allowing first home buyers access to their superannuation savings to supplement their other savings for the deposit on a first home.

Critics, like Opposition Leader Bill Shorten, say "…rather than raid superannuation and starve people of income in retirement, you need to reform negative gearing in capital gains tax deduction".[2]

What this study shows however, is that superannuation has been a relatively poor investment in the recent past, and investing their savings in their own home is the best investment an average Australian could have made, by a factor of almost 2.95 times!

It also shows that Labor's changes to negative gearing and capital gains tax, would not remove investors from the market.

Labor's proposed policy heavily penalises investors but it is likely they would still be active in the housing market because based on the last 5 years, a geared investment in housing would still beat an investment in superannuation by up to 71% after tax!

For owner occupiers, under Labor or Coalition policies, the after-tax return on housing was up to 26.83%, while for investors the maximum after-tax return was 15.86% under the Coalition and 11.67% under Labor.

The absolute best superannuation return over the same period was 10.8% (only available to employees of Goldman Sachs and JB Were) down to -0.3%. The median was 6.8%.

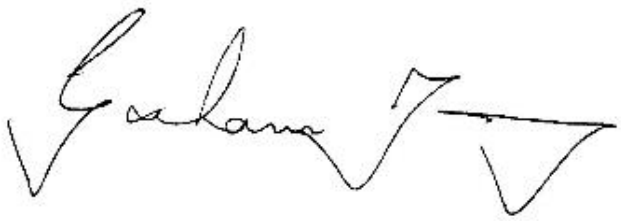
The major findings of this study are:

- Existing tax policy significantly advantages owner occupiers over investors with the after-tax return being as much as 74% better for the owner-occupier than the investor.
- The startlingly better rate of return received by owner occupiers over investors indicates owner occupiers are not being outbid by investors because of the tax arrangements. This leads to the conclusion it is the relative ease with which parties can secure a deposit which makes the difference. **Increasing access to savings for a deposit is the only measure likely to increase housing affordability for first home buyers without prejudicing the savings of other Australians by decreasing the price of housing.** (Supply side measures, as well as interest rate movements, will also have an impact, but over time, and not without side-effects that might be said to be undesirable.

[1] "Housing Affordability – the Deposit Gap" AIP, June 29, 2016. https://aip.asn.au/wp-content/uploads/2016/07/Deposit_Gap_16_06_30.pdf

[2] http://www.couriermail.com.au/news/queensland/bill-shorten-calls-for-negative-gearing-reform-not-super-raiding/news-story/7098e66d65a432c7ffb580f58dac0d35

- A geared investment in housing over the period 2011 to 2016 returned up to 2.95 times more than a comparable investment in superannuation would have over the same period. This made borrowing as much as possible a winning wealth maximisation strategy, irrespective of the tax arrangements supporting investment.
- In the last 5 years the net savings of Australians would have been adversely affected by directing money into superannuation in preference to housing, thus adversely affecting them in their retirement.
- The ALP policy of quarantining losses against income from the property would increase the tax advantage that owner-occupiers have, but investor returns would still be sufficient to encourage discretionary investment in housing by non-owner-occupiers because the returns for most would still have been better than superannuation.
- The major increase in tax revenue under the ALP plan occurs because there is a 50% increase in the tax paid on capital gains, while the increase in revenue from quarantining deductions is largely due to timing. This means the policy will encourage investors to hold on to properties to avoid the capital gains tax, all other things being equal. This is likely to lead to a less liquid, and more expensive, real estate market.
- The significant increase in the capital gains tax should also have ramifications for investment in other industries, and act as a disincentive to investment.
- Returns increase with gearing. This means that gearing by investors is encouraged in general because it results in higher returns. As increased taxation rates reduce the returns for investors, they encourage them to gear up to compensate.
- The better after-tax returns that obtain for lower income earners indicates that not only are owner-occupiers advantaged by the system, but so are lower income earners, which explains the fact that most negative gearers appear to have a modest income. If you are the stereo-typical medical specialist on a million dollars a year, there are undoubtedly higher returning investments you could make.



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May 3, 2017

3. Effective after-tax investment returns: owner-occupiers and investors using average figures 2011 to 2015

We ran three scenarios. One was for a housing purchase with no deposit, one with a 20 per cent deposit and one with no deposit and 100 per cent borrowing. All scenarios impute rental on the average house to the owner-occupier, so that the actual investment is the difference between rent and mortgage payments on a comparable dwelling.

Figure 1 shows the rates of return that would have been achieved on the purchase of an average value residence of $490,800 in 2011, and then sold for the average dwelling price in 2016 of $631,400 for owner-occupiers and investors allowing for tax at their marginal rate, and imputed rent.

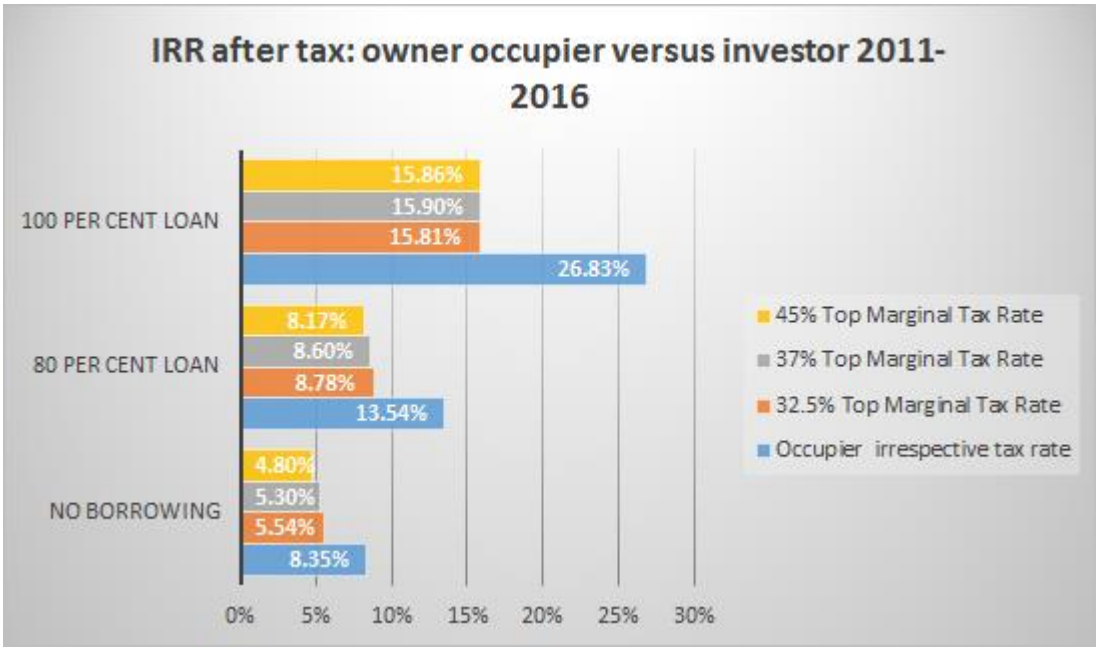

Figure 1: IRR after tax: owner occupier versus investor 2011-2016

What stands out on this graph is that the owner occupier's return is far superior to that of the investor in all scenarios.

This is due to a combination of factors.

Because shelter is a necessity, the owner-occupier would be paying rent if they were not paying a mortgage. After a number of years of inflation in rents the rent becomes less than the mortgage payments in most scenarios we modelled. At this stage the owner-occupier receives an effective tax benefit because what they save in rent is net of tax. In some countries, such as the Netherlands and Switzerland, rent is in fact taxed (and there is a corresponding tax deduction for interest payments).

So the owner occupier in Australia is in fact enjoying a tax advantage versus someone who rents, and someone who invests in a second or third dwelling. The renter has to pay from their after-tax income, and the investor has to pay tax on any surplus.

Secondly, owner occupiers are exempt from capital gains tax. As the graph below shows, were the investor to be exempt from capital gains as well the return would be significantly higher.

It turns out that the ATO does well out of gearing as it inflates the size of the property that can be bought, and therefore the capital gains tax that will eventually be paid. The figure below looks at the percentage increase in returns were there no tax on capital gains for investors.

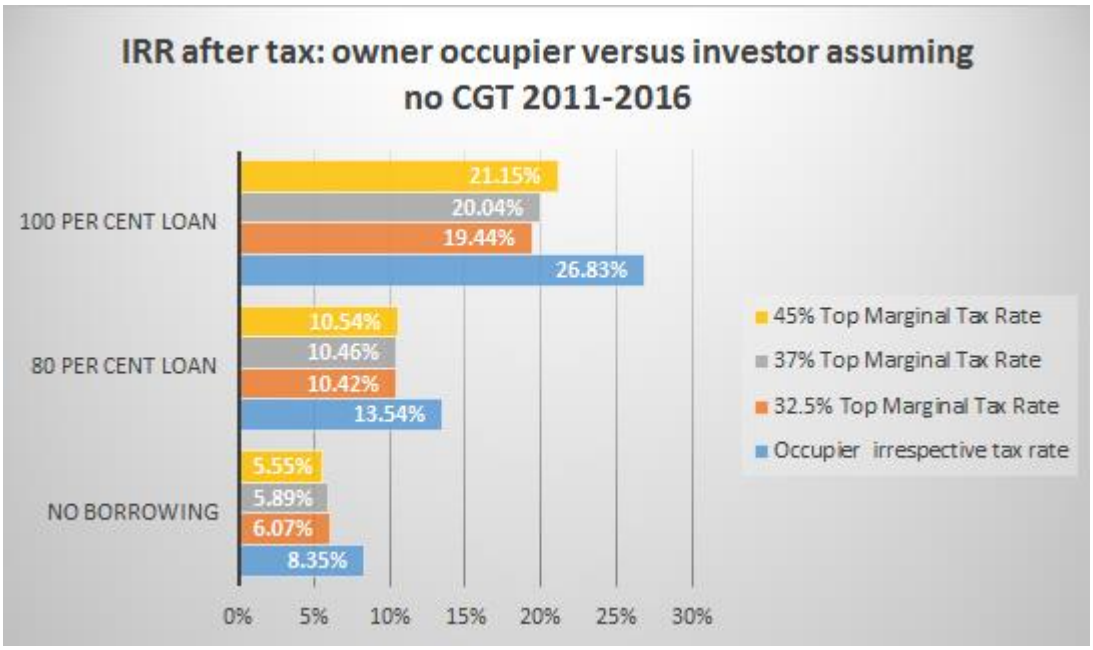

Figure 2: IRR after tax: owner occupier versus investor assuming no CGT 2011-2016

The next figure shows the percentage point improvement in returns if there were no tax on capital gains. It demonstrates how much more significant tax on capital gains is in a more highly leveraged property.

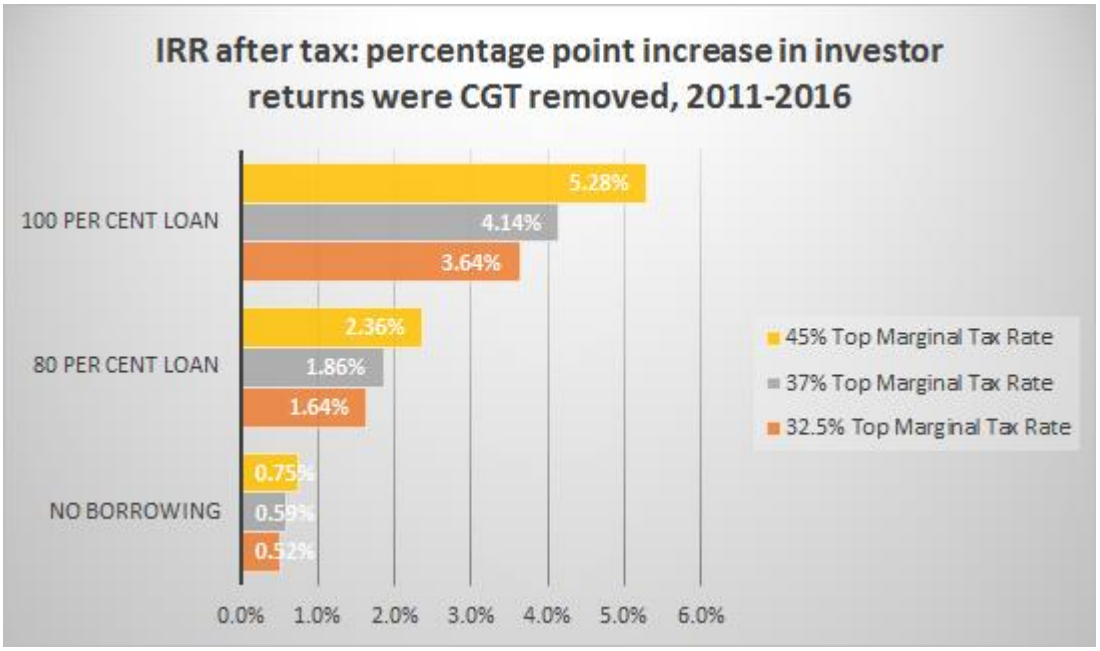

Figure 3: IRR after tax: percentage point increase in investor returns were CGT removed. 2011-2016

Investors are further handicapped by the fact that in most states first home buyers receive a discount on stamp duty. We have not modelled land tax, but this is also a cost paid by investors, but not generally by owner-occupiers.

4. Effective after-tax investment returns (assuming the ALP policy on existing housing}: owner-occupiers and investors using average figures 2011 to 2015

The next figures look at the investment returns for investors, had the ALP's policy of quarantining expenses against income from the property, and decreasing the GST discount to 25%, been operating over the period.

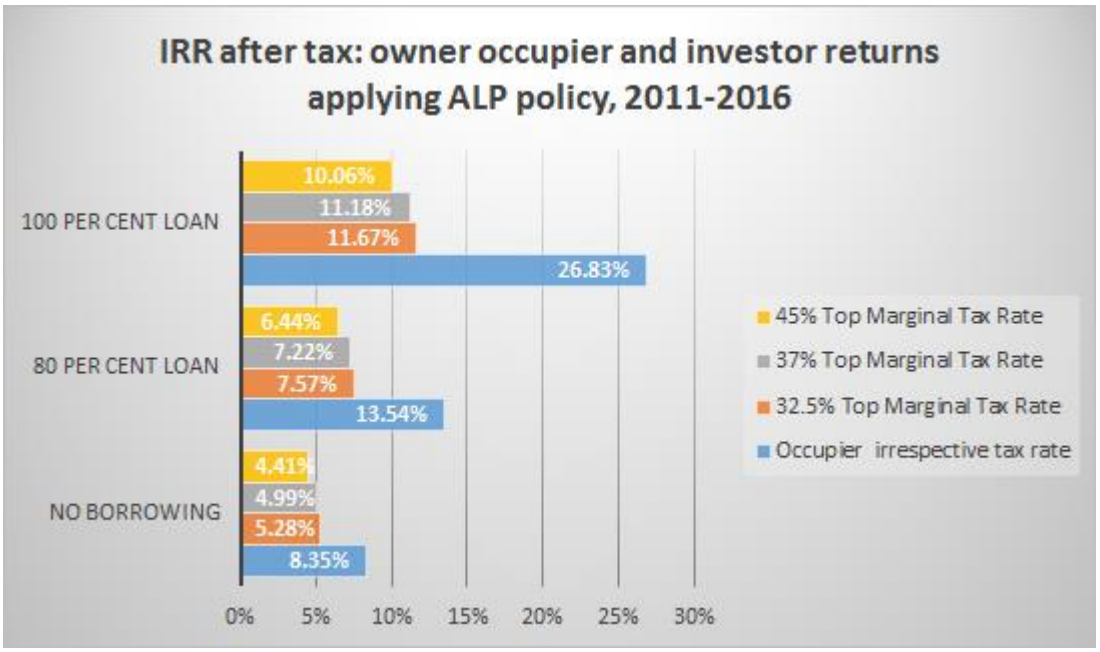

Figure 4: IRR after tax: owner occupier and investor returns applying ALP policy, 2011-2016

This further entrenches the after tax advantage in terms of returns received by owner occupiers as represented by the increase in the margin between their returns and those of investors.

The table below looks at the percentage point difference between the current situation, and the hypothetical situation under Labor over the same historical period to see how much worse off the investor would be.

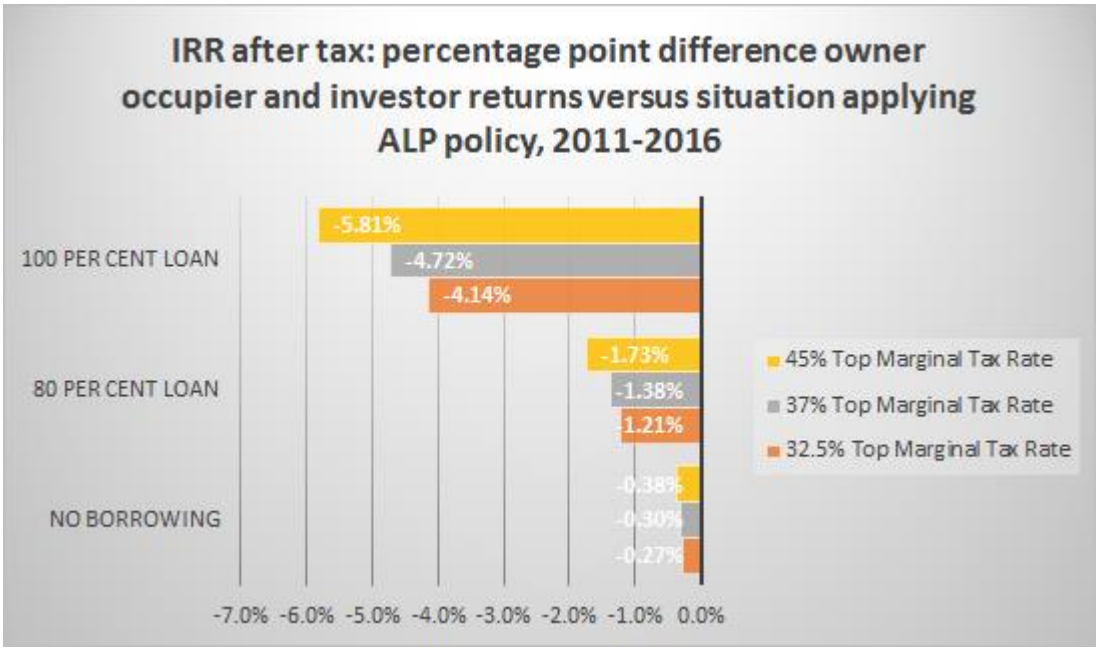

Figure 5: IRR after tax: percentage point difference owner occupier and investor returns versus current situation and applying ALP policy, 2011-2016

Labor's policy dramatically favours the owner occupier in terms of tax, particularly with higher gearing. As many investors are using equity in their own home as the deposit, this is likely to be the most relevant scenario.

It also dramatically increases the percentage of investor return that is snared for the tax office.

5. Net increase in taxation under ALP policy, in discounted dollars, over 2011-2016

The figure below shows the increase that would occur in tax on the investor under the Labor proposal.

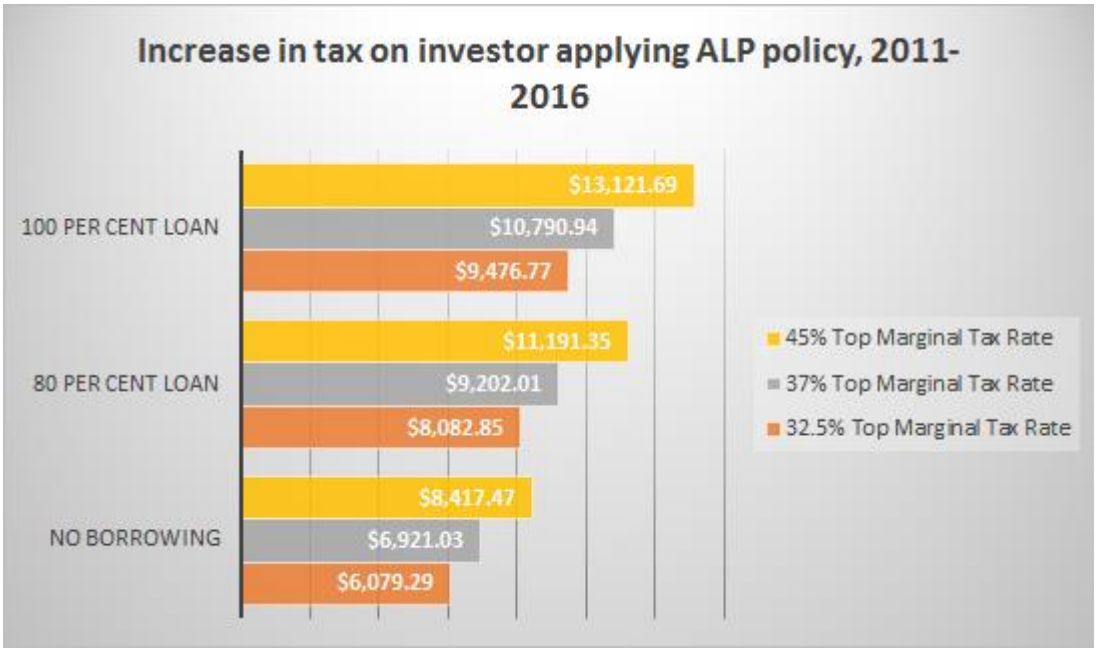

Figure 6: Net increase in taxation under ALP policy, in discounted dollars, over 2011-2016

As the period is 5 years, this is an increase per year in discounted terms ranging between $1,215.86 to $2,624.34 per annum on the average house, depending on the investor's tax bracket.

However, a substantial part of this is due to the increase in tax paid on capital gains, which Labor increases by 50% over the current arrangement when they change the discount from 50% to 25%. This makes Australia the second most expensive country for taxing capital gains in the OECD, second only to Denmark.[3]

The increase due to the negative gearing changes is negligible, as Figure 7 shows, meaning that negative gearing has been unjustly framed as distorting the market for real estate.

[3] "ALP would make Australia the second most expensive OECD country for Capital Gains Tax" AIP, March, 2016 https://aip.asn.au/2016/03/alp-would-make-australia-the-second-most-expensive-oecd-country-for-capital-gains-tax/

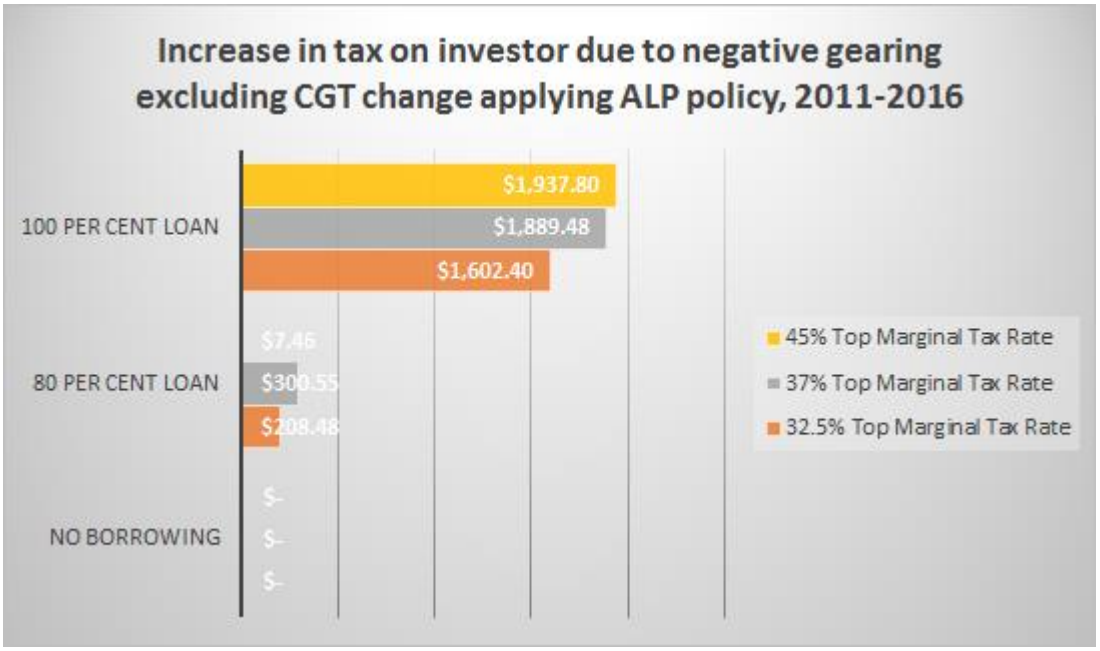

Figure 7: Increase in tax on investor due to negative gearing excluding CGT change applying ALP policy, 2011-2016

Given the significant increase in tax paid occurs because of the increase in capital gains tax, and this only occurs when the property is sold, the Labor policy is likely to lead to fewer transactions in the property market as the tax can be deferred by not selling the property. This could theoretically increase prices, rather than the reverse.

Additionally, it means that the ability of investors who have a long time horizon to compete with owner-occupiers is only marginally affected.

As the ALP's policy applies to all capital gains it is likely to affect savings and investment across a range of fields, not just housing.

6. After tax Investment in housing versus superannuation returns 2011 to 2016

The following tables use the median return from superannuation funds monitored by APRA as the benchmark. The range runs from 10.8%, a return earned by the Goldman Sachs and JB Were Employees fund, down to -3.0% for the Super Safeguard Fund.

The median return is 6.8%.

The figure below contrasts the modelled returns received on the average property over the 2011-2016 period with the median return. The real estate investment is clearly better, except in the case where a house is purchased outright.

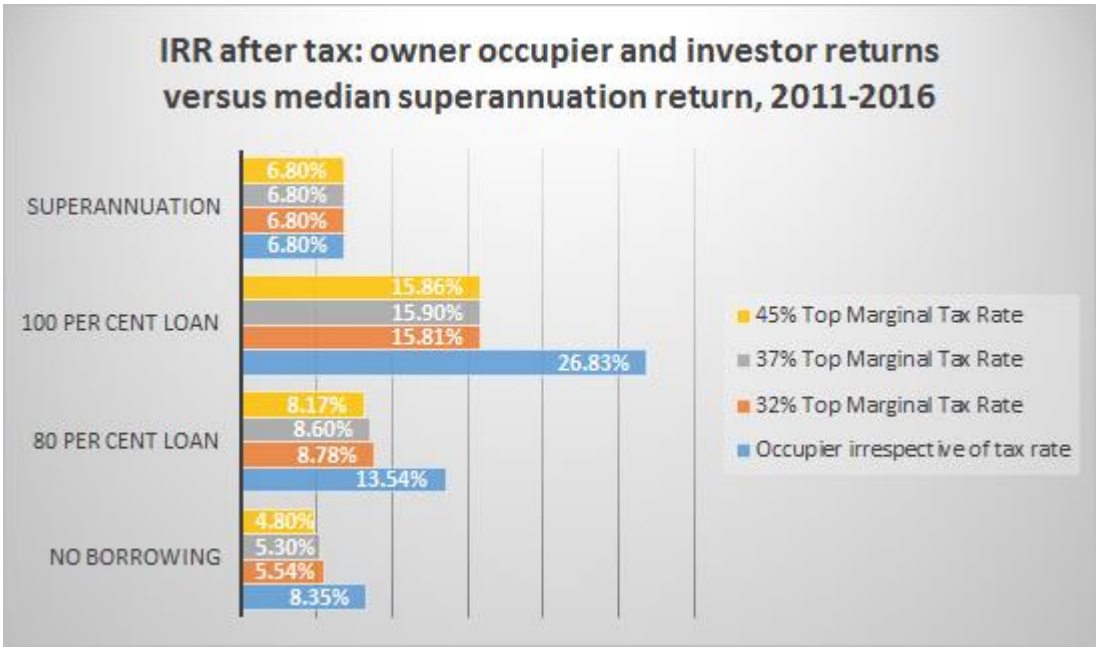

Figure 8: IRR after tax: owner occupier and investor returns versus median superannuation return, 2011-2016

The key to the return in housing is obviously in the gearing. And residential housing is one asset class that Australians are prepared to gear. This is undoubtedly due to a combination of factors, including that, for an owner-occupier, the house provides shelter which would otherwise have to be purchased from someone else. As long as mortgage payments are not too different from rent, the owner is not running a lot of risk in their personal circumstances, and their effective investment in the value of the house as an investment is quite low.

For the investor, houses are reasonably homogenous investments, and new tenants are relatively easy to come by. While the price might fluctuate from time to time, as long as payments are made to the bank, there is unlikely to be a problem. If mortgage repayments are not too different from rent, then again the risk is relatively low.

Shares are generally not borrowed against, so even if the value of the stock market rises as fast as that of the housing market, financial engineering is likely to produce better returns for a highly geared home owner. This reduces as the gearing reduces.

It should be noted in this context that while borrowing against shares is generally regarded as risky, public companies almost invariably carry a level of debt themselves, so an investment in shares is effectively geared.

7. After tax Investment in housing versus superannuation returns applying ALP formula 2011 to 2016

This final figure shows that even after penalising investors more heavily than at present, housing investment would still have paid off under the ALP scenario in all the geared scenarios, apart from that of a borrower on the top marginal tax rate who only borrows 80% of the purchase price.

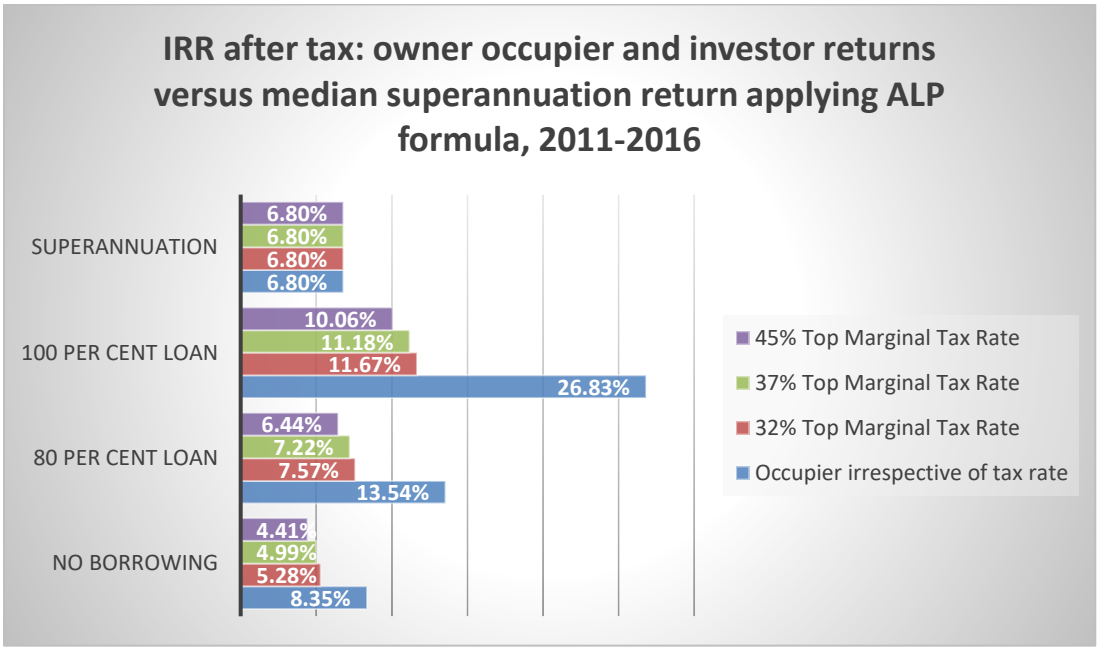

Figure 9: IRR after tax: owner occupier and investor returns versus median superannuation return applying ALP formula, 2011-2016

8. Model assumptions

a. Period of spreadsheet is from September 2011 to September 2016 to approximate the five year period between censuses. Sale takes place at the beginning of September quarter.
b. Average house price calculated by taking average house prices found in Table 6. ABS 6416.0 Residential Property Price Indexes: Eight Capital Cities
c. Lending rate was approximated by taking the RBA cash rate for the month when each quarter fell, and adding a 3 percentage point margin. http://www.rba.gov.au/statistics/cash-rate/
d. Rent was calculated by taking the average rent in 2011 from ABS table 14100DS0007_2017-03 and then indexing it by the CPI index for rentals from ABS64015
e. Rates were calculated by taking the median local government rate from the 2008 as documented by the Senate Inquiry "A good house is hard to find: Housing affordability in Australia" and applying the index figures to it for local government rates from ABS64015
f. An Interest only loan calculation has been made, not principal and interest. While this will not reflect all borrowers, there is actually little difference in the first 5 years of a 25 year loan when very little principal is actually repaid. And what is most important in this model is the comparison between owner-occupiers and investors, and to make this accurate, factors like type of loan should be identical.
g. We parameterised an allowance for acquisitions of 2% for first home owners, and 6% for investors. This represents stamp duty and legal costs, and taking into account the various concessions and rates levied around Australia which vary between states and generally exempt first home buyers for house purchases under $500,000.
h. Land Tax is generally not levied on the average owner-occupied house, but is levied on investment properties. It varies between jurisdictions and is dependent on the number of houses owned, the value of the houses, and which state they are located in. We couldn't find a record anywhere of anyone having estimated the average land tax amount. According to the state government websites NSW would levy nothing on our representative property, SA $56, WA $62.56, Qld $429.4, Vic $1099.77 and Tas $1712.00. So we've ignored land tax, but should be noted it will reduce the investor return versus the owner-occupier.
i. No allowance was made for maintenance. Again, this is too variable to model.
j. Tax rates were held constant. It is possible that as a result of inflation, promotion, or the eventual capital gains, the property owner might go up into a higher tax bracket. We have not attempted to model this, but in any event it will only effect the investor, and will make their investment return after tax even lower versus the owner occupier.
k. Gross capital gains was calculated by the formula: Average House September 2016-Average House September 2011-Acquisition Costs-Sales costs.
l. Capital gains tax now was calculated by the formula: Gross Capital Gainsx(1-CGT Discount)xTop Marginal Tax Rate.
m. Capital gains tax under Labor was calculated by the formula: (Gross Capital Gains-Carried Forward Losses)x(1-CGT Discount)xTop Marginal Tax Rate
n. For the Home Owner Current model, quarterly cash flow for the owner occupier was calculated by the formula: Imputed Rent-Quarterly Loan Payment – Rates. Capital return was calculated by the formula: Average House Value September 2016-Debt-Sale Costs.
o. For the home owner current model, quarterly cash flow for the investor was calculated by the formula: Rent-Quarterly Loan Payment-Rates. It was then adjusted to reflect tax by calculating tax on the basis of Quarterly Cash Flow x Top Marginal Rate. Effective aftertax cashflow was calculated by the formula "Cashflow-Prima Facie Tax". Capital return was calculated by the formula: Average House Value September 2016-Debt-Sales Costs-Capital Gains Tax.
p. For the home owner Labor model, owner occupier formulae remained the same.

q. For the home owner Labor investor model, most formulae remained the same apart from those involving tax. Tax was calculated in the same way, but carried forward for rebate against eventual positive cash flow or capital gains. Profit on sale after tax was calculated by the formula: Average House Value September 2016-Debt-Sales Costs-Capital Gains Tax.
r. Super return was calculated by taking the median of super returns as reported in APRA AFLSS 201606