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Sent: 27 September 2003 21:04
To: housing@pc.gov.au
Subject: Supplementary Submission to the Inquiry on First Home Ownership

This submission comments on the questions raised on pages 11 and 12 of the September 2003 Issues Paper.

RELATIVE COSTS OF RENTING VERSUS OWNING

* BACKGROUND

Investors are constantly faced with the need to choose between alternatives - for example, whether to buy now or to buy later; whether to acquire shares or to acquire property; whether to borrow or use only their own funds; whether to make an offer for property X or for property Y; and so on.

Even if a home is regarded as an investment the question of choice still remains: is it wise to put any available money into an owner-occupied house or would it be better to invest this sum in some other way and live in premises owned by someone else?

There is no clear-cut answer to this dilemma, in part because every person has different tastes, different objectives and different budgetary requirements. Furthermore, single persons might have a totally different perspective on this subject than families.

Thus the relative advantages of buying and renting a house which are discussed below will carry different weights according to the individual circumstances.

Furthermore, in purely financial terms, comparisons may need to be made between the investment returns on any available funds, the interest rates on any borrowed sums and the rent levels applying to the type of premises being considered - and these can all vary from time to time and from place to place.

However, non-financial considerations are naturally also very relevant in the case of a home - a factor which does not normally apply in the case of other types of investment. To that extent, buying a house can also be viewed as just acquiring an item of discretionary expenditure, although admittedly a fairly large one.

In the discussion which follows the word "house" includes both a stand-alone house and an apartment.

* ADVANTAGES OF BUYING A HOUSE

Many people will judge a house mainly in terms of its lifestyle attributes rather than its merits as a pure investment. However, both aspects are clearly relevant and are accordingly considered below.

A house which is actually owned by the persons who live in it, rather than by a landlord who sees himself primarily as an investor-owner, can readily be tailored to better meet the needs and wishes of its occupants.

In addition, all money spent by owner-occupiers on enhancements benefits those persons permanently instead of providing windfall gains to the owner of the premises at the end of the lease.

Apart from that, physical changes to their house can readily be made by owner-occupiers in order to accommodate unusual tastes. For understandable commercial reasons landlords would probably refuse permission for alterations that could adversely affect their subsequent resale or reletting opportunities.

Ownership of a home also gives security of tenure - occupiers cannot be thrown out merely because a landlord wants to use the premises in some other way or because a landlord has sold out to a successor who wants vacant possession as soon as the existing lease permits this.

Another attraction is the exemption for a principal residence from capital gains tax. The fact that the imputed rent is not taxed in this country is also very relevant.

For persons or couples eligible for grants under the Federal Government's First Home Owners' Scheme - a scheme which might not always be there - buying rather than renting presents another plus.

For some persons planning their retirement the favourable treatment of a home under the means test would also be of value - quite apart from the enhanced standard of living which the ownership of a home which is fully paid for can give to all persons in retirement.

A house can give its owners protection from inflation - although, of course, other equity assets can do this do as well and the hedge is not perfect. If owners have large mortgages then they can even benefit from inflation. But persons who are leasing other people's premises inevitably face increases in their rent payments each year or so, which can be painful during periods of high inflation or market shortages.

Apart from that, payments in respect of a house can be regarded as an unofficial form of superannuation contributions, while rent paid to a landlord is to that extent wasted.

Some people might see another advantage in owning rather than renting - they can deliberately buy a cheap house in poor condition and accept the inconvenience of this while they make physical improvements to it. This can, for example, be very relevant if the purchaser is a handyman (although painting can be done by almost anybody). This can provide convenient part time work, possibly for both partners of a marriage, in a form which in addition legally avoids income tax, as the improvements can often be achieved for the cost of the materials involved, with the labour being unpaid.

Buying offers a greater choice of housing stock - in some localities there may be few, if any, houses for rent.

Some people like the forced saving aspect involved in building up a deposit for a loan and then paying it off. Such people may not make committed payments without the discipline of this type of self-imposed pressure and would otherwise fritter away the money on unnecessary consumption items.

Finally, an owner-occupied home is widely regarded as an excellent security for a loan. Even where a house is still subject to an existing mortgage which was put in place for its original purchase after some years a further loan can in practice readily be arranged against the owner's equity in it.

Of course, the question of whether such deals - which can prejudice the tenure if things go wrong - are wise as distinct from merely being possible is another matter.

Even when a house is not put up as a specific security its ownership enhances the owner’s credit rating.

* ADVANTAGES OF RENTING A HOUSE

Owning a house does not make much sense for persons whose jobs necessitate relocating at frequent intervals. In contrast, renting suitable premises in such circumstances avoids the considerable costs of buying and selling real estate and of refinancing any loan on mortgage. It also avoids the hassle of putting a house on the market and looking for potential purchasers.

Furthermore, being a renter can make it easier for a person to accept a job offer or a promotion in a different locality, safe in the knowledge that the hassle and monetary risk involved in selling an existing home will not be a consideration.

Renting also avoids the direct costs of rates, land tax, repairs, maintenance, depreciation and insurance. No doubt some of these costs are built into the rent, but market forces tend to limit the extent to which this can be done.

Not buying a house frees up capital which can be invested in assets chosen purely on their investment potential. Similarly, the money which is then not needed for periodical loan repayments can also be applied to long term investments.

Naturally, such a strategy requires a certain amount of self-discipline to enable its purposes to be achieved. To illustrate: A family which might have devoted, say, 25 to 30 per cent of its income to servicing a home loan should be willing to make a similar savings commitment even when following a different investment plan.

Renting is, of course, also very suitable for persons:

* who are in need of immediate housing but who lack the necessary cash for a deposit
* who want to try out living in a particular locality before making a long term commitment to it
* who lack the time or interest in maintaining a house and garden.

* CRITERIA

The criteria for buying a house to be lived in and buying a house as an investment are rather different.

When buying a house for oneself the aim would be to acquire a property that satisfies the known needs and preferences of the specific family that is to reside there. Likely future increases in the market value of the property, while important, are usually not the main consideration.

When buying a house to be occupied by others it is much more relevant to consider two other factors. Is the type of building, its condition and its location such that:

* it will appeal to as wide a range of potential tenants and purchasers as practicable
* the prospects of capital appreciation are as high as possible?

Houses with unusual features which might delight some individuals but which would be regarded as negatives by most other people do not usually make sound investments.

Prudent investors will have regard to the available net returns after allowing for likely expenses, in comparison with those available from competing investments. Prospective owner-occupiers for the long term, in contrast, may be willing to pay a premium for something which appeals to them - even if, in strict economic terms, such a purchase would amount to overcapitalising.

Persons wanting a home are restricted to buying residential property and furthermore doing so in a particular locality. Investors, on the other hand, can buy property of any category in any locality. They also have the choice of acquiring other classes of asset instead if they think that this will give them a higher return and/or involve less risk.

* ARITHMETICAL ASPECTS

The relative figures for comparing buying and renting a house will naturally vary with the assumptions made. It is, as always, necessary to compare like with like in dollar terms - although for the lifestyle and other reasons discussed above this cannot give the complete picture.

In pure arithmetical terms the results will usually favour the option of renting a house to be used as the principal residence and using the capital thus freed up for one or more unconnected investments. The other option - actually buying a house which is to be lived in - will generally seem less attractive.

There are several reasons for this:

* the gross returns available from such investments will usually be higher than the unreasonably low yields which in practice seem to be acceptable to most residential landlords
* an investor gets income tax deductions for depreciation and loan interest, whereas an owner-occupier does not
* a residential tenant is usually not liable for outgo such as maintenance, repairs, building insurance, rates and land tax.

A numerical example follows. It assumes that in both cases a sum equal to two-thirds of the value of the asset is to be borrowed and that the growth prospects from inflation and other factors are identical in the two scenarios.

	BUYING	RENTING
	$	$
* CAPITAL		
Residence	300,000	0
Non-residential investment property	0	300,000
Loan	-200,000	-200,000
Equity	100,000	100,000
* REVENUE		
Investment income @ 8%	0	24,000
Loan interest @ 6%	-12,000	-12,000
Sub-total	-12,000	12,000

Income tax @ 31.5%	0	-3,780
Rent	0	-15,000
Outgo	-4,000	0
Net income	-16,000	-6,780

Although some of the above assumptions are arbitrary the figures help to put into perspective a view sometimes expressed, namely that paying rent to a landlord amounts to paying away "dead" money.


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