Submission to the

Productivity Commission Inquiry

into First Home Ownership

October 2003

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1. Introduction

This submission explores the factors driving recent housing price rises and the associated decline in the numbers of first homeowners. The submission then proposes a number of solutions to address the key factors impacting on the accessibility of home purchase to first time buyers.

As VCOSS's mission is to advocate the needs and interests of disadvantaged and vulnerable groups in Victoria, this submission focuses particular attention on the accessibility of home purchase to lower income Victorians.

2. Victorian housing market

In the last decade, investors' dominance of the housing market has markedly increased, with the monthly proportion of housing loans for investment climbing from 23 per cent in June 1993 ($1.028 billion) to 40 per cent in June 2003 ($6.88 billion).

Although linked, the drivers of preparedness to pay in each of the housing purchase and investor markets are unique. These factors are explored below.

2.1 Home purchase market

Preparedness to pay in the home purchase market is driven by the estimated lifetime costs of purchase vis. a vis. alternatives, such as private rental, and by income.

In the last decade in the Victorian housing market, private rental costs and property prices have increased, and interest rates have decreased. As a consequence, people's desire to purchase housing for owner occupation – and fear of being locked out of the housing market by price rises - has increased.

However, while increasing rental costs have increased the attraction of home purchase, high rental costs have also reduced the capacity of renters to save, particularly for people in lower income quintiles. In Victoria over the last 25 years (1975/76-1998/99), real private rents paid by low-income earners have increased by 5.4 per cent whereas their real household incomes have fallen by 27.4 per cent.[1] This translates into households being forced to spend a greater proportion of their household income on rent. In Victoria in 1975-76, low-income households spent on average 29.1 per cent of their income on rent but by 1998/99 spent 42.1 per cent.

Rent increases relative to income growth have been harshest for low-income earners. This is a product of both sluggish relative wage growth in lower income quintiles and the lack of supply of affordable rental housing.

Research by Wulff and Yates (2001), indicates that between 1986 and 1996, stock of low rent dwellings in Melbourne shrank 6.2 per cent[2] while the numbers of low-income private renter households expanded by 72.5 per cent.[3] As a consequence in 1996, Melbourne had a shortfall of 10,630 low rent dwellings.[4]

The lack of supply of low rent dwellings for low-income households has been exacerbated by higher income households 'trading down' to lower cost rental stock.[5]

The high rental costs-low-income nexus presents an insurmountable barrier to many households' ability to enter home ownership. Strategies to improve the accessibility of home ownership to this group necessarily must target income levels and income security and the problem of the lack of supply of affordable housing.

Although not included in the terms of reference of this inquiry, achieving housing security for households most disadvantaged in housing markets, and for whom home ownership is not a realistic option, is critical to these households' wellbeing and to the broader social good. Intervention to increase the supply of affordable rental stock is critical to achieving this aim.

Increasing the supply of affordable rental housing would also improve the bridge to home ownership provided by private rental for households whose incomes are temporarily low but will increase. Private rental has traditionally provided this function but as rents have increased, household's capacity to save has been undermined. Difficulty in saving for a deposit has been compounded by households' increasing level of HECS and credit card debt.

2.2 Housing investment

Home purchasers do not only compete with each other for housing, but must also compete with investors. The primary driver of the price that investors are prepared to pay for a house is the expected return on their invested capital relative to the return they may expect from investing in alternatives. In recent years, returns on alternatives to property have plummeted with many share market-based investments delivering negative returns. Returns on bank deposits (interest) have also remained low.

Meanwhile returns to investing in property have been high, particularly where investors have reaped capital gains, which has largely been in the higher end of the property market.

3. Housing market interventions

Currently, multiple Government policies and taxation measures impact directly on the housing market with varying impact. These are considered below.

3.1 First Home Ownership Grant

The First Home Ownership Grant (FHOG) provides a direct payment to first homeowners at the time of home purchase. Relative to investors and existing home owners, the FHOG increases the purchasing power of first homeowners by $7000 - the sum of the grant.

However, by increasing the sum households have to spend, the grant also contributes to the inflation of housing prices, and hence reduces the advantage of the grant.

3.2 Social Housing

Investment by State and Federal Governments in social housing through the Commonwealth State Housing Agreement (CSHA) provides an affordable rental option for many low-income households. Australia's early social housing programs provided a mechanism for households to save for a deposit for their own home. However, decreased investment in social housing programs and increased targeting of this housing to the lowest income and most marginalised households has excluded from social housing most households who might have the means to save were their rent payments affordable.

As noted above, the lack of affordable housing presents a significant barrier to lower income households having access to home ownership as the lack of supply forces households to pay more than they can afford in rent and takes away their ability to save.

Social housing is an efficient means by which housing security can be delivered to households for whom rental housing is the most appropriate long term option and is an effective means to bridge households transition into home ownership.

3.3 Negative Gearing and Capital Gains Tax

The concessional taxation treatment of housing investment has undoubtedly exacerbated the housing price boom. Taken together, negative gearing and the capital gains tax concession, reduce the costs, and hence increase the returns to investment in assets in which capital gains form a significant proportion of expected income, such as housing, shares and collectibles.

Negative gearing reduces the costs of investment by enabling investment costs, including interest payments, to be offset against wages. In 2001, deductions through negative gearing cost the Federal budget $13.3 billion.

The Government's treatment of capital gains discounts the tax paid on income from capital gains by 50 percent. In the two years following the introduction of this discount in 2000, the amount lent to investors increase by 89 per cent, compared to the 56 per cent growth in housing overall.

While business costs such as property maintenance and insurance are justifiably offset against income, there is less justification for providing an allowable deduction for interest.

While homeowners pay no capital gains tax on their principle residence, a greater discount than received by investors, this advantage does not improve affordability at the time of home purchase. Further, as homeowners would most often sell one house only to purchase another, capital gains are rarely fully realised by homeowners.

3.4 Stamp Duty

The State Government levies stamp duty on property transfers presenting a cost to investors and homeowners alike. While this increases the upfront cost of home purchase, stamp duty also presents a disincentive to property transfers and thereby to profit taking by investors. In so doing it decreases the attractiveness of the property market to short term speculative investors. This is positive news to home purchasers.

Speculation also tends to exacerbate cyclical market fluctuations, increasing the risk to home purchasers (and investors) of holding negative equity in property.

Was stamp duty decreased across the board, prices in the housing market would be unlikely to follow. Bidders would simply bid more, inflating house prices to the amount ‘saved’ in stamp duty.

By reducing churn in property ownership, stamp duty also benefits renters whose tenancies are often disrupted by the sale process, and who risk losing their tenancy when properties are sold.

3.5 Land Tax

Land tax is payable on the unimproved value of land where that land is not the owner’s principle residence. Consequently, it advantages homeowners relative to investors.

4. Solutions to improve the accessibility of home ownership to lower income Victorian households

Improving the accessibility of home ownership requires housing market interventions that are appropriately targeted at clear policy goals. Currently different taxes operate at cross purposes with respect to the aim to increase the accessibility of home ownership, particularly to low income households.

The growing dominance of investors in the housing market indicates that the main source of leverage for improving the accessibility of home purchase to more households lies in impacting on investor decisions.

The following recommendations are specifically targeted to increase the competitive advantage of home purchasers relative to investors and to particularly increase the competitive advantage of the most disadvantaged home purchasers, low-income home purchasers. To achieve an enhanced position for low-income home purchasers recommendations are geared to increase their competitiveness relative to higher income home purchasers.

4.1 First Home Ownership Grant

The First Home Ownership Grant (FHOG) has merit as it increases the purchasing power of first home purchasers relative to both investors and people upgrading their housing. However, it currently makes no distinction between low and high-income purchasers of property.

A simple means to restructure this grant to advantage low income purchasers relative to higher income purchasers is to provide a higher grant to purchasers of lower value properties with a sliding scale as property value increases.

RECOMMENDATION 1

1. That the Commonwealth Government restructure the First Home Ownership Grant to provide a higher grant to purchasers of lower cost properties, according to the following scale:

- ❒ 10,000 for properties to $200,000
- ❒ $7,000 for properties $200,001 to $400,000
- ❒ $3,000 for properties $400,001 to $500,000

- ❒ $0 for properties $500,001 and above.

4.2 Social Housing

In order to provide affordable housing options to lower income households saving for their own home – and to improve housing security for households in private rental, a substantial expansion in social housing is needed.

RECOMMENDATION 2

2. That the Commonwealth Government fund a stream of capital funding in addition to the CSHA to expand the supply of social housing.

Options are also available to increase the involvement of private investors in the provision of affordable rental housing. The most effective of these, outlined in the Affordable Housing National Research Consortium paper *Policy Options for Stimulating Private Sector Investment in Affordable Housing Across Australia*, is the 'bond scheme model'. This model specifically addresses market failure in the lower value end of the private rental market by addressing the gap between investment costs and income. Such a model would be enhanced by the reforms to negative gearing outlined below.

A key advantage of the bond scheme model is that it enables the Government's investment to be 'captured' by the intended beneficiaries as investment funds generated are controlled by State Housing Authorities or other nominated social housing providers.

RECOMMENDATION 3

3. That the Commonwealth Government fund a subsidy to leverage private investment in affordable housing congruent with the Affordable Housing National Research Consortium 'bond scheme model'.

4.3 Negative Gearing

Negative gearing in its current form provides a substantial subsidy to housing investors, a large proportion of which is not captured into low cost rental housing.

By subsiding investors in a way home purchasers are not subsidised, negative gearing undermines the objectives of the first homeowners grant by gifting investors a competitive advantage vis a vis first homebuyers.

A substantial restructure of negative gearing is necessary to both increase the supply of affordable housing and to increase the competitive advantage of home buyers vis a vis investors.

RECOMMENDATION 4

4. That the Commonwealth Government restructure negative gearing to:

- ❒ For new investments, eliminate the offset of interest payments but maintain the offset of genuine business expenses, such as maintenance, insurance and water supply in all existing (already constructed) housing.
- ❒ For existing investments, to phase out the offset of interest payments over a 10 year schedule while maintaining the offset of genuine business expenses

- For new investments in newly constructed housing, to maintain the offset of interest payments on affordable housing - up to $300,000 on house and land and up to $250,000 per unit on multi-unit developments, and maintain the offset of genuine business expenses.[6]
- Direct the substantial gains to the Federal budget arising from this restructure into social housing.

4.4 Capital Gains Tax

By offering a tax advantage on capital gains income in the property market that is not available on other investments, the discount on capital gains tax has increased demand pressure in the housing market from investors. This demand pressure is inflationary and has disadvantaged homeowners.

RECOMMENDATION 5

5. That the Commonwealth Government apply the full amount of capital gains tax for non-home occupiers and maintain the full concession for home occupiers and direct the gains to the Federal budget arising from this reform into social housing.

4.5 Stamp Duty

Stamp duty has a positive impact on the housing market by decreasing housing churn and limiting speculative short-term investment. However, it does present an upfront cost, and hence a barrier to home purchasers.

While there would be little if any price advantage from decreasing stamp duty across the board, there would be a distinct advantage to low income home purchasers if stamp duty was restructured to increase the affordability of more modest properties. This reform could be made revenue neutral by increasing the tax on purchase of luxury homes.

VCOSS recommendation on stamp duty is consistent with the Housing Justice Roundtable Submission Recommendation 4, the rationale and methodology for which are attached.

RECOMMENDATION 6

6. That the Victorian State Government restructure stamp duty to a smoothly increasing scale that provides substantial stamp duty relief at the lower end of the cost spectrum and increases stamp duty to luxury properties.

With the advent of the housing price boom, the Victorian State Government has received windfall revenues from stamp duty while the affordability of housing to lower income households has worsened.

In order to build in a mechanism by which housing price escalation also contributes to positive outcomes for low-income households a proportion of stamp duty revenues should be targeted to programs to expand the supply and amenity of social housing.

RECOMMENDATION 7

7. That the Victorian State Government legislate to quarantine a proportion of stamp duty revenues to programs to programs to expand the supply and amenity of social housing.

4.6 Land Tax

As land tax advantages homeowners relative to investors it should remain unchanged.

RECOMMENDATION 8

8. That the Victorian State Government maintain land tax at its current level.

5. Summary of Recommendations

1. That the Commonwealth Government restructure the First Home Ownership Grant to provide a higher grant to purchasers of lower cost properties, according to the following scale:
   - $10,000 for properties to $200,000
   - $7,000 for properties $200,001 to $400,000
   - $3,000 for properties $400,001 to $500,000
   - $0 for properties $500,001 and above.

2. That the Commonwealth Government fund a stream of capital funding in addition to the CSHA to expand the supply of social housing.

3. That the Commonwealth Government fund a subsidy to leverage private investment in affordable housing congruent with the Affordable Housing National Research Consortium 'bond scheme model'.

4. That the Commonwealth Government restructure negative gearing to:
   - For new investments, eliminate the offset of interest payments but maintain the offset of genuine business expenses, such as maintenance, insurance and water supply in all existing (already constructed) housing.
   - For existing investments, to phase out the offset of interest payments over a 10 year schedule while maintaining the offset of genuine business expenses
   - For new investments in newly constructed housing, to maintain the offset of interest payments on affordable housing - up to $300,000 on house and land and up to $250,000 per unit on multi-unit developments, and maintain the offset of genuine business expenses.[7]
   - Direct the substantial gains to the Federal budget arising from this restructure into social housing.

5. That the Commonwealth Government apply the full amount of capital gains tax for non-home occupiers and maintain the full concession for home occupiers and direct the gains to the Federal budget arising from this reform into social housing.

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7. That the Victorian State Government legislate to quarantine a proportion of stamp duty revenues to programs to programs to expand the supply and amenity of social housing.

8. That the Victorian State Government maintain land tax at its current level.

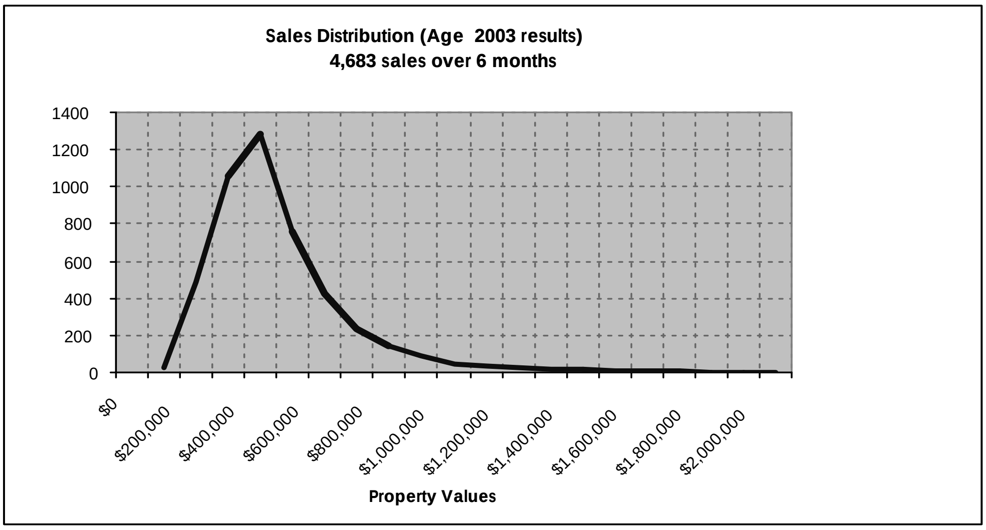
6. Appendix 1 - Collection of Stamp Duty on Residential Properties in Victoria

The task was to test the feasibility of adjusting the schedules currently used to assess stamp duty to meet two objectives:

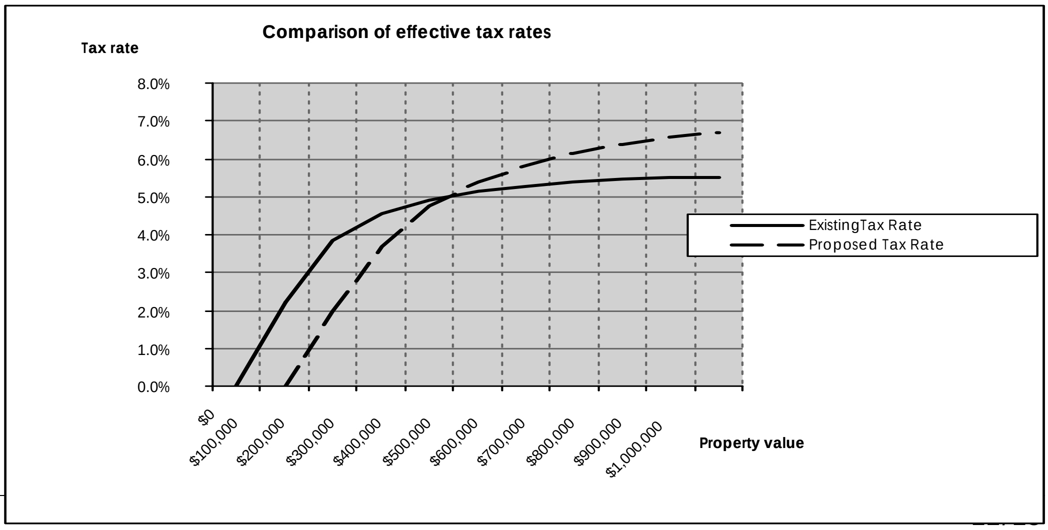
1. To reduce burden on first home buyers purchasing at the more affordable end of the price spectrum.
2. To maintain as far as possible a revenue neutral outcome for State finances

The method used involved the following steps and assumptions:

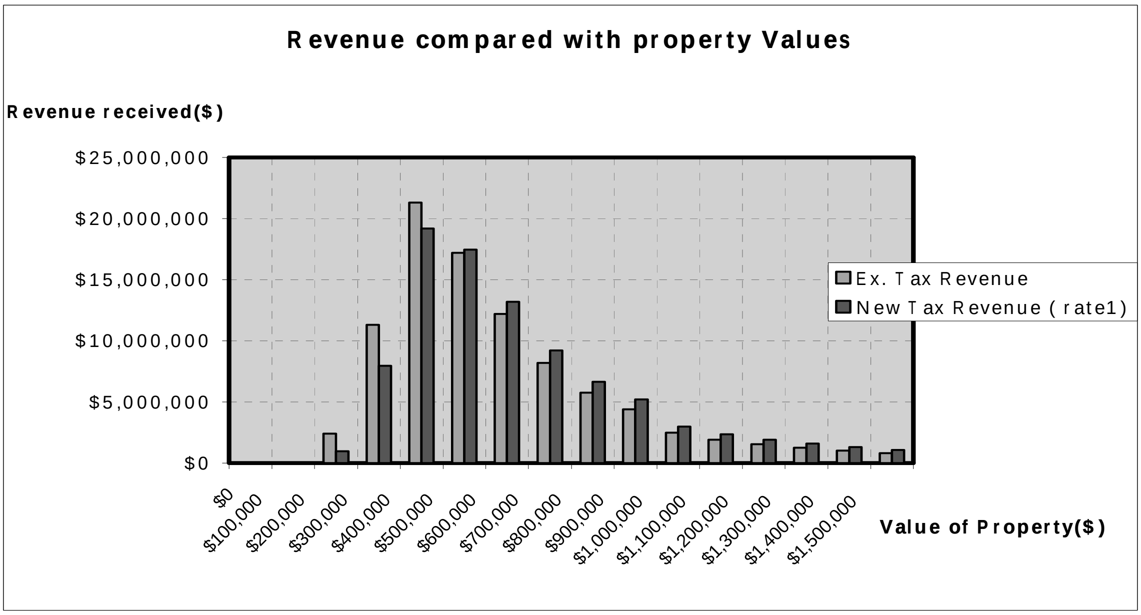
1. Records of house sales in metropolitan Melbourne were gathered from *The Age* newspaper for the period April to September 2003.
2. These were plotted and as might be expected fell into a normal distribution around the median house price



3. The existing schedules were then applied to this sample to estimate the tax revenue obtained from these sales.
4. New scales were then created to meet the design criteria and adjusted to provide a comparable tax income.



5. The change with respect to housing consumers in buying in different price ranges is illustrated in the following table:



6. The main features are:
   - Under the new schedules purchases up to $200,000 have a minimum reduction of pay approximately half the current stamp duty equivalent to $3,660
   - At $300,000 their payment is reduced by 20% equivalent to$2,660.
   - At $400,000 it is reduced by about 4% equivalent to $660.
   - The schedule is progressive with regard to price so that for house purchases of $1,000,000 the duty increases by 20%

7. The following spreadsheet sets out the detailed calculations together with relevant assumptions.

Melb. Metro.

Sale price	Existing rates (1)	Proposed rates (2)
$0	$0	$0
$100,000	$2,200	$0
$200,000	$7,660	$4,000
$300,000	$13,660	$11,000
$400,000	$19,660	$19,000
$500,000	$25,660	$27,000
$600,000	$31,660	$35,000
$700,000	$37,660	$43,000
$800,000	$43,660	$51,000
$900,000	$49,500	$59,000
$1,000,000	$55,000	$67,000
$1,100,000	$60,500	$75,000

		Tax revenue		**Tax revenue**
Sales distribution (3)	Ex Av Rate	**Existing (4)**	Av Rate I	**Proposed (5)**
23.0	$1,100	**$25,300**	$0	**$0**
492.0	$4,930	**$2,425,560**	$2,000	**$984,000**
1061.0	$10,660	**$11,310,260**	$7,500	**$7,957,500**
1279.0	$16,660	**$21,308,140**	$15,000	**$19,185,000**
759.0	$22,660	**$17,198,940**	$23,000	**$17,457,000**
425.7	$28,660	**$12,200,562**	$31,000	**$13,196,700**
236.5	$34,660	**$8,197,090**	$39,000	**$9,223,500**
141.9	$40,660	**$5,769,654**	$47,000	**$6,669,300**
94.6	$46,580	**$4,406,468**	$55,000	**$5,203,000**
47.3	$52,250	**$2,471,425**	$63,000	**$2,979,900**
33.3	$57,750	**$1,923,075**	$71,000	**$2,364,300**

$1,200,000	$66,000	$83,000
$1,300,000	$71,500	$91,000
$1,400,000	$77,000	$99,000
$1,500,000	$82,500	$107,000
$1,600,000	$88,000	$115,000
$1,700,000	$93,500	$123,000
$1,800,000	$99,000	$131,000
$1,900,000	$104,500	$139,000
$2,000,000	$110,000	$147,000

24.3	$63,250	**$1,536,975**	$79,000	**$1,919,700**
18.3	$68,750	**$1,258,125**	$87,000	**$1,592,100**
13.8	$74,250	**$1,024,650**	$95,000	**$1,311,000**
10.3	$79,750	**$821,425**	$103,000	**$1,060,900**
7.8	$85,250	**$664,950**	$111,000	**$865,800**
5.8	$90,750	**$526,350**	$119,000	**$690,200**
4.3	$96,250	**$413,875**	$127,000	**$546,100**
3.3	$101,750	**$335,775**	$135,000	**$445,500**
2.3	$107,250	**$246,675**	$143,000	**$328,900**
4683.5				
Relative income		**$94,065,274**		**$93,980,400**
				-$84,874

NOTES:

a. (1) Existing rates are 1.4% of the property value for first $20,000 plus 2.4% of value in excess of $20,000 to $115,000 plus 6% of value above $115,000 to $870,000. Above $870,000 rate is 5.5% of total value of the property.

b. (2) Proposed rates are no charge for the first $100,000, 4% of the value in excess of $100,000 until $200,000, plus 7% of the value in excess of $200,000 plus 8% of the value above $300,000.

c. (3) This distribution is obtained from the actual sales in Metropolitan Melbourne as reported in *The Age* for April-September 2003. The values between $500,000 and $1,000,000 are interpolated using equal area and those in excess of $1,000,000 extrapolated by progressive reduction.

d. (4) & (5) The relative tax revenues for existing and proposed scales are obtained by the product of the number of properties and the effective rate.

e. The 2003-04 budget estimate for financial and capital transactions is $2,348.2 million. The variation predicted by this model would be of the order of $2 million downwards.

Given the volatility in the variables impinging on the calculation and that Treasury estimates have varied by several hundred million in recent years it is pointless to seek greater accuracy.

7. Endnotes

[1] Burke and Ralston (2003), *Analysis of Expenditure Levels of Household Indebtedness of Public and Private Rental Households, 1975 to 1999*, AHURI, April 2003.
[2] Wulff, Yates and Burke, 2001, *Low Rent Housing in Australia 1986-1996*. Table 3.1, p. 25.
[3] Ibid. Table 3.3, p. 29.
[4] Ibid. Table 3.5, p. 32.
[5] Ibid
[6] These sums and scheduled are indicative only and should be modelled to determine housing cost levels that deliver affordable rental housing to average and below average income households.
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