

4th Pacific Rim Real Estate Society Conference

Perth, 19-21 January 1998

SOME IMPACTS OF RECENT BUDGETARY POLICY UPON THE PROPERTY INDUSTRY IN AUSTRALIA

Mervyn Fiedler, M.Com., Ph.D., Dip FP, FCPA

Adjunct Professor.
Land Economics Program,
University of Technology, Sydney.

E-mail: Mervyn.Fiedler@uts.edu.au

A Refereed Paper

**Key Words: Australian Economy; Fiscal Policy; Property Industry;
Property Taxation; Superannuation; Macroeconomics**

Abstract:

Following its election in March 1996, the Howard-led Liberal-National Parties Coalition Government has introduced two Federal Budgets, the hallmark of each being fiscal stringency. The literature (Waxman and Lenard, et al) suggests that fiscal policy may have a marked impact, not only upon saving and investment, but on property market activity. The paper examines the global and domestic economic forecasts and projections presented by the Government with each Budget, and against which the respective Budgets were framed, and notes that the economic settings which influence construction and other business behaviour have generally been too optimistic, especially in relation to growth and employment. Several measures introduced in the Budgets, particularly the superannuation contributions surtax and adjustments to the cost base of assets for certain tax deductible expenses (for capital gains tax purposes), are examined. It is concluded that the direct effects of these measures are negative in the main for the property industry, although the superannuation contributions surtax may lead to a switch away from discretionary superannuation investment to negatively geared property investment. But the greatest impact, which has apparently overwhelmed these negative measures, is the influence of the Government's perceived tighter fiscal approach on both long and short-term interest rates. The paper notes that both levels of interest rates have fallen by around 2.5 per cent since the Howard Government came to office with positive flow-ons to improved investor confidence and affordability. In fact, over the past year, a spate of partial indicators point to firmer building activity, with major forecasting groups expecting further price rises over the next two to three years, especially in and around Sydney and Melbourne. The paper concludes with a tabulation of risk factors which may intrude to upset this otherwise positive outlook for the Australian property industry.

1. **INTRODUCTION**

In March 1996, the Howard-led Liberal-National Coalition Parties won the Federal election with an overwhelming majority after 13 years of Labor Government. The new Government was elected on a platform to govern in an economically responsible manner, with emphasis on lowering unemployment, increasing saving and maintaining low-inflationary economic growth.

Shortly after taking office, the new Government announced that, on opening the books of account, the budgetary position was worse than expected and that financial stringency would be necessary to repair the fiscal state. It presented a Charter of Honesty, promising open budgetary policy.

Since its election, the Howard Government has presented two annual Budgets, in August 1996 and in May 1997. In the absence of a mini-Budget, the next Budget will be in May 1998. The Budgets presented to date not only cut expenditure and introduced some measures which directly affected the property industry but created a reputation for the Government of responsible fiscal management, in the eyes of both overseas and domestic investors. This, in turn, created a setting for substantial reductions in both long-term and short-term interest rates, both beneficial for the property industry.

The purposes of this paper are:

- to note some contributions from the literature on the influences that fiscal policy may have upon property market activity;
- to review briefly, as a further backdrop, the state of the global and Australian economies as at the two Budget dates and as at the present time (January, 1998);
- to assess the Howard Government's tighter budgetary stance;
- to examine the 1996-97 and 1997-98 Budget measures which are of importance to the Australian property industry;
- to describe some public housing initiatives taken by the Government;
- to outline the recent performance of the property industry in Australia by reference to a range of partial indicators;
- to provide a summary of impacts of the Government's policy measures on the Australian property industry; and
- to identify several risk factors which may intrude to hamper the otherwise expected positive performance of the Australian property industry in the medium term.

2. **LITERATURE REVIEW**

Several writers [eg. INDECS (1995); Nevile (1997) and Waxman and Lenard (1997)] have drawn attention to the fact that the Government's budgetary or fiscal policy may have a marked impact upon the property market, as well as on saving, investment, growth and employment. Over the past two decades in Australia, Government measures such as:

- the introduction of the capital gains tax legislation in 1985, including the exemption given to the principal place of residence;
- the abolition of negative gearing in 1985 and its restoration two years later;

- the introduction in 1985 – and subsequent changes in 1987 – of building depreciation allowances [Australian Master Tax Guide (1997)]; and
- the extent of encouragement given to foreign investment in Australian property;

have had noticeable effects upon property market activity. Moreover, the failure to tax imputed rent on owner-occupied dwellings is another factor stimulating the high degree (around 70 per cent) of home ownership in Australia.

Furthermore, Waxman and Lenard (1997) have drawn attention to the impact which fiscal policy may have upon levels of interest rates, which in turn affects business and consumer confidence and housing affordability. Indirectly, the introduction of dividend imputation has encouraged share investment, arguably with some detriment to property and other forms of investment.

Of course, influences other than fiscal policy have had strong impacts on property markets. Global and Australian economic conditions, including the recessions of 1981-83 and 1990-91 along with the current East Asian financial and economic crises, efforts to promote tourism, the exercise of monetary policy, the Sydney 2000 Olympics, future property price expectations and – importantly – the extent of over or under-supply of property stock have had significant influences on Australian property prices and market activity. [BIS Shrapnel (1997a), et al].

3. GLOBAL AND AUSTRALIAN ECONOMIC OUTLOOK

As a further backdrop to the issues considered in this paper, Table 1 summarises a selection of the global and Australian economic variables and outlook, as presented in the 1996-97 and 1997-98 Budgets. Also included in Table 1 are the 1996-97 economic outcomes, as revealed by published statistics. A brief critique of both sets of forecasts, in the light of current experience, follows the Table.

TABLE 1

Global and Australian Economic Outlook – Budget Forecasts and Performance 1996-97 and 1997-98

	1996-97 Budget Forecasts %	1996-97 Actual %	1997-98 Budget Forecasts %
<u>Overseas</u>			
<u>Major Trading Partners</u>			
Growth in Real GDP	4.25	4.5	4.5
Inflation	3.0	2.75	3.0
Trade Weighted Index (Index Points)	58	59	60

Australia			
Real GDP Growth	3.5	2.5	3.5
Dwellings Investment Growth	-3.0	0.6	11.0
Non Dwelling Investment Growth	15.0	17.4	18.0
CPI Inflation	2.0	1.3	1.0
Average earnings	5.0	3.9	4.0
Employment Growth	1.5	1.1	2.0
Unemployment Rate	8.5	8.7	8.25
Current Account Balance (\$bn)	-20.0	-17.0	-21.0
Current Account Balance (% GDP)	-4.0	-3.2	-4.0

SOURCES: Budget Papers, 1996 and 1997; ABS; RBA.

Table 1 shows that the Federal Government forecasts overestimated real GDP growth and employment growth in 1996-97. They over-estimated inflation and the current account deficit. Although domestic economic activity remains buoyant, there is a risk - in the light of recent experience, particularly the deflationary impact of the recent Asian economic and financial crises - that it has again over-estimated GDP and jobs growth in 1997-98 and under-estimated the current account deficit. However, although the macroeconomic impacts on the building industry are not as strong as forecast by the Treasurer, both dwelling and non-dwelling investment activity was stronger in 1996-97 than forecast. Stronger growth still is expected by the Government in both dwelling and non-dwelling investment in 1997-98.

Table 2 shows that between June 1996 and October 1997, the major short-term and long-term interest rates in Australia had fallen by at least 2 ½% or 250 basis points, with bank housing loan variable rates down by 3%. This, in turn, has led to a significant improvement in home loan and property purchase affordability, and – in some areas – has helped to stimulate dwelling price rises.

TABLE 2

Other Key Economic Indicators – Australia
1995-97

	June, 1995 %	June, 1996 %	June, 1997 %	October, 1997 %
<u>Interest Rates</u>				
Official Cash Rate	7.4	7.5	5.5	5.0
90-Day Bill Rates	7.6	7.6	5.3	4.9
Housing loan Variable Rates	10.5	9.75	7.2	6.7
10-year Treasury Bonds	9.2	8.9	7.1	6.0
<u>Home Loan Affordability</u>				
Proportion of Income Devoted to Home Loan Repayments	29.0	26.6	23.6	23.3

SOURCE: Reserve Bank of Australia, Bulletin, October, 1997; Home Loan Affordability, 1997; ABS.

4. The Howard Government's Budgetary Stance

Following its election and its announcement that, according to its review of the fiscal books, Australia's budgetary situation was worse than it imagined, the Howard Government took several remedial steps. In particular, the Government has

- introduced a Charter of Honesty;
- tightened fiscal policy sharply in the 1996-97 Budget, particularly on the expenditure side;
- maintained its stringent fiscal stance in the 1997-98 Budget, producing a further substantial reduction in the underlying Budget deficit. Moreover, the proceeds from the sale of one-third of Telstra will provide a headline Budget surplus in 1997-98;
- announced forward estimates for an underlying Budget surplus by 1998-99; and

- provided strong growth forecasts of dwelling and non-dwelling construction investment and of plant and equipment investment, all of which are positive indicators for the property industry.

The Howard Government's fiscal strategy has been reasonably well received by global financial markets. Since 1 July 1996, and particularly since the 1996-97 Budget, Australian bond yields have fallen from 8.9 per cent to 7.1 per cent in June 1997, to 6.0 per cent in October 1997 and to around 5.6 per cent in early January 1997. The differential between Australia and US bond yields has fallen in that time from around 250 basis points to approximately 25 basis points at present (January 1998). This is a clear measure of confidence by international and domestic investors that the Howard Government will maintain fiscal firmness and maintain low levels of inflation.

Of course, other factors have intruded at times to influence bond yields. A notable example is the concern about possible deflation generated by the Asian crisis which has been widely interpreted as a major driver of Australian bond yields to levels below 6 per cent over the last three months. Nevertheless, the Government's firm fiscal stance and the generation of lower inflationary expectations are widely perceived as the key determinants of the fall in bond yields in Australia over the past 18 months.

On the other hand, housing loan interest rates are also influenced by short term rates, including the cash rate, the 90-day bill rate and rates for different forms of lender finance. The key reasons for the five successive easings in monetary policy over the last 18 months have been the absence of any immediate threat that the top end of the Reserve Bank's underlying inflation target of 2% to 3% per annum will be breached and the need to stimulate employment. However, the Howard Government's firmer fiscal policy has provided a favourable and supporting economic setting, against which the interest rate cuts could be made.

5. 1996-97 BUDGET MEASURES

a) The Measures

A key policy measure included in the 1996-97 budget, with significant implications for the property industry was the imposition of a surtax of 0 to 15% on deductible superannuation contributions in respect of high income earners earning over \$70,000 per annum taxable income. This provision was introduced with immediate effect.

In addition, extensive cost-cutting measures, aimed at reducing the Budget deficit sharply in 1996-97 and creating a setting for further expenditure and deficit cuts in 1997-98, were introduced.

b) The Impacts

The impact of the superannuation surtax is two-fold. First, it has provided – and will continued to provide - additional revenue for the Federal Government (of the order of

\$500 million, per annum), thereby making a significant contribution towards bringing the Budget into surplus. Secondly, after the 1996-97 Budget, many observers claimed that the measure would tend to divert a portion of high income earners' discretionary money away from superannuation into other forms of investment, including negatively geared property investment. The resultant slower growth in superannuation funds would mean less investment demand by those funds for the various asset classes, including property.

In the event, while investment in various forms of property, including listed property trusts – whose market capitalisation exceeded \$20 billion in 1997 for the first time – has risen over the last two years, superannuation fund assets have continued to grow in value. In fact, at the end of September 1997, superannuation fund assets had increased to \$A316 billion, a rise of 20 per cent over the figure of a year earlier. Even though much of this rise can be accounted for by enhanced capital market performance, it is noteworthy that superannuation contributions over 1996-97 were up by 11 per cent compared to the previous year. Accordingly, the impact of the contributions surtax on superannuation fund growth was apparently smaller in 1996-97 than was widely anticipated at the outset.

As noted in Section 4 above, the Government's Budget strategy has favourably impressed financial markets. Markets perceived that the Howard Government has been – and is – determined to improve Australia's fiscal settings and consequently create a setting for inflation and interest rates to fall to their lowest levels for a generation.

6. 1997-98 BUDGET MEASURES

a) The Measures

- Tax concessions for saving. This was the centrepiece of the Budget and provided a tax rebate of 15 per cent (or up to \$450) for savings – broadly defined – up to \$3,000 in a year, and commence in 1998-99. By 2000-01, they will cost the Government about \$2 billion a year. The saving rebate replaced the previous Labor Government's L-A-W tax cuts, which would have cost an estimated \$4 billion annually.
- Reduction of the indexed cost base of an asset, for capital gains tax purposes, at the time of its disposal, by the amount of net revenue deductions allowed, including expenditure for building allowances, mains electricity connection costs and charges for extending telephone lines.
- Confirmation that the sale of one-third of the shares in Telstra would take place in 1997, providing at least \$10 billion to be allocated towards reducing public debt.
- The planned sale of over 50 Government properties - mainly commercial buildings and mostly in Canberra – to realise \$800 million over the next three years.
- The sale of leases of the Federal Airports Commission and the sale of the Australian Industry Development Corporation and the National Rail Corporation.

b) The Impacts

These measures are expected to influence activity in property markets in various ways.

- The maintenance of a firm fiscal policy stance is expected to help keep interest rates at relatively low levels over 1997-98 and into 1998-99.
- The tax rebate on savings will reduce - and defer until 1998-99 - the costs (\$4 billion per annum) associated with the ALP Government's L-A-W tax cuts, and has thus also contributed to firmer fiscal policy.
- The changes to reduce the cost base of depreciable assets are widely expected to impact significantly on property investors who hold properties for a number of years before disposing of them. The Property Council of Australia has estimated that the revenue raising potential of this measure is around triple the \$140 million per annum estimated by the Government. Landlords will seek to pass on some of the impost as higher rents. Further, the widely drawn measure will extend beyond building owners to embrace the rural sector and mine sites. In effect, the measures convert a deal of "tax-free income" (arising from the building allowance) for investors into "tax-deferred income" (tax on capital gains to be paid when the property is sold). Nevertheless, although there have been some industry reports of reduced investment sales activity remains fairly buoyant, and it is not entirely clear whether the easing of demand which has occurred has stemmed from this measure or from other influences, eg. the Asian crisis.
- In the event, the sale of one-third of Telstra's shares in late 1997 was highly successful. The proceeds have provided a greater contribution to the headline Budget surplus, which is now expected to be larger than announced in the Budget.
- The large sale of Canberra office space in particular will also augment the Budget surplus, but may weaken an already soft Canberra property market.
- Similarly, the other asset sales will help to increase the Budget surplus further.

7. PUBLIC HOUSING

Following a review by the Industry Commission (1993), Housing Assistance legislation was passed in 1996. The aim of the new policy is to enable more people to have access to cheaper housing. Briefly the outworkings of the policy are:

- no new public housing;
- market rents to be charged; and
- rent subsidies for all low-income earners.

The new policy is in line with the user pays attitude or market-orientation of the Coalition Government, with overt subsidies for low-income earners. Under the new policy, the 920,000 people currently engaged in private rental accommodation receiving subsidies will get increases in their subsidies whilst 325,000 public tenants will pay higher rents, which on average are expected to involve increased payments of \$40 per week in New South Wales (Karantonis, 1997).

In the Federal Budget of 1997-98, the Government announced public housing reform efficiencies, which will produce annual saving of \$50 million. It also tightened eligibility for rental assistance, which will save a further \$60 million in a full year. (Australia, Budget Papers, 1997-98).

8. BUILDING INDUSTRY ACTIVITY UNDER THE HOWARD GOVERNMENT

While qualitative assessments about the likely impact of the Howard Government's Budget measures on property markets have been made in Sections 5 and 6 above, the final outcome will depend on the interaction of a wide range of determinants, of which Commonwealth fiscal policy is just one, albeit a very important influence. While it is too early yet to draw firm conclusions, an initial indication of property market behaviour under the Howard Government can be gauged from a study of the movements in a range of partial indicators over the past year (to September/October, 1997). This period includes the year immediately following the 1996-97 Budget and several months following the 1997-98 Budget. Overall, these indicators suggest that building activity has improved. However, the presence of time lags must be recognised and the full effects of many of the Budget measures may not be evident until later in 1998.

To date, however, the following statistics summarise recent trends in building activity;

- **The value of building approvals** in Australia, comprising new dwellings, non-dwellings, and alterations and additions to buildings, in the year to October 1997 were 15 per cent higher than in the year to October 1996. (ABS, 1997a).
- **New dwelling approvals** have increased in value by 19% in value, **alterations and additions** by 13.5% and **non-dwellings** by 12% over the year to October, 1997. (ABS, 1997a).
- In numerical terms, **total dwellings (including conversions) approved** in Australia rose by 13% from 126,000 in the year to September 1996 to 142,000 in the year to September, 1997. Private dwellings predominated, amongst structures approved, with **private homes approvals** rising 12% in the year, while **private other dwellings (mainly units)** rose by a strong 19% over the same period. (ABS, 1997a, 1997b).
- Not all approvals lead to physical commencement of the structure. **Total dwellings (including conversions) commenced** in the year to September 1997 were 132,000 or 7% fewer than approvals. But **private house commencements** rose by 7% over the

year while **private other dwelling commencements** were up by 11.5%. (BIS Shrapnel, 1997b).

- The **value of non-dwellings commenced** in the year to June 1997 rose by around 10% on a year earlier. (BIS Shrapnel, 1997b).
- Of **non-dwellings commencements**, over the year ended June 1997 compared with the year ended June 1996, in value:
 - offices were up by 37%;
 - factories were up by 12%;
 - education and health were up by 19%;
 - other social buildings were up by 29%;
 - hotels were up by 2%;
 - shops were down by 18%; and
 - education and health were down by 20%. (BIS Shrapnel, 1997b).
- Although there are currently some concerns about the viability of some inner city unit developments, eg. in and around Sydney, building activity is fairly robust. Housing prices have risen in key areas, and there are **prospects for further price rises in housing** over the next two years in parts at least of Sydney and Melbourne, with price movements in the other State capitals likely to be more subdued. (BIS Shrapnel, 1997a).

9. SUMMARY OF IMPACTS

The impacts of the Federal Government's fiscal approach have been both direct and indirect. Directly, some measures, eg. the superannuation surtax and the reduction of the adjusted cost base of a property for capital gains tax purposes by the amounts of selected tax deductions claimed, have the potential to diminish property investment (by superannuation funds and private investors) and / or place higher imposts on property owners. If the owners can pass the potential additional capital gains taxes on to private renters, the tax burden will be shifted in part at least from property owners to property renters. Unless, in turn, the renters are businesses or sub-lessees who may partly recoup their extra costs from customers/sub-lessors through higher priced goods and services, they will bear the burden of the taxes. In that event, some property investors could exit the property market and seek alternative investments, which, at the extreme, could lead to over-supply of stock and downwards pressure on prices. However, there is little evidence of this to date. A further influence in New South Wales are the increases in, and extensions to, land taxes from 1 January, 1998.

The superannuation surtax may lead to a switch by some investors away from superannuation into negative gearing of property investment, but superannuation is still growing strongly.

Indirectly, the Howard Government's tight fiscal management approach has been beneficial to the property industry. The stringency imposed by both Budgets over the past two years has given both overseas and domestic investors more confidence in the fiscal management capacity of the Federal Government. Bond yields have fallen by over 250 basis points over 1996 and 1997, due to falling inflationary expectations, greater investor confidence and prospectively fewer bonds being issued in future as the Federal Budget deficit is reduced. As a further consequence of low inflation and intractably high unemployment, the Reserve Bank has reduced official interest rates five times, from 7.5% to 5%, over the past 18 months. These measures have led to lower mortgage rates, improved affordability and greater investor confidence.

Overall, the interaction of all of these developments has been positive for Australian property markets, especially encouraging investor confidence and helping affordability. As a consequence, Australian property markets generally (and in most sectors) have surged in the last year or so, as evidenced in many areas by increased sales, higher prices, rises in housing commencements and completions, improved dwelling and non-dwelling investment expenditure and higher industry employment. These benefits support the attainment of higher national economic growth, although in 1997-98, the growth outcome could be dampened by around 1.0 per cent through the negative impact of the East Asian economic and financial crises.

10. CONCLUSION

On balance, the fiscal management of the Howard Coalition Government has provided a favourable economic climate for property investment. However, the Australian economy operates in a global environment and significant developments overseas can be quickly transmitted to affect Australian property markets. Already, in 1997, there have been some impacts on property sales and investment activity in Australia arising from the negative effects of the 1997 Asian financial and economic crises.

More specifically, key risks for the Australian property industry in the medium term include:

- any global downturn among the major economies, which could react upon the Australian economy, overall levels of investor confidence and property markets;
- ongoing and/or further weakness in Asian economies, which could lead to a further withdrawal of Asian investors from the Australian property market, leading in turn to more sales of existing properties and/or diminished future demand – some market sources suggest that up to 40% of investment properties in some Sydney complexes may have been purchased by Asian interests, some at least of whom are expected to sell if the Asian domestic economies weaken further;

- policy changes away from the current stringent economic policy to unduly loose fiscal and/or monetary policy, which could lead to rises in inflation, interest rates and bond yields, and diminished global and domestic investor confidence; and
- the emergence of over-supply in key markets.

Overall, the outlook for all segments of the Australian property market is one of guarded optimism, with further growth – albeit patchy and sectional at times – in property investment and real estate values until the end of the decade, at least.

SELECTED REFERENCES

Australia (1996), Budget Papers, AGPS, Canberra.

Australia (1997), Budget Papers, AGPS, Canberra.

Australian Bureau of Statistics (ABS) (1997a). Building Approvals, 8731.0, Canberra, October.

ABS (1997b). Building Activity, 8752.0, Canberra, June Quarter.

ABS (1997c). National Income, Expenditure and Product: Australian National Accounts, 5206.0, Canberra, September Quarter.

BIS Shrapnel (1997a). Building in Australia, Sydney.

BIS Shrapnel (1997b). Building Industry Prospects, Sydney, December.

Home Loan Affordability (1997). Jointly produced by Real Estate Institute of Australia and Citibank Ltd, September Quarter.

INDECS (1995). State of Play 8: The Australian Economy Policy Debate, Allen & Unwin, Sydney.

Insurance and Superannuation Commission (1997). ISC Bulletin, Canberra, September.

Karantonis, A (1997), “Housing Policy – Is the Government Fulfilling its Role.” Land Economics Program Working Paper No. 1.97, University of Technology, Sydney, October.

Neville, J. (1997). “Fiscal Policy in Australia”, in Kriesler, P. (1997). The Australian Economy 2, Allen & Unwin, Sydney.

Waxman, P. and Lenard, D. (1997). Investing in Residential Property: Understanding the Market, 3rd edition, Wrightbooks, Melbourne.