CHAPTER 11

Housing and Tax: The Triumph of Politics over Economics

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1 THE HENRY TAX REVIEW AND ITS RECOMMENDATIONS AFFECTING HOUSING

The Henry Review, established to provide a comprehensive review of Australia's tax system, was set the task of making recommendations that "will position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century and enhance Australia's economic and social outcomes".[1]

The Review was one of the outcomes of the 2020 Summit held in April 2008, "which proposed a comprehensive review of State and Federal taxes to consider measures to harmonise and simplify taxes, reduce inefficient taxes, ensure a progressive system and address negative interaction with the welfare system".[2] It was defended on the grounds that "there has not been a comprehensive review of the Australian taxation system, including state taxes, for at least the last 50 years. There is stronger pressure than ever for a tax system that works in the fairest, simplest and most efficient way".[3]

In broad terms the Review Panel was given *carte blanche* in how it fulfilled its task. Some constraints imposed on it, such as being required to recognise that revenue should be raised "so as to do least harm to economic efficiency, equity (horizontal, vertical and intergenerational), and minimise complexity for taxpayers and the community",[4] reflect conventional tax principles. Others, such as the requirement to "reflect the Government's policy not to increase the rate or broaden the base of the GST; preserve tax-free superannuation payments for the over 60s; and the announced aspirational personal income tax goals",[5] were potentially more restrictive.

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1 Terms of reference to the Henry Review, in Australia's Future Tax System Review Panel, *Australia's future tax system: Report to the Treasurer* (December 2009) (AFTS Report), Pt 1, p vii. The Terms of Reference for the Review were announced in the 2008-09 Budget of the Australian Government.

2 Swan (Treasurer) (2008).

3 Swan (Treasurer) (2008).

4 AFTS Report, Pt 1, p vii, terms of reference (para 2).

5 AFTS Report, Pt 1, p viii, terms of reference (para 5). These aspirational goals were not made explicit in the terms of reference but the simultaneous *Media Release no 035* (13 May 2008) by Treasurer Swan outlined the proposed tax cuts announced in the 2008-09 Budget that were in addition to those announced in the 2007-08 Budget.

Housing was mentioned explicitly only in a directive to consider enhancing taxation arrangements on property,[6] and in a directive that the Review should make recommendations that ensured there were appropriate incentives for individuals to save and provide for their future, including access to affordable housing.[7]

A significant proportion of the recommendations made in the AFTS Report, however, affect housing. Of 138 recommendations in the AFTS Report, at least 25 (on a relatively conservative count) can be construed as being directly related to housing. The most readily identifiable of these deal with capital gains taxation, property transfer taxes or stamp duties, land taxes and housing assistance provided through the transfer system. On release of the AFTS Report, the Treasurer stated that taxation of the family home, capital gains taxation and negative gearing would not be implemented at any stage (Swan, 2010). Other options, such as the introduction of a tax on bequests that were only floated by the Henry Review as a possibility for the future, were also ruled out.

Omissions also affect housing as much as, or maybe even more than, the recommendations listed. Many of these, such as the inclusion of income from savings invested in owner-occupied housing in the personal income tax base, are explicitly rejected in the AFTS Report. Others, such as introduction of a recurrent wealth tax as distinct from a wealth transfer tax, are not even considered. On the transfer side, explicit assistance to renters is covered in detail, but that provided to home purchasers is not discussed.

The specific recommendations included in the AFTS Report, those that were explicitly excluded and those that might have been considered are all covered below. Before an examination of either the recommendations or those that might have been, however, this chapter begins with an overview of the demographic, social, economic and environmental challenges of the 21st century that are likely to arise within Australia's housing system, since these challenges provide a starting point for an assessment of recommendations on housing taxation and transfers. This overview is provided in *Housing challenges in the 21st century*. *The extent of housing taxation and transfers* provides an assessment of the order of magnitude of the major taxes and subsidies that currently are provided to housing. This is followed by a discussion of their impact on the housing system in *The impact of housing taxation on housing*. *The contribution made by the AFTS Report recommendations in addressing housing challenges* examines the recommendations in the AFTS Report in light of the challenges that Australia's housing system is likely to face in the 21st century. *Conclusions* completes the analysis.

2 HOUSING CHALLENGES IN THE 21ST CENTURY

One of the key housing challenges in light of the demographic, economic, social and environmental pressures that Australia faces is that which was identified in the terms of reference: namely, ensuring that all households have access to affordable housing. This particular challenge has emerged as a response to a structural decline in housing affordability which, in turn, has contributed to reduced access to owner-occupation for moderate income first home buyers and

6 AFTS Report, Pt 1, p vii, terms of reference (para 3.4).

7 AFTS Report, Pt 1, p viii, terms of reference (para 4.2).

to high levels of rental stress amongst lower income households in the private rental market. Addressing it requires an understanding of the pressures in the housing market that have contributed to these outcomes.

For most of the past century, Australia's housing system has been dominated by private provision of housing. Post-war housing policies supported the growth of home ownership as the tenure of choice and public housing provided a long term, affordable alternative for lower income households. Private rental housing was primarily a transitional tenure for young and mobile households. Home ownership served as a form of insurance that protected the aged from poverty in retirement.

In the past few decades, however, this traditional foundation has been challenged as a number of structural factors, both global and local, have placed this housing system under considerable pressure. Since the mid 1980s, global trends have fuelled housing demand. Real household incomes have increased; disinflation has meant that nominal interest rates have fallen and borrowing capacity has increased; deregulation and financial innovation has meant that finance is more readily available. In Australia these pressures have been exacerbated by population growth fuelled by steady natural growth and sustained migration and by an ageing population (arising from increased longevity). [8] This increased demand, together with a sluggish supply response, exacerbated by an urban settlement pattern in Australia which adds to land supply constraints and by urban consolidation policies that reinforce these, has contributed to dwelling prices rising ahead of household incomes, declining affordability and reduced access to home ownership for first home buyers. [9]

Although the aggregate home ownership rate in Australia has remained relatively stable at around 70% for the past 50 or so years, this stable home ownership rate is primarily a result of the ageing of a population that gained access to home ownership before the structural factors outlined above had an impact on the ability of moderate income first home buyers to become home owners. Increasingly, home purchase has been limited to moderate to high income households (often two earner households) or those willing or able to live in less accessible locations. Affordability pressures have been added to by lifestyle changes (including deferred partnering, lower fertility), increased divorce rates and rising numbers of single parent households. Between 1981 and 2006, home

8 Di Pasquale and Wheaton (1994), Ellis, (2006) and Tsatoronis and Zhu (2004) provide a more general discussion of these trends at a global level. Ellis (2010), Productivity Commission (2004), Richards (2008, 2009) and Yates (2008) do so with a focus specifically on local factors.

9 Positive feedback effects from existing owners add to difficulties faced by first home buyers as increased house prices lead to increased wealth and further add to pressures on house prices through wealth induced increase in demand for larger and better located housing. Environmental concerns have added pressures on construction costs. Stylised models of the housing market such as those employed in the AFTS Report show that the long run (aggregate) house price to income ratio (with interest rates at their normal or long run level and no population growth) will increase if the income elasticity of demand is greater than the algebraic sum of housing supply elasticity and the price elasticity of demand for housing. Housing supply elasticity is higher the greater is the elasticity of land supply (which will depend on physical or regulatory constraints), and the lower is the share of land in the total cost of housing. See, for example, Muth and Goodman (1989) or Renaud (1989).

ownership rates for households with a reference person aged between 25 and 34 years old declined by 10 percentage points to 51% and by seven percentage points to 68% for those between 35 and 44 years old (Yates *et al*, 2008, p 32).

Over the same period, the stock of public housing initially rose but then declined in absolute terms so that the total stock by 2006 was less than it was in 1986. The combination of a decrease in home ownership amongst younger households (whether because of affordability constraints or lifestyle preferences) and the decline in public rental has created additional demand pressures on the private rental market. This has been felt most severely at the lower end of the market. Between 1986 and 2006, although the overall stock of private rental dwellings increased, the stock of low rent private rental dwellings affordable for lower income households declined to the point that there was an inadequate stock of affordable dwellings in the private rental market for the low income households who had no other housing options available to them (Yates and Wulff, 2005; Wulff *et al*, 2009). This shortage was exacerbated by allocation of the limited supply of low rent stock to moderate and high income households. By 2007-08 the shortfall of private rental dwellings affordable and available for households in the bottom two quintiles of the income distribution was almost 500,000 dwellings (National Housing Supply Council, 2010, p 105). This shortage is exacerbating the housing affordability problems for low income households in the private rental market.

Of particular concern for the future is the high incidence of affordability problems amongst older low income renters. A study of the intergenerational sustainability of the housing system projected that aggregate home ownership rates will decline by 2045 as a result of ongoing affordability constraints for younger households and the cohort effects of those currently excluded from home ownership. The study concluded that "over the next forty years the Australian housing system is projected to generate increasingly unsustainable housing outcomes, primarily as a result of an increasing reliance on the private rental market to meet the housing needs of a growing and ageing population" (Yates et al, 2008, p 41). This arises primarily because of an assumption that home ownership rates do not recover and a projection that, as a result, as the population ages, an increasing proportion of an ageing population will rely on private rental housing for their housing needs. [10]

Given the way in which housing is provided in Australia, in the end, the key housing challenge associated with ensuring that all households have access to affordable housing is the challenge of providing affordable rental housing for those for whom home ownership is either not accessible or not appropriate. The

10 This study was based on economic and demographic assumptions consistent with those employed in the then current intergenerational report (Australian Treasury, 2007). It combined household projections to 2045 with age specific trends in home ownership and trend projections of housing costs and income distributions based on income and housing costs based on 2001 data to remove the impact of the house price increases in the first decade of this century in case these turn out to have cyclical asset price boom elements. Yates and Bradbury (2010) use evidence from the most recent household expenditure survey in Australia to raise concerns about the capacity of the current retirement income system to provide an adequate standard of living for a relatively small, but nonetheless significant, proportion of the population.

following section provides an assessment of the extent of housing taxes and transfers that are relevant to addressing these challenges. [11]

3 THE EXTENT OF HOUSING TAXATION AND TRANSFERS

The key tax bases that are relevant to housing in the Australian tax system are, at a federal level, the (individual) income and consumption (GST) tax bases and, at a State or local level, the transactions (stamp duties) and wealth (land taxes and rates) tax bases. In broad terms, imputed rent and capital gains from owner-occupied housing are exempt from income tax. The cost of financing the purchase and other expenses are not deductible. Rental properties are subject to income tax, including capital gains tax (CGT) at a 50% discounted rate (if held for at least 12 months) and are eligible for a 2.5% annual depreciation allowance on the construction cost of the building. Expenses are deductible and can be offset against income from other sources. GST applies to land and new houses but not to established dwellings. Housing services (rents) are exempt. Subject to some concessions for first home buyers, sales of residential properties are taxed through duty on conveyances (stamp duties). Only rental properties are subject to annual land taxes. All residential property is subject to municipal rates, although concessions do exist for some low income owners. Stewart (2010) provides an excellent, detailed overview of the tax treatment of both owner-occupied and investor housing under the current income tax and transfer system. Table 1 provides a summary of the major taxes and subsidies affecting housing in Australia.

Table 1: Major Australian Taxes and Subsidies Affecting Housing

Tax or subsidy	Main features
Tax concessions	
Non-taxation of imputed rents	Imputed rental income is not assessed as part of taxable income.
Non-taxation of rental services	There is no consumption tax on imputed or actual housing rents.
Concessional capital gains taxes	(a) Home owner-occupiers pay no capital gains tax.
	(b) Property investors pay tax on half of the nominal capital gains.
Tax treatment of losses on rental property (negative gearing)	Investors can deduct 100% of nominal losses from rental property against other taxable income.
Public expenditure subsidies	
First home owner grants	Grants of $7000 to first home owner purchasers since 1 July 2000.
Assistance to private renters	Australian Government provides rental subsidies to low income persons, who comprise about one quarter of all private renters.
Assistance to public housing tenants	State governments provide public housing to 5% of all Australian households — in most cases at below market rents.

11 The AFTS Report, Pt 1, p xxiii summarises the Henry Review's assessment of the housing affordability challenge and the key directions taken to address this.

Main taxes on land and housing	
State land taxes	States taxes on value of land used for rental properties and second homes. Some land taxes on premium value owner-occupied property.
Local government taxes	Local governments levy land taxes (rates) on most residential properties.
Stamp duties on transfers of land and housing	Most State governments levy stamp duty on value of property when it is transferred.
GST on home renovations, land sales and new buildings	10% GST applies to (a) maintenance and renovation expenditure for existing housing and (b) sales of land and new buildings.
Infrastructure developer charges	Most State and local governments levy infrastructure charges on developers.

Source: Abelson and Joyeux (2007).

A brief overview of the way in which housing is treated by the current tax and transfer system was provided in the background paper prepared for the Henry Review.[12] This covered the treatment of both owner-occupied and rental housing under the current income tax system, State based stamp duties and land taxes and inclusion of the family home in the pension assets test. This overview provided a selective assessment of the possible impact of these taxes and transfers, observing that stamp duty on transactions can discourage turnover, influence housing decisions and inhibit mobility; that land taxes favour owner-occupied over investment housing and can both encourage investment in properties where land is a low proportion of total value (such as apartments) and discourage large scale investors; and that the asset test can create "lock-in" effects that may discourage sales of housing. Whilst these specific taxes or exemptions can be considerable, they fall into insignificance when compared with the much greater concessions that apply through the income tax system. Other than recognition of the potentially distortionary and destabilising effects of an asymmetric tax system that treats gains and deductions differently,[13] the AFTS Report made no observations about the potential impact of the income tax system on the housing system.

This section provides estimates of the extent of the taxes, tax expenditures and transfers that affect housing to provide an indication of their respective orders of magnitude. Generating these estimates is problematic for a number of reasons. The first is that the array of property taxes that affect housing or residential property may, or may not, apply specifically to housing and may, or may not, apply differentially depending on whether housing is owner-occupied or rented. The second is that housing is affected as much by what is not taxed as by what is taxed. This is particularly relevant for the impact of income and consumption taxes that apply generally to other goods or assets but from which housing often is exempt. Again, these exemptions may apply differentially to different types of housing. For these and other reasons, assessment of the size of a number of

12 Australian Treasury (August 2008), p 253 (Box 8.1). This overview followed immediately from a discussion of real effective marginal tax rates in the background paper (Australian Treasury, August 2008, p 252). Of passing interest is the difference between these estimates and those presented in the AFTS Report (Pt2, Vol 2, p 67) despite the same assumptions regarding key parameters. These differences highlight the sensitivity of such calculations to specific assumptions made.

13 AFTS Report, Pt 2, Vol 2, p 74.

housing taxes, tax expenditures or transfers requires a number of assumptions to be made. As a result, the estimates recorded here should be regarded as indicative rather than authoritative. Some of the issues involved in providing specific estimates are discussed briefly below.

3.1 Taxes

In their collection of revenue statistics, the OECD includes the following in the property tax category: taxes on immovable property, taxes on net wealth, inheritance and gift taxes, taxes on financial and capital transactions and other non-recurrent taxes on property such as once and for all taxes. Of these, two broad categories dominate: recurrent taxes on immovable property, such as land taxes or rates; and transaction taxes, such as stamp duties, based on property transfers. In 2006, property taxes in the OECD contributed 5.7% of total tax revenue, with taxes on immovable property and transaction taxes accounting for almost 95% of this contribution. In Australia, property taxes contributed 9.1% of total tax revenue in 2006 with taxes in the two key categories each accounting for approximately half of the revenue raised from property taxes.[14] In 2005-06, land taxes in Australia raised $3.6 billion, municipal rates raised $8.8 billion and stamp duties on conveyances raised $10.8 billion (ABS, 2010, Table 18).[15]

Not all of these property taxes, however, are taxes on housing. They are, however, often regarded as taxes on housing because of the significant contribution that residential property (primarily through land values) makes to the property base. Freebairn (2009), for example, attributes 70% of transactions taxes to taxes on housing. A similar figure is likely to apply to the local government rates component of taxes on immovable property but, because owner-occupied housing is exempt from land tax and because of the relatively high thresholds that apply in most jurisdictions, the burden of the (relatively low revenue raising) land tax on housing is considerably smaller.[16] In principle, developer charges are also included in the OECD definition of property taxes. The AFTS Report (Pt 2, Vol 2, p 423) reports a total of $0.7 billion in 2005-06 from the two largest States. ABS (2010, Table 18) reports a total of $0.9 billion for all States. Data from taxation statistics (ATO, 2008, Table 16) indicate that rental investors claimed approximately $0.5 billion in land tax expenses in 2005-06.

Unlike a number of countries, Australia has no wealth taxes, also included in the OECD definition of property taxes. The contribution of such taxes elsewhere, whether through net wealth taxes or wealth transfer taxes, was less than 0.5% of total tax revenue across all OECD countries in 2006. As with the taxes above, such taxes are often classified as taxes on housing because of the dominant contribution that housing, and particularly owner-occupied housing, makes to individual net wealth either during or at the end of an individual's lifetime.

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14 The sensitivity of stamp duties in particular means that its contribution varies considerably over the property cycle.

15 Data are reported for 2005-06 for consistency with tax expenditure data reported below. The respective estimates for 2008-09 (the latest available by mid 2010) are $5.5 billion for land taxes, $10.0 billion for rates and $9.5 billion for stamp duties. Other taxes on immovable property amounted to $1.1 billion in 2007-08.

16 The Commonwealth Grants Commission (2008, p 10) attributes less than 30% of total land tax collected in 2006-07 to taxes on residential land.

In total, these taxes have the capacity to have an impact on housing but, as considered below, a far greater impact is likely to be felt by the range of tax expenditures that arise from exempting housing from the tax base.

3.2 Tax expenditures

Tax expenditures are generally defined as a departure from the generally accepted or benchmark tax structure which produces a favourable tax treatment of particular types of activities or taxpayers, but the question of what constitute tax expenditures is not clear cut because of the difficulties in defining a generally accepted benchmark. This can be illustrated by the differences in the international tax treatment of housing shown in Table 2 which highlights the different ways in which both owner-occupied and investor housing are treated in a range of OECD countries. The current tax treatment of owner-occupied housing in the Australian tax system leads to it being described as a (pre-paid) consumption tax (in that there is no tax paid on the income from housing but purchase costs are not tax deductible). [17] The AFTS Report recommends it should stay this way:

> Australia's personal income tax system should continue to represent a hybrid personal income tax - with income from long-term, lifetime, savings taxed at a lower rate than other income or exempt from income tax. In particular, the main forms of lifetime savings for most Australians, superannuation and owner-occupied housing, should continue to be taxed at a lower rate or exempt from income tax - consistent with an expenditure tax benchmark that exempts the returns to saving. [18]

Whether housing is taxed according to a consumption or expenditure base, while income is taxed, the exemption of income from housing from the tax base means that housing is treated differently from other goods and services with consequent efficiency and equity implications. The extent of favourable treatment can be measured against either a tenure neutral (where all types of housing are treated similarly by the tax system) or a tax neutral (where income from housing is treated in the same way as income from other assets) benchmark. Yates (2010) provides a detailed discussion of the issues associated with identifying tax expenditures. Further discussion can be found in the Treasury's annual tax expenditure statement (Australian Treasury, 2010b) where estimates are made under both a tenure neutral and tax neutral benchmark.

Tax neutrality is difficult to determine because of the variety of ways in which income from assets is treated in the tax system, as shown by the range of effective marginal tax rates that apply to savings by asset class in the AFTS Report. [19] Tenure neutrality, however, is more straightforward. On a tenure neutral basis, owner-occupied housing would be treated in the same way as investor housing: that is rental income would be taxed; mortgage interest and operating costs would be tax deductible and capital gains would be taxed at a 50% concessional rate. On a tax neutral basis, investor housing is advantaged by the concessional treatment of capital gains, by the taxation of gains on realisation rather than accrual and by the asymmetric tax treatment of income and deductions.

A majority of OECD countries have tax systems that are based on a comprehensive income base but, as the examples in Table 2 imply, none apply it in

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17 AFTS Report, Pt 2, Vol 1, p 97.

18 AFTS Report, Pt 2, Vol 1, p 12. A pure consumption tax, however, would tax bequests.

19 AFTS Report, Pt 2, Vol 1, p 67.

its purest form. In part this can be attributed to the political impossibility (and administrative difficulties) of fully taxing owner-occupied housing in the same way as other forms of capital income (and, in particular, of fully taxing imputed rent and taxing capital gains or losses on accrual rather than realisation). In part it arises because of the use of nominal rather than real income as the tax base and of annual income. [20]

Table 2: International Comparison of Taxation Regimes

	Tax on imputed rent	Interest tax deductibility		Negative gearing	Deprec^{n}	Capital gains tax		Land tax	
	Owner	Owner	Investor	Investor	Investor	Owner	Investor	Owner	Investor
Australia	no	no	yes	yes	yes	no	half	L	yes
Canada	no	no	yes	yes	yes	no	half	yes	yes
France	no	no	yes	L	yes	no	no	L	L
Germany	no	no	no	yes	yes	no	no	L	L
Netherlands	yes	yes	n/a	n/a	no	n/a	n/a	yes	yes
NZ	no	no	yes	yes	yes	no	no	L	L
Sweden		yes	yes	yes	no	L	L	yes	yes
Switzerland	yes	yes	yes	no	outlays	yes	yes	yes	yes
UK	no	no	no	no	no	L	yes	yes	yes
USA	no		yes	L	yes	no	yes	L	yes

L = Limited

Sources: Derived from Ellis (2006, p 11) and Lawson and Milligan (2007, p 46).

In the same way that housing benefits from tax expenditures associated with the income tax base, it also benefits from similar concessions in relation to other major tax bases employed in OECD countries. The most obvious is the consumption or sales tax base. In the same way that proposals have been made to move from a comprehensive to a dual income tax system, often proposals to move from an income to a consumption tax base are based on a desire to reduce the distortions that arise from the failure to adequately tax income from owner-occupied housing (or, more generally, from failures to tax capital income neutrally). The broader question of whether income or consumption should be taxed has been discussed at length (for example, Zodrow, 2000) but while both are taxed, issues associated with exemptions from the tax base of either remain.

Australia, like most OECD countries, employs a broad based consumption tax that taxes goods and services at a flat rate. However, both rent and imputed rent are exempt from the GST. While this exemption from the tax base generally can be regarded as a tax expenditure, an exception can arise if housing is taxed on a pre-payment approach. In principle, this occurs if sales of new housing and

20 A pragmatic response to this has been to employ a dual income tax system such as that introduced in most of the Nordic countries in the early 1990s. A basic principle of the dual income tax is neutrality in capital income taxation which means that, in principle, both (real) capital gains and an imputed rent from owner-occupied housing would be included in the tax base but both would be taxed at a lower rate than labour income (Sørensen and Johnson, 2009, p 113). However, in most of the Nordic countries, owner-occupied housing is still treated concessionally (as can be seen in Table 2).

renovations are taxed at the point of sale which means that the consumption tax on the service flow over the life of the asset is pre-paid at the time the house is purchased. In practice, however, pre-payment of a tax on services means that windfall gains are not taxed and, in any case, exemptions to the pre-payment approach often apply. In Australia, new homes are taxed at the standard rate (of 10%) but new home buyers (of either new or existing homes) are provided with a first home owner grant to compensate for the tax.

Distortions and equity effects arise from tax expenditures whether these are associated with a consumption tax base or with an income tax base. These are considered in *The impact of housing taxation on housing* below.

3.3 Transfers

The final group of measures in Australia's tax and transfer system that affect housing are those made under its system of transfer payments. The more significant of these are considered here.

As with many of the taxes and tax expenditures considered above, housing assistance in Australia is provided in a way that differs according to the tenure of the recipient. Commonwealth rent assistance (CRA) is available to private renters who are in receipt of an existing transfer payment. In 2005-06, $2.1 billion was paid in CRA. By 2008-09 this had increased to $2.6 billion (Productivity Commission, various years). In principle, rent assistance provides a subsidy to rent paid; in practice, over 70% of recipients receive the maximum amount available which means that CRA acts as an income supplement to eligible persons who rent privately. No assistance is provided to low income renters who are not in receipt of social security payments. Tenants in public housing pay income related rents which generally are below market rents. Total assistance provided in 2007-08 has been estimated to be around $1.3 billion (AFTS Report, Pt 2, Vol 2, p 599).

First home purchasers have received assistance in the form of the First Home Owner's Grant (FHOG) since 2001, supplemented by the First Home Owner's Boost (FHOB) as part of the Government's stimulus package. The untargeted FHOG has varied between $7,000 and $14,000 depending on whether it is used to purchase new or existing dwellings. Until the introduction of the FHOB, approximately $1 billion per year was being spent.[21] Since 2008, assistance has also been available in the form of tax advantaged first home savers accounts but there has been only limited take up of these in the first years of their operation.

Assistance to existing owners is provided through the exemption of the family home from a number of assets tests that apply. As with tax expenditures, an assessment of these must be made against a well-defined benchmark. An obvious choice is a tenure neutral benchmark which provides owner-occupiers with the same level of exempt assets as currently available to non-owner-occupiers. Income and asset test free areas and cut out points as at September 2009 are outlined in the AFTS Report (Pt 2, Vol 2, p 546). Updates are available from the Department of Families, Housing, Community Services and Indigenous Affairs (FaHCSIA)

21 FHOB outlays have effectively doubled these outlays for the period for which the stimulus has been in operation. Also, generous supplements to FHOG and FHOB have been provided by State governments. Neither the FHOB payments nor the State based supplements are recorded here, on the ground that these have been part of a stimulus response rather than part of the tax/transfer structure.

website.[22] At September 2009, home owners were able to hold $129,000 more in assets than were non-home owners before the assets test meant they became ineligible for a pension. No estimate has been made of the total value of this concession because of its interaction with the income test. Gavin Wood[23] suggests a value of around $700 million if the exemption limit for owner-occupied housing was set at the 90th percentile of the home owners' housing equity distribution.

3.4 Summary

Table 3 provides an indication of the relative order of magnitude of a selected range of the taxes that affect housing in one way or another.[24] A number of initiatives that are currently relatively small programs, or are once-off initiatives, have not been included in this Table. Examples are the First Home Savers Accounts (FHSA) providing matched grants and tax free savings for those saving for a first home and the National Rental Affordability Scheme (NRAS) that provides tax credits to investors in social rental housing and aims to add 50-100,000 new rental dwellings to the housing stock. Each currently account for less than $100 million per year. More details of these smaller programs can be found in the AFTS Report (Pt 2, Vol 2, p 601) and NHSC (2010, pp 79-91).

Table 3: Estimates of Aggregate Values of Taxes, Tax Expenditures and Transfers

	Yates	Official	
	2005–06	2005–06	2007–08
Income base	$b	$b	$b
owner-occupied housing			
net imputed rent exemption	6.9	2.5	4.0
non-taxation of imputed rent		19.0	21.0
non-deductibility operating costs		–16.5	–17.0
non taxation capital gains	29.8	39.5	43.5
investor housing			
discount on capital gains	4.2	2.0	3.6
rent less deductions (neg. gearing)	1.2	na	na
Consumption base			
owner-occupied housing			
non taxation rental services	4.8	na	na
rented housing			
non taxation rental services	1.6	na	na
all new housing			
GST on land and new housing	na	–6.0	–6.0
Property base			
owner-occupied housing			
less FHB concessions	na	na	1.7
exemption from land tax	3.5	na	3.6
pensioner exemptions from rates	na	na	0.2

22 http://www.fahcsia.gov.au.

23 Personal communication with the author.

24 Yates (2010, pp 125-134) provides estimates from other sources (Senate Select Committee, 2008; Freebairn, 2009; and Abelson and Joyeux, 2007) and explains the sources of difference in the various estimates.

investor housing			
land tax	–0.5	–0.5	–0.5
all housing			
stamp duties on conveyancing	–10.8	>–10.8	>–13.0
rates	–8.8	>–8.8	>–9.4
other (incl user charges	–0.9	–0.9	–1.1
Transfers			
private renters			
CRA (private)	2.1	2.1	2.1
subsidised rent (public)	1.2	1.2	1.6
owner-occupiers			
FHOG (purchaser)	1.0	1.0	1.0
assets test exemption (owners)	0.7	na	na

Sources: Taken where available from Australian Treasury (2008a, 2010b); AFTS Report, Pt 2; ABS (2010); ATO (2008); Commonwealth Grants Commission (various years) and AIHW (2007, 2008). Supplemented with GST estimates from Freebairn (2009) and Abelson and Joyeux (2007); asset test exemption estimates from Gavin Wood (personal communication).

As can be seen from Table 3, housing is affected by a variety of taxes, tax concessions and transfers. Abelson and Joyeux (2007, p 17) describe housing as a paradox given the coexistence of numerous taxes and substantial subsidies, many of which apply simultaneously. However, as Table 3 also shows, subsidies in the form of tax expenditures to owner-occupied housing under the income tax system dominate. The most recent Tax Expenditure Statement (Australian Treasury, 2010b, p 7) points to the capital gains exemption as being the most significant of all the reported tax expenditures for 2009-10 (despite being considerably lower in 2008-09 than the data reported in Table 3 because of a slowing of dwelling price inflation).

4 THE IMPACT OF HOUSING TAXATION ON HOUSING

The impact of the taxes and concessions varies considerably according to the tax base against which the concession is benchmarked, and according to whether housing is owned or rented. As a consequence, these taxes and concessions can have very different distributional effects. However, all have one common effect: they introduce considerable distortions into the price that people pay for housing services or into the return they receive on their housing assets. As such, they have the potential to introduce inefficiencies into the way in which the housing market operates.

4.1 Distributional effects

At an aggregate level, the tax expenditures from the major tax exemptions listed in Table 3 provided an average annual subsidy of almost $7,000 per household per year in 2005-06. The benefits, however, are not equitably distributed. Owner-occupiers, high income households and older owners all benefit disproportionately. By tenure, they are equivalent to a subsidy to:

- owner-occupiers of more than $8,000 per household per year;
- renters of just over $1,000 per year.

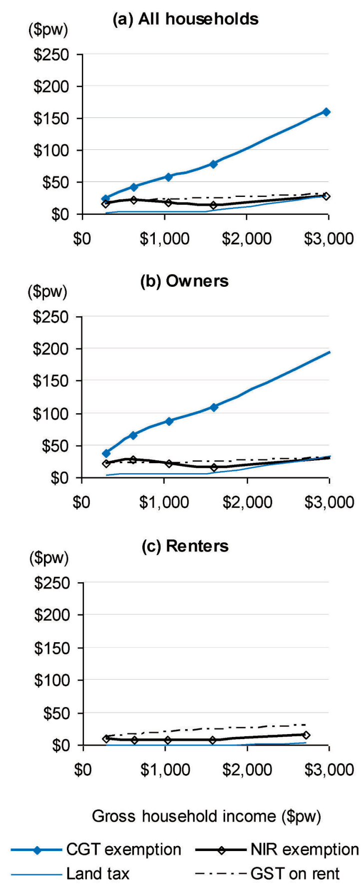
The value of these subsidies also varies by income and by age as well as by tenure:

- for all households (that is, owners and renters) in the top income quintile, the average annual benefit from the largest of the tax exemptions alone (exemption of the family home from the capital gains tax) is over $8,000 per year, around seven times the average annual benefit of $1,200 per year for households in the lowest income quintile;
- for owners in the top income quintile, the average annual benefit of the capital gains tax exemption is more than $10,000 per year;
- households in the top income quintile also receive an average benefit of approximately $1,500 per year from the exemption of the family home from land tax, more than nine times the average annual benefit of $160 for households in the lowest income quintile;
- for owners in the top quintile, the average annual benefit of the land tax exemption is around $1,800;
- the benefits from the exemption of imputed rent from both the income tax and the goods and services tax is more equally distributed by income quintile with households in the top income quintile deriving a benefit of around $900 per year, less than double the $500 benefit for those in the lowest income quintile.

The overall distribution of tax expenditures to owners and renters by household income and tenure are shown in Figure 1 and, for selected age groups, in Figure 2. The assumptions that underlie these estimates, more detailed breakdowns and dollar values for the estimates illustrated can be found in Yates (2010). [25]

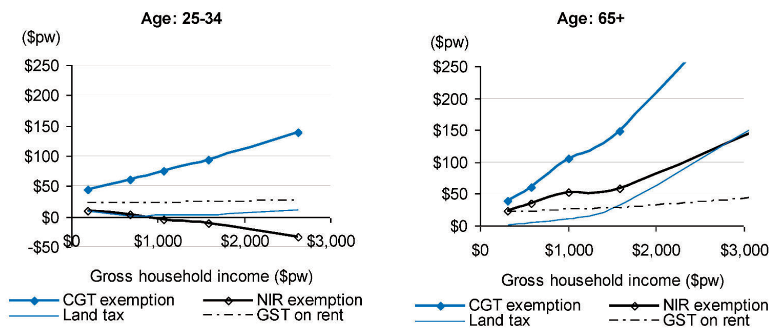
25 The key estimates in Yates (2010) that are presented here were derived from unit record data on relatively conservative assumptions. Notional imputed rent (NIR) estimates were based on the ABS experimental estimates of imputed rent for 2005-06 (ABS, 2008) and capital gains estimates were based on the assumption of capital gains of 4%. Over the period from 1985 until 2006, actual gains were 8% per year and real gains were 4% per year. In both cases, the tax rate applied was that of the higher income earner in the household based on taxable income without housing income included in the base. An earlier draft of Yates (2010), prepared for the Brotherhood of St Laurence, is available at: http://www.ahuri.edu.au (accessed on 31 July 2009).

Figure 1: Tax Expenditures by Household Income and Tenure



Source: generated from ABS (2008).

Figure 2: Tax Expenditures by Income, Tenure and Selected Age Groups, Owners: 2005–2006



Source: generated from ABS (2008).

Figure 1 highlights the significantly greater extent to which high income rather than low income households benefit and the greater extent to which owner-occupiers benefit compared with renters. Figure 2 highlights the extent to which younger owner-occupiers (most of whom have relatively low equity in their dwellings and face high mortgage debt) are relatively disadvantaged by the structure of tax expenditures because of their inability to deduct the costs of purchasing their home from the income it produces. This disadvantage, however, is greatest for higher income younger purchasers because of their greater borrowing capacity. Overall, the greatest benefits go to older owners who are outright owners, who benefit both from the increased value of their dwelling over time and from the increased value of the rental services it provides.

These estimates are taken from a study (Yates, 2010) that focused solely on the distributional impact of tax expenditures and so exclude direct subsidies provided as a result of assistance provided to first home owners (for example, through first home owners grants) and to private renters (for example, through rent assistance). The estimates also exclude the effects of the explicit taxes on housing reported in Table 3. Rates are likely to have a similar impact to the subsidies that are related to dwelling rental values.

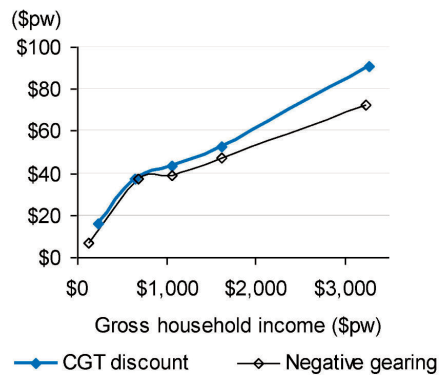
Distribution of the $2.1 billion provided as Commonwealth Rent Assistance across 1.6 million private renter households in 2005-06 results in an average subsidy of around $1,300 per year. Unlike tax expenditures, however, CRA is well targeted and is paid primarily to the 600,000 renter households in the bottom two quintiles of the income distribution.[26] The in-kind benefits provided through public housing are also well targeted to lower income renters. Public housing tenants are estimated to receive benefit of approximately $5,000 per year or $100 per week (AIHW, 2008, p 19).

Subsidies that are specifically targeted to rental investors are similarly perversely distributed. Figure 3 shows the distributional implications of the 50%

26 The Productivity Commission *Report on Government Services* (2007, Table 16.1) reports average CRA per eligible income unit as $2,236 per year or just over $40 per week for 2005-06.

capital gains discount and the benefit of being able to deduct costs associated with income from rental housing against other sources of income.[27]

Figure 3: Tax Expenditures by Income, Investors: 2005–2006



Source: generated from ABS (2008).

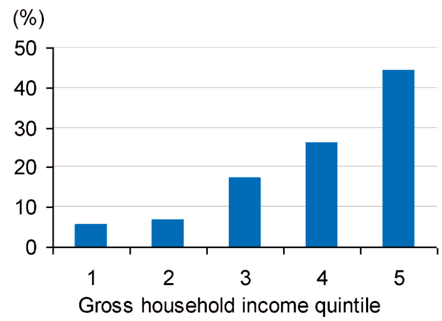
As investors are often the same households who benefit extensively from the subsidies to owner-occupation, the subsidies illustrated in Figure 3 generally reinforce those illustrated in chart (b) in Figure 1. These subsidies provide additional benefits to:

- investors (most of whom are also owner-occupiers) of more than $4,000 per household per year; and to
- high income households who invest in rental housing of $1,500 per year from the capital gains tax discount. The smaller number who negatively gear receive a tax advantage of a further $3,000 per year.

Figure 4 shows that the proportion of rental investors who negatively gear increases as household income quintile increases.

27 As above, more details can be found in Yates (2010).

Figure 4: Proportion of Households with Rental Losses by Household Income: 2005–2006



Source: generated from ABS (2008).

4.2 Efficiency effects

Preferential tax concessions to owner-occupied housing potentially encourage excess consumption of and investment in owner-occupied housing; distort tenure choice in favour of owner-occupation; and contribute to urban sprawl.

Subsidies for home ownership often are justified on the grounds that there are externalities associated with home ownership:

> The value of housing derives from more than the day-to-day shelter it provides. More than two-thirds of Australians enjoy the benefits of owning their own home. Whether they are a first homeowner with little equity or a retiree whose mortgage has been paid off, the security of tenure associated with home ownership provides an additional benefit over and above physical shelter. In many areas, a stable base of home ownership underpins social integration. Home ownership can benefit not only homeowners, but their communities too. [28]

To the extent that these arguments can be supported, they provide an argument for assisting those who would not otherwise become home owners into home ownership (and for protecting those at risk of falling out of home ownership). However, none of them provide a justification for providing greater subsidies for high income home owners. As recognised by the Senate Select Committee on Housing Affordability in Australia (2008, para 4.38), tax expenditures support home owners, not home ownership. Similar outcomes arise from the exclusion of the family home from the means tests for government payments. The perverse effects they can have on home ownership are covered below.

Insofar as these, or any of the other taxes and concessions that affect housing, do not correct for market failures that might exist in housing markets, the distortions they introduce involve efficiency costs or deadweight losses (Freebairn,

28 AFTS Report, Pt 2, Vol 2, p 410. An overview of social benefits of home ownership can be found in Rohe *et al* (2003) or Dietz and Haurin (2003). Increasingly, however, the methodologies that have led to these conclusions are being questioned. Aaronson (2000) and Apgar (2004) point to omitted variable biases, as does Shlay (2006, p 511) who suggests that [the] "alleged effects of homeownership may be artefacts of self-selection and the conflation of homeownership with unobserved characteristics coincident with buying homes".

2009, p 13).[29] Estimates of the extent of these inefficiencies, however, tend to suggest that deadweight losses are relatively low (see, for example, Reece, 1975; Piggott, 1986; Abelson and Joyeux, 2007) primarily because supply elasticities are assumed to be relatively low.

In general, efficiency losses (and who bears the burden or who benefits from the taxes and subsidies that affect housing) depend on the responsiveness of housing supply and demand. In the short run, the supply of housing is almost completely inelastic: annual completions (which are greater than net additions) represent less than 2% of the total housing stock.[30] Demand, however, can vary in response to price changes, even in the short run and, when influenced by speculative factors, is likely to do so. Given this short run inelasticity of supply, any decrease in a tax on housing or increase in a subsidy that results in an increase in demand (whether from owner-occupiers or landlords), therefore, is likely to benefit existing owners of housing and land in the first instance.[31] In principle, as supply elasticity increases in the longer term, the burden or benefit of taxes and subsidies is more likely to be shared by buyers and sellers. Only in the extreme case of an infinitely elastic supply will all of the burden be borne or benefit enjoyed by the buyer (or those demanding housing). Over time, the responsiveness of supply depends on the extent to which new land is released for housing, on the intensity of use of newly released land and on changes in the intensity of use of existing land for housing.

Whenever the elasticity of supply is less than infinite, subsidy induced increases in housing demand (reflected in the demand for bigger and better quality dwellings in better locations), are capitalised into dwelling prices. They are also likely ultimately to add to pressures on rents for those who are renting privately.

Existing taxes, as well as tax expenditures, also have significant efficiency effects. Stamp duties, for example, disproportionately affect movers over those who stay put, and contribute to inefficient use of the existing housing stock by discouraging households from moving. The AFTS Report lists a number of associated inefficiencies that follow. Amongst these are: reduced mobility and associated higher unemployment and lower productivity; increased commuting and associated increased congestion, and increased renovation and an associated

29 There are numerous non-tax factors that contribute to inefficiencies in housing markets. Housing is lumpy and spatially fixed. It is heterogeneous – no dwelling is exactly the same as another. It is a long-lived asset that is traded relatively rarely. As a result of these characteristics and idiosyncratic preferences of consumers, housing markets are thin (Arnott, 1989). These and other factors contribute to further imperfections. Information on dwelling prices and rents is relatively poor which creates uncertainty. Transaction costs (not just financial costs, but also psychological and other costs associated with relocation) are high. Capital markets are imperfect. Households are unable to borrow against expected future income and are unable to insure against income loss. Agency costs exist in rental markets. Positive externalities (such as greater social stability) are associated with high levels of tenure security (often incorrectly presumed to be provided only by owner-occupation).

30 Abelson and Joyeux (2007) point out that expenditure on alterations and additions also needs to be taken into account when examining supply response.

31 Note that existing owner-occupiers are both demanders and suppliers of housing services.

larger housing stock with higher environmental costs.[32] They also reduce access to housing for those who are credit constrained.[33]

In principle, land taxes are efficient because the immobility of land makes them difficult to avoid. They will be fully capitalised into land prices and borne by existing land owners. In practice, however, because the current land tax regime exempts owner-occupiers, land taxes distort land use and fall more heavily on rental investors and, through investors, onto renters. Because they apply cumulatively, they also discourage large-scale investors in rental property. This further adds to rent pressures by limiting the extent to which landlords reduce risk by diversifying their portfolios and the extent to which they can benefit from economies of scale in tenancy management. The current structure of land tax in Australia is often given as one of the reasons why the private rental market is dominated by ″Mum and Dad″ investors and why there is limited investment in rental housing by institutional investors.

4.3 Price effects

By subsidising owners of housing (whether as owner-occupiers or investors), the demand for housing is increased and the value of the subsidy is capitalised into higher house prices. Owners are compensated for this by the subsidies they receive; renters are not. Overall, therefore, the subsidies provided to housing through the tax expenditures covered in this chapter are both vertically and horizontally inequitable. The largest benefits go to high income owner-occupier households. The smallest benefits go to low income renter households. For existing owners, dwelling price increases often are seen as a benefit. It is the potential downward pressure on house prices that removal of a subsidy or imposition of a tax might bring about that contributes significantly to political difficulties that arise when the question of changing the existing structure of taxes and subsidies is raised.

It can be argued, however, that, unlike increases in financial wealth, increases in house prices or housing wealth do not make households better off at all and that “housing wealth isn’t wealth” at all. This argument is based on the claim that any increase in housing wealth will increase the opportunity cost of the services provided by housing (Buiter, 2008). Higher house prices are thus offset by an increase in the (actual or imputed) cost of housing consumption. However, this holds only if home owners live in their dwellings indefinitely. Because households do not live indefinitely and because not all households are home owners or are consuming their desired level of housing services, there are strong distributional effects of increases (or decreases) in house prices. For every current home owner made better (worse) off, a future home owner or a renter is made worse (better) off. Buiter argues (2008, p 1):

> The fundamental value of a house is the present discounted value of its current and future rentals, actual or (in the case of owner-occupiers) imputed. Anyone who is “long” [in] housing, that is, anyone for whom the value of their home exceeds the present discounted value of the housing services they plan to consume over their remaining lifetime, will be made worse off by a decline in house prices. Anyone “short” [in] housing will be better off. So the young and all those planning to trade up

32 AFTS Report, Pt 2, Vol 1, p 255.

33 Many States, however, do have stamp duty concessions for first home buyers.

> in the housing market are made better off by a decline in house prices. The old and all those planning to trade down in the housing market will be worse off. Another way to put this is that landlords are worse off as a result of a decline in house prices, while current and future tenants are better off.

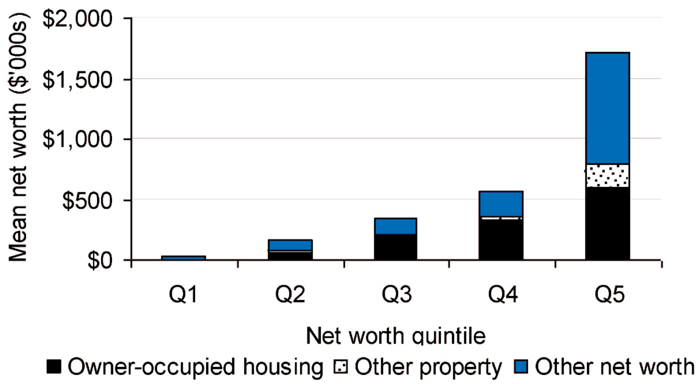
There is, therefore, an inherent political conflict between a desire to make housing more affordable for renters and future home owners and a desire to protect the housing wealth of the majority. In Australia, the highest home ownership rates and the highest rates of ownership of investor housing are observed amongst middle age and older households. The demographic reality of an ageing population (who entered home ownership in an economically more benign era) means the political scales are tilted in their favour.[34]

Richards (2008) suggests that, because they are affected on both sides of the balance sheet, owner-occupiers can be thought of as being "hedged" against increases in the cost of housing. He also suggests that the gap between older and younger households may be narrowed if older households do not extract the value of the increased equity in their dwelling but pass this on in the form of inheritance to the younger generation. Given wealth disparities in the distribution of wealth are even greater than disparities in the distribution of income, and that most housing wealth is held by households who also hold most other forms of wealth, such behaviour has the scope to increase intergenerational inequities and to disadvantage children whose parents did not become home owners. Such children are likely already to be disadvantaged by their parents' lower income status and by the insecurity of tenure that is a characteristic of the private rental tenure.

In 2005-06, persons in the top quintile of the equivalised income distribution had 39% of total income; households in the top quintile of the net worth distribution had 61% of total net worth. Average net worth of renter households was only around 15% of the total net worth of owner households (ABS, 2007, p 10). Figure 5 illustrates the distribution of net worth and shows the considerable contribution that owner-occupied property (and to a lesser extent other property) makes to net worth.

34 Yates (2007) provides an overview of the different factors that have affected access to home-ownership.

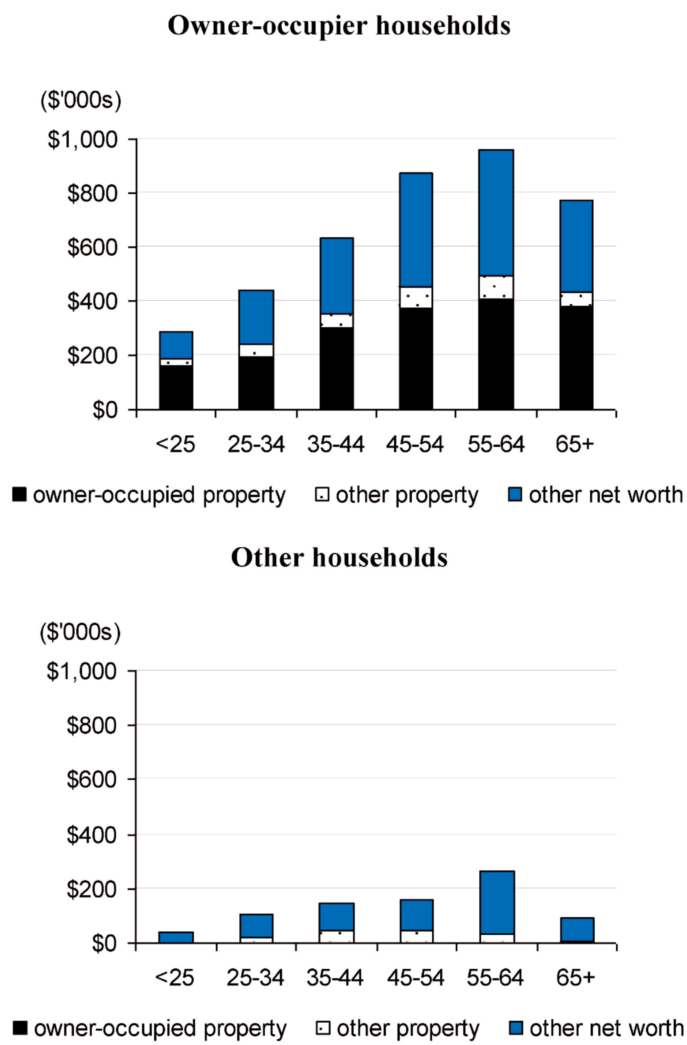
Figure 5: Distribution of Household Wealth by Net Worth Quintile: 2005–2006



Source: generated from ABS (2008).

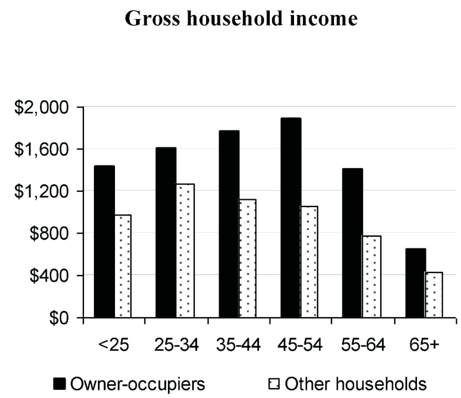
Tenure, net worth and income are all affected by life-cycle characteristics. However, disaggregation of both net worth and income data by age shows that renters are economically disadvantaged compared to their owner-occupier counterparts. Figure 6 provides a breakdown of net worth by tenure and age. Figure 7 does the same for gross income and equivalised disposable income (to allow for differences in household structure). Both show that, at any stage in their life-cycle, renters are economically disadvantaged compared with owners.

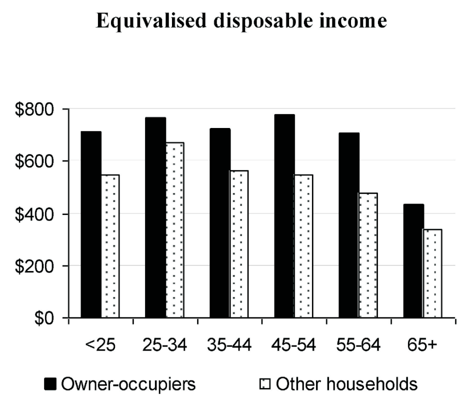
Figure 6: Distribution of Household Net Worth by Age and Tenure: 2005–2006



Source: generated from ABS (2008).

Figure 7: Distribution of Household Income by Age and Tenure: 2005–2006





Source: generated from ABS (2008).

This section has suggested that one reason why it is politically difficult to implement changes that might result in a downward pressure on house prices, however advantageous this might be for those who do not yet own their own dwellings, is that existing owners and, in particular, older owners benefit from increases in dwelling prices.

4.4 Other effects

It has also been suggested that such biases can increase price volatility. Van den Noord (2005, p 31) provides an argument for why this might happen:

> Even though tax incentives by themselves do not cause volatility in house prices (except in the period immediately following their introduction as prices adjust to the new equilibrium), they interact with and magnify the shocks that impinge on house prices.

He also suggests that well functioning rental markets can reduce this pressure. Rental markets affected by speculative investment driven by asymmetric treatment of gains and losses, however, are unlikely to do this.

Part of the rationalisation provided in the AFTS Report for the proposed more neutral tax treatment of savings (brought about by introduction of a uniform 40%

discount on interest income, net residential property income, capital gains and also to certain interest expenses) is that this will reduce the current bias towards negative gearing and improve macroeconomic stability.[35] A uniform discount would reduce some of the bias that currently benefits investors who earn capital gains. However, the pragmatic necessity of retaining tax on realisation rather than accrual means that none of the deferral advantages are addressed, and geared investment is still relatively more advantageous than that with no gearing.

Because a switch to a 40% discount rate would reduce the discount that currently applies to capital gains with a presumed movement out of rental housing by investors, an increase in rents and increased need for rental assistance for tenants, the AFTS Report highlights the need to reform housing assistance measures before any distortions are reduced.[36]

In a recent quantitative study, Wood and Ong (2010, p 5) suggest that the shortages observed in the low rent end of the private rental market can be attributed to a number of sources of market failure: namely, principal-agent problems, taxation measures and regulations. Agency costs arise because of the excess demand for affordable rental properties; taxation measures arise because the asymmetric treatment of rent and capital gains in residential rental property results in low tax bracket investors with high user costs being clustered in the low rent (but high gross rental yield) segment of the market (Wood and Tu, 2004, p 431). Their high user costs create a relative disincentive for investment in low rent dwellings. Their low incomes mean that they are vulnerable to cyclical downturns that affect short term returns on investment. Wood and Ong show that an after-tax economic cost (user cost) variable is an influential variable in persuading many investors to exit the market.[37]

5 THE CONTRIBUTION MADE BY THE AFTS REPORT RECOMMENDATIONS IN CONTRIBUTING TO HOUSING CHALLENGES

The previous section has focused primarily on the impact of aspects of the tax system that were ignored, but did not go unnoticed, by the Review. It has shown that the tax expenditures that exist in the current income tax system are inequitably distributed and do nothing to contribute to housing affordability. They favour owners once they have paid off their mortgage; they support those who can afford to borrow to invest in rental housing. They disproportionately benefit older, high income home owners. By lowering the user cost of housing for owner-occupiers (and for negatively geared investors) they reinforce factors that add to housing demand and add to dwelling price pressures in the presence of

35 AFTS Report, Pt 1, p 74.

36 AFTS Report, Pt 1, p 74.

37 They also show that negatively geared investors are more likely than others to exit. On the other hand, on the basis of a qualitative study, Seelig *et al* (2009, p 4) conclude "that the picture of the sophisticated, well-informed and economically rational investor does not well describe the norm among rental investors. A mix of 'bounded rationality' and 'emotional opportunism' is perhaps a better descriptor of how people approach the housing market as prospective rental investors".

supply inelasticities. They provide greater incentives for investors in high rent properties than for investors in low rent properties and, therefore, do little to add to the supply of low rent dwellings.

The Henry Review was not unaware of these effects:

> The personal tax system affects the affordability of rental housing through the assessment of income from investment in residential rental properties, offsetting expenses (such as interest costs) and capital gains. The housing market is also affected by the exemption of owner-occupied housing from the personal income tax and the capital gains tax system, stamp duties on housing transactions, GST on the price of supplying new housing, council rates and land taxes… Similarly, when the tax system affects housing prices it can also affect fairness, for example, if the tax system makes it difficult for disadvantaged groups to afford housing. [38]

The question that this final section addresses is whether the recommendations made in the AFTS Report do enhance Australia's economic and social outcomes as they are reflected in its housing system, whether they enhance taxation arrangements on property and whether they improve access to affordable housing.

5.1 Stamp duties and land taxes

Recommendations 51 and 52 proposed that stamp duties be abolished and be replaced with a broad based and progressive land tax. As a turnover tax, stamp duties were seen as having a range of efficiency and equity effects. However, while the significant tax incentives that encourage over-consumption and over-investment in owner-occupied housing remain, it is not obvious that stamp duties are the primary determinant of a poor allocation of resources in the housing system. Also, given the presumption that stamp duties can add to the factors that constrain access to owner-occupation for credit constrained borrowers, their removal could add to pressures on dwelling prices without an offsetting tax to replace them. This is one reason why the AFTS Report recommended that stamp duties be replaced by a land tax. [39] A more obvious reason is the need to protect the States' revenue base.

As a tax on an immobile factor, a broad based land tax on the unimproved capital value of land is efficient. It captures the economic rent that arises from the increases in land value that arise from population pressures and economic growth. [40] The recommendation that the land tax base eventually should be broadened to include all land (that is, owner-occupied as well as agricultural land) might be seen as an attempt by the AFTS Report to offset some of the perverse and distortionary benefits that arise from the tax exemptions accorded to the income from owner-occupied housing. Because economic rent does not arise from savings, its taxation will not create savings disincentive effects. Although the AFTS Report argued [41] that, in general, land tax is not a good tool for achieving vertical equity objectives because land holdings are just one component of a person's wealth portfolio, the recommendation that a progressive rate be applied with an

38 AFTS Report, Pt 2, Vol 2, pp 415-416.

39 AFTS Report, Pt 2, Vol 1, p 264.

40 The AFTS Report illustrates the equivalence of a 1% tax on land rent and a 17% tax on economic rent (Pt 2, Vol 1, p 270).

41 AFTS Report, Pt 2, Vol 1, p 250.

increasing marginal rate schedule and a threshold determined by a per square metre value could be interpreted as an implicit recognition of the vertical inequity associated with the current income tax exemptions for owner-occupied housing.

Once the argument for taxing (unearned) capital gains from owner-occupied housing is dismissed, it becomes critical to examine an alternative way of doing this if horizontal and vertical equity objectives are to be given any credence. This is where land tax proposals come to the fore. In taxing economic rent, or the unearned incremental increases in land values arising from increasing demand in light of restricted land supply, land taxes can be used as an alternative to replace capital gains taxes on owner-occupied housing. As such, they are beneficial in helping to reduce the demand pressures that drive housing affordability problems.

Also, by broadening the base and applying the tax on a per holding basis, rather than on aggregate land holdings, the recommendation should result in a reduced land tax burden on rental investment properties and should remove one of the disincentives for large-scale (including institutional) investment in rental housing. Alternative sources of investment in rental housing may well be critical if the proposed changes to the taxation of rental investment property are implemented. Such changes are needed if investment in affordable rental housing is to be encouraged.

5.2 Changes to personal income taxation and the taxation of rental investment property

Several changes were recommended in relation to the taxation of the income from savings that are likely to have an impact on investment in rental properties. Recommendation 14 proposed a 40% discount on income from savings related to net interest income, net residential income (including interest expense), for capital gains and losses (and for interest expenses related to listed shares). Recommendation 15 proposed that the changes that affected net residential income be adopted only following reforms to the supply of housing.

The proposal to introduce a 40% discount on relevant income from savings represented a move away from a comprehensive income tax base and towards a dual income tax system which aimed to remove some of the anomalies in the way in which income from savings is treated. Taxing capital more lightly than labour reduces the distortions that arise from exempting the family home, the major form of savings for most households, but leaves a significant bias towards this form of asset accumulation and is unlikely to have any impact on reducing the demand pressures that contribute to unaffordable housing for those who are not yet home owners. Given current inequalities in the distribution of wealth, it also raises questions about the distributional effects of a tax system in which income from capital is taxed at a lower rate than at present.

For rental investors, the proposal represents a reduction in the current 50% discount that applies to capital gains and extending the discount to interest deductions represents an increase in the effective marginal tax rate for high income investors who are highly geared. The extension of the discount to net rental income reduces the effective marginal tax rate for investors who rely on equity investment and rental income rather than geared investment and capital appreciation for their return.

In principle, these changes reduce the benefits to highly geared individual investors who have introduced a considerable amount of instability into the housing market and open up the private rental market for institutional investors more concerned with rental yield than with capital gains. In practice, however, yields most probably will have to increase considerably before such investors take over the role currently played by small scale individual investors. Such changes, however, are thought to be essential if an affordable private rental market is to emerge. [42]

It is a concern with the implications for affordability in the private rental market that led to the AFTS Report subjecting Recommendation 15 to the qualifications that the supply of housing and housing assistance be reformed.

5.3 Housing supply reforms

Recommendations 69 and 70 indicate the reforms envisaged in relation to housing supply. Recommendation 69 focuses on reform of the planning system. Recommendation 70 focuses on the role of infrastructure charges in housing developments.

Reforms to housing supply are seen as important because "higher house prices are likely to result from zoning, lengthy approvals processes and building codes and other standards imposed on building quantity". [43] Reforms that affect land supply obviously are important. Increases in housing demand will add to pressures on price and the extent to which resultant housing affordability problems persist will depend on how quickly and effectively supply responds to increases in demand.

The first report of the National Housing Supply Council (NHSC, 2009, ch 3) highlights some of the constraints that restrict the response of land supply in the short and medium term. Any improvements in these shorter run responses will help reduce house price volatility. However, longer run effects of increases in demand for housing depend on the long run supply housing supply elasticities. As discussed in *Housing challenges in the 21st century* above, these ultimately depend on land supply elasticities, on the elasticity of substitution between capital and land and on the share of land in the land and housing package. Any reforms that improve responsiveness by increasing density (increasing the share of capital relative to land) will increase the long run elasticity of housing supply.

However, most of the increased demand for housing in Australia has been an increased demand for urban housing and Australia's cities, unlike results generated from theoretical models based on presumptions of infinite land supply elasticities, are not built on ever expanding featureless plains. As the AFTS Report recognises in its discussion of land taxes, ultimately the supply of urban land is limited. Thus, in the long run, there are fundamental constraints that mean planning reform alone will not prevent house prices from rising as demand increases with increased standards of living, with increased population, and with tax incentives that favour consumption of owner-occupied housing over other goods and services and investment in owner-occupied and rental housing over other assets. Reforms that constrain demand are also needed.

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42 The National Rental Affordability Scheme (NRAS) was based on combining tax credits and rental assistance to generate the yields needed to encourage investment in affordable rental housing. The third round, open for most of 2010, has explicitly targeted institutional investors in an attempt to develop rental investment as an asset class for these investors.

43 AFTS Report, Pt 2, Vol 2, p 422.

Where there is a close nexus between infrastructure charges and the services provided by those charges, these can be regarded as a user charge or benefit tax and the primary issue becomes one of intergenerational equity given that current purchasers of new dwellings are being required to pay for services that a generation or more ago were paid for out of general revenue. As with land taxes, where these charges are known in advance, they can be factored into the cost of development and passed back to the original land owners. Major problems arise, however, when charges are implemented after land has been purchased. In such instances, they are likely to reduce land supply by encouraging land banking of undeveloped land until prices increase sufficiently to absorb the increased charge. Equity issues are also likely to arise in the future as infill increases relative to greenfield development and the pressure increases on local infrastructure in established areas and the question of who should pay for these services becomes less clear.

5.4 Housing assistance reforms

Recommendations 102 to 106 form the basis of the housing assistance reforms designed to ensure that there is an adequate standard of housing for all. These focus entirely on reforms to assistance provided to tenants in private and public or social rental markets. They are concerned primarily with efficiency effects of the current forms of assistance (specifically in relation to work incentives) and with horizontal equity within rental markets rather than with ensuring affordable outcomes. [44] There is, however, recognition of the high housing cost burdens faced by lower income renters in the private rental market and an acknowledgement that these have increased in the past few years as real rents have increased. The proposed response to this — to index rent assistance to national rents rather than to the Consumer Price Index (CPI) — will contribute to preventing a further deterioration in affordability but does not address the affordability problems currently faced by those in the private rental market. In light of underlying pressures on house dwelling from structural factors, these affordability problems are likely to increase if nothing is done to stimulate investment at the affordable end of the private rental market.

Little is made of the fact that, within the rental sector, it is only social housing that has the capacity to provide the same kind of security of tenure that is regarded as being one of the rationales for subsidising owner-occupation. The proposals to gradually replace the in kind assistance provided to social renters by charging them market rents and subsidising these with rent assistance opens up opportunities for new forms of social rental provision. The availability of rent assistance has been an important component of recent initiatives that have attempted to stimulate investment in social rental housing (and which have required rents to be set at no more than 80% of market rents) but these initiatives also have required a significant additional subsidy in the form of tax credits or direct grants for this to generate a maximum of 100,000 affordable dwellings. [45]

44 There is no recognition of the horizontal inequities that exist between renters and owners.

45 The subsidy of $8,000 per dwelling per year for ten years is indexed to the rent component of the CPI from 2008. Funding was initially provided for 50,000 incentives (or dwellings) with the promise of 50,000 more after 2012 should the scheme be successful.

The current shortfall of dwellings that are available in the private rental market and affordable to lower income households of almost 500,000 is well in excess of the anticipated increase in supply.

Assisting middle income households into home ownership may be one way of removing current pressures on the private rental market (since many of the limited supply of lower rent dwellings are occupied by middle income households). However, the AFTS Report is silent on the efficiency or equity effects of housing assistance programs that focus on first home ownership. The First Home Owner's Grant (which operates through the transfer system) and the First Home Saver's Account (which operates through the tax and transfer system) both provide subsidies to those able to access home ownership. Compared with the more expensive tax expenditures that benefit established owner-occupiers, they do support home ownership per se rather than home owners. However, they are not targeted to those most in need of assistance and are demand side subsidies that add to pressures on house prices and reduce housing affordability for those excluded from home ownership.

Similar critiques apply to the implicit demand side subsidies that apply to exclusion of the family home in the income and assets test for targeting government payments. Recommendation 88 in the AFTS Report proposed increasing fairness by imposing a cap on this exemption with amounts above the cap included in the assets test and subject to deeming. Because the proposed cap was set so that only 10,000 age pensioners would be affected, this proposal would have little impact on reducing the current biases towards owner-occupation and the resultant perverse equity and efficiency effects.

5.5 Monitoring and reporting

The final proposals to be highlighted in this chapter are Recommendations 132, 135, 137 and 138 at the end of the AFTS Report. These propose that the government should provide a regular assessment of the overall performance of the tax and transfer system, including estimates of efficiency and distributional effects; that Budget decision making processes should measure and treat tax expenditure and spending programs symmetrically to ensure there is no incentive to deliver programs through one mechanism or another; and that independent standards should be developed so that both the Commonwealth government and the States can provide regular reports on the broader economic and distributional effects of tax expenditures. This suggests that the Henry Review recognised the importance of tax expenditures and the potential they have to adversely affect economic and social outcomes.

6 CONCLUSIONS

In making its report on ways in which Australia's tax and transfer system might by improved, the Henry Review has made a number of recommendations that have a significant impact on housing and Australia's housing system. Many of these are likely to achieve the Review's goals of a more efficient and more stable housing system. Whether or not they will achieve a more equitable and more affordable system depends on whether the recommendations that address the politically difficult aspects of taxing housing are acted upon.

These more politically difficult aspects are associated with the taxation of those who are beneficiaries of the current tax and transfer system in relation to housing. The AFTS Report takes a pragmatic view of the political difficulty of removing the distortions that arise from tax expenditures associated with owner-occupied housing. In this it bows to political rather than economic principles. However, it does propose new taxes that might offset these distortions.

The AFTS Report recognised that high prices or rents result from increases in housing demand, and suggests that these can only be sustained at high levels when supply is not responsive. It makes a number of recommendations that should improve the short to medium term responsiveness of land supply. However, with urban land supply constrained by more than just planning and zoning regulations, and the responsiveness of housing supply dependent upon the extent to which capital can be substituted for land (through increased dwelling density), the capacity of the housing system to respond to increases in demand without putting upward pressure on dwelling prices is severely limited, and some consideration needs to be given to ways in which demand pressures can be reduced. In particular, consideration needs to be given to ways in which the demand pressures from those who are already adequately housed can be reduced.

In its recommendation that a progressive broad based land tax be introduced, the Henry Review goes a considerable part of the way to addressing the inequalities that arise from increases in land values that do not arise from individual effort but arise from increases in productivity, increases in economic growth and increases in population. In tying this recommendation to the removal of stamp duties and justifying it on efficiency grounds, the Review dodges the politically sensitive issue of the distributional impact of such a change. It also pushes the responsibility for distributional outcomes, generally regarded as the responsibility of the central government, onto the States. This almost guarantees that no substantive changes will be made. While land is not mobile, people are and land taxes are likely to face the same race to the bottom that led to the demise of State based death duties.

The Review reports efficiency gains, improved stability and fiscal sustainability as positive outcomes of its proposed reforms. It provides no information on the distributional implications of reforms that leave the major tax expenditures associated with housing untouched.

In respect of housing and tax, the AFTS Report represents an attempt to balance the conflicting pressures of politics and economics, in part by making limited comment on the winners and losers from the various reforms proposed. The response of the Government to the recommendations represents a triumph of politics over economics.

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