June 2010

Housing and tax: the triumph of politics over economics

Judith Yates
University of Sydney

Paper prepared for conference on Australia's Future Tax System: a post-Henry review, Sydney, 21-23 June, 2010

Abstract

This paper argues that the key affordability challenge that Australia faces in the 21st century is that of providing affordable rental housing for those for whom home ownership is either not accessible or not appropriate. It suggests that affordability problems are a result of income and population growth putting pressure on demand and of inequitable subsidies through the tax and transfer system being capitalised into dwelling prices. Ultimately land supply constraints place a capacity on the housing system to respond to increased demand without increasing land (and housing) prices

The Henry Tax Review's recommendations that affect housing are likely to achieve its objectives of a more efficient and more stable system. However, the Report fails to acknowledge the impact that the current tax and transfer system has on affordability outcomes for the most vulnerable in society and it dodges an explicit consideration of the distributional implications of its proposals. In part this reflects an attempt to balance the conflicting pressures of politics and economics. The response of the Government reflects the triumph of politics over economics.

Table of contents

Housing and tax: the triumph of politics over economics

1. The Henry Tax Review and its recommendations affecting housing

The panel set up to provide a comprehensive review of Australia's tax system (the Henry Review) 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." (para 3)[1]

The review was one of the outcomes of the 2020 Summit, "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." 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." (Swan, 2008)

In broad terms the 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" (para 2), 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" (para 5)[2], were potentially more restrictive.

Housing was mentioned explicitly only in a directive to consider enhancing taxation arrangements on property (para 3.4) 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 (para 4.2).

A significant proportion of the recommendations made in the Report on Australia's Future Tax System (the AFTS Report), however, affect housing. Of 138 recommendations in the 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. The explicit recommendations made in the AFTS Report that affect housing and the government's immediate response to them are summarised in Table A.1 in the Appendix to this paper.

The list in Table A.1 ignores important potential options that affect housing as much as, or maybe even more than, the recommendations listed. Many of these, such as the inclusion of

---

[1] Direct quotes and paragraph references are from the Terms of Reference for the Review announced in the 2008-09 Budget of the Australian Government. Copies of the Terms of Reference can be found in Treasury (2008a, 2009a).

[2] These aspirational goals were not made explicit in the Terms of Reference but a simultaneous Media Release (no. 035) outlined the proposed tax cuts announced in the 2008-2009 budget that were in addition to those announced in the 2007-08 Budget.

income from savings invested in owner-occupied housing in the personal income tax base, are explicitly rejected in the 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 paper begins with an overview of the demographic, social, economic and environmental challenges of the 21st century that are likely to arise within its housing system, since these challenges provide a starting point for an assessment of recommendations on housing taxation and transfers. This overview is provided in section 2. Section 3 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. Section 5 examines the recommendations in the AFTS Report in light of the challenges that Australia's housing system is likely face in the 21st century. Section 6 concludes.

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 is that which was identified in the terms of reference: viz. 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 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).[3] 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

[3] 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.

reinforce these, has contributed to dwelling prices rising ahead of household incomes, declining affordability and reduced access to home ownership for first home buyers.[4]

Although the aggregate home ownership rate in Australia has remained relatively stable at around 70 per cent 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 life-style changes (including deferred partnering, lower fertility), increased divorce rates and rising numbers of single parent households. Between 1981 and 2006, home ownership rates for households with a reference person aged between 25 and 34 years old declined by 10 percentage points to 51 per cent and by 7 percentage points to 68 per cent for those between 35 and 44 years old. (Yates et al., 2008: 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 life style 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: 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. It concluded "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: 41) This arises primarily because of an assumption that home ownership rates do not recover and a projection

[4] 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).

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.[5]

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 in either not accessible or not appropriate. The following section provides an assessment of the extent of housing taxes and transfers that are relevant to addressing these challenges.[6]

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 CGT at a 50 per cent discounted rate and are eligible for a 2.5 per cent 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, from Abelson and Joyeaux (2007), provides a summary of the major taxes and subsidies affecting housing in Australia.

[Table 1 here]

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. 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 is reproduced in Box A.2 in the Appendix at the end of this paper.[7] 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

---

[5] This study was based on economic and demographic assumptions consistent with those employed in the then current intergenerational report. 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 noughties house price increases 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.

[6] Box A.1 in the Appendix to this paper summarises the Henry Review's assessment of the housing affordability challenge and the key directions taken to address this.

[7] This overview followed immediately from a discussion of real effective marginal tax rates in the back ground paper (Treasury, 2008a: p252). Of passing interest is the difference between these estimates and those presented in the Report (Treasury, 2009a: p67) despite the same assumptions regarding key parameters. These differences highlight the sensitivity of such calculations to specific assumptions made.

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 (Treasury, 2009a: p74), 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 more problematic than the overview of housing taxes in Box A.1 would imply 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 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 estimates are discussed briefly below.

Taxes

In their collection of revenue statistics, the OECD include 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 per cent of total tax revenue, with taxes on immovable property and transaction taxes accounting for almost 95 per cent of this contribution. In Australia, property taxes contributed 9.1 per cent 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.[8] In 2005-06, land taxes in Australia raised \$3.6b, municipal rates raised \$8.8b and stamp duties on conveyances raised \$10.8b (ABS, 2010: Table 18).[9]

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 per cent 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

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

[9] Data are reported for 2005-05 for consistency with tax expenditure data reported below. The respective estimates for 2008-09 (the latest available by mid 2010) are \$5.5b for land taxes, \$10.0b for rates and \$9.5b for stamp duties. Other taxes on immovable property amounted to \$1.1b in 2007-08.

housing is considerably smaller.[10] In principle, developer charges are also included in the OECD definition of property taxes. Treasury (2009b: 423) report a total of $0.8b in 2005-06 from the two largest states. ABS (2010: Table 18) report a total of $0.9b for all states. Data from taxation statistics (ATO, undated: Table 16) indicate that rental investors claimed approximately $0.5b 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 per cent 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.

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 taxes the tax base.

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 1 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). (Treasury, 2009b: 97) 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."[11] (Treasury, 2009b: 12)

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 Treasury (2010) 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 Treasury (2009b: 67). Tenure neutrality, however, is more

[10] The Commonwealth Grants Commission (2008: p10) attribute less than 30 per cent of total land tax collected in 2006-07 to taxes on residential land.

[11] A pure consumption tax, however, would tax bequests.

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 per cent 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 asymmetry of the 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 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.[12]

[Table 2 here]

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 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 per cent) 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 section 4.

---

[12] 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 (Sorenson and Johnson, 2009: 113). However, in most of the Nordic countries, owner-occupied housing is still treated concessionally (as can be seen in Table 2).

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, $2.1b was paid in CRA. By 2008-09 this had increased to $2.6b. (Productivity Commission, various years). In principle, rent assistance provides a subsidy to rent paid; in practice, over 70 per cent of recipients receive the maximum amount available which means that CRA acts as an income supplement is 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 $1.3b (Treasury, 200b: 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 $1b per year was being spent.[13] 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 (Treasury, 2009b: 546). Updates are available from the FAHCSIA website. 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. Wood (personal communication) suggests a value of around $700m if the exemption limit for owner-occupied housing was set at the 90th percentile of the home owners' housing equity distribution.

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.[14] 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

---

[13] 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.

[14] Yates (2010: Table B1) provides estimates from other sources (Senate Select Committee, 2008; Freebairn, 2009; and Abelson and Joyeaux, 2007) and explains the sources of difference in these and those in Table 3.

(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. These each currently account for less than $100m per annum. More details of these smaller programs can be found in Treasury (2009b: 601) and NHSC (2010: 79-91).

[Table 3 here]

As can be seen from Table 3, housing is affected by a variety of taxes, tax concessions and transfers. Abelson and Joyeaux (2007: 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 (Treasury, 2010: 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 good and housing services or into the return they receive on their assets. As such, they have the potential to introduce inefficiencies into the way in which the housing market operates.

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 time 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 Figure 2. The assumptions that underlie these estimates, more detailed breakdowns and dollar values for the estimates illustrated can be found in Yates (2010).[15]

[Figure 1 here] [Figure 2 here]

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 that focussed 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 $2.1b provided as Commonwealth Rent Assistance across 1.6m 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.[16] 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: 19)

Subsidies that are specifically targeted to rental investors are similarly perversely distributed. Figure 3 shows the distributional implications of the 50 per cent capital gains discount and the benefit of being able to deduct costs associated with income from rental housing against other sources of income.[17]

[Figure 3 here]

As investors are often the same households who benefit extensively from the subsidies to owner-occupation, the subsidies illustrated in Figure 3 generally can be added to those illustrated in Figure 1.

---

[15] An earlier draft of Yates (2010) was prepared for the Brotherhood of St Laurence and can be downloaded from http://www.ahuri.edu.au.

[16] 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.

[17] As above, more details can be found in Yates (2010).

- 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 receive an additional tax benefit of $1,500 per year from the capital gains tax discount and the smaller number of these 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.

[Figure 4 here]

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 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." (Treasury, 2009b: 410)[18]

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 (2008: 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, 2009: 13).[19] Estimates of the extent of these inefficiencies, however, tend to suggest that deadweight losses are relatively low (see, for

[18] 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: 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."

[19] 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 re-location) 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 externalites (such as greater social stability) are associated with high levels of tenure security (often incorrectly presumed to be provided only by owner-occupation).

example, Reece, 1975; Piggott, 1986; Abelson and Joyeaux, 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 per cent of the total housing stock.[20] Demand, however, can vary in response to price changes, even in the short run and, when influenced by speculative factors, is quite 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.[21] 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 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), subsidies 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; increased renovation and an associated larger housing stock with higher environmental costs (Treasury, 2009b: 255). They also reduce access to housing for those who are credit constrained.[22]

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.

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.

---

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

[21] Note that existing owner-occupiers are both demanders and suppliers of housing services.

[22] Many States, however, do have stamp duty concessions for first home buyers.

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 paper 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,

> "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 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." (Buiter, 2008: 1)

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 aging population (who entered home ownership in an economically more benign era) means the political scales are tilted in their favour. [23]

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 to already be disadvantaged by their parents lower income status and by the insecurity of tenure that is a characteristic of the private rental tenure.

---

[23] Yates (2007) provides an overview of the different factors that have affected access to home-ownership

In 2005-06, persons in the top quintile of the equivalised income distribution had 39 per cent of total income; households in the top quintile of the net worth distribution had 61 per cent of total net worth. Average net worth of renter households was only around 15% of the total net worth of owner households. (ABS, 2007: p10). 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.

[Figure 5 here]

Tenure, net worth and income are all affected by lifecycle 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 here] [Figure 7 here]

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.

Other effects

It has also been suggested that such biases can increase price volatility. Van den Noord (2005: 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 per cent 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 (Treasury, 2009a: 74). 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 per cent 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 increase need for rental assistance for tenants, the AFTS Report highlights the need to reform housing assistance measures before any distortions are reduced. (Treasury, 2009a: 74)

In a recent quantitative study, Wood and Ong (2010: p5) suggest that the shortages observed in the lost rent end of the private rental market can be attributed to a number of sources of market failure: viz. 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: p431). Their high user costs create a relative disincentive for investment in low rent dwellings. Their low incomes means 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.[24]

5. The contribution made by the AFTS Report recommendations in contributing to housing challenges

The previous section has focussed primarily on the impact of aspects of the tax system that were ignored, but not unnoticed, by AFTS Report. 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 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." (Treasury, 2009b:415-416)

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.

Stamp duties and land taxes

Recommendations 51 to 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

[24] 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: 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."

add to pressures on dwelling prices without an offsetting tax to replace them. This is one reason why the report recommended they be replaced by a land tax (Treasury, 2009b: 264). 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.[25] The recommendation that the land tax based eventually should be broadened to include all land (that is, that owner-occupied as well 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 (Treasury, 2009b: 250) argued 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 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 taxing 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 on 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.

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 per cent 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 per cent discount on 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

[25] The AFTS Report illustrates the equivalence of a 1 per cent tax on land rent and a 17 per cent tax on economic rent. (Treasury, 2009b: 270)

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 per cent 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.[26]

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.

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." (Treasury, 2009b: 422) 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 quickly and how effectively supply responds to increases in demand.

The first report of the National Housing Supply Council (NHSC, 2009: chpt 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 section 2, these ultimately depend on land supply elasticities, on the elasticity of substitution between capital 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 our cities, unlike results generated from theoretical models

---

[26] 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.

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, increased population and 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.

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 in to 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.

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.[27] 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 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 per cent of market rents) but these initiatives also have required a significant additional subsidy (in 2008 of a CPI indexed $8,000 per dwelling per year for ten years in the form of tax credits or direct grants) for this to generate a maximum of 100,000 affordable dwellings over its current lifetime. The current shortfall of dwellings that are

[27] There is no recognition of the horizontal inequities that exist between renters and owners.

available in the private rental market and affordable to lower income households of almost 500,000 is well in excess of this 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 to 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.

Monitoring and reporting

The final proposals to be highlighted in this paper 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 Australian 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 makings 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 its 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 address 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, it 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 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.

AFTS Report 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 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.

References

Aaronson, D. (2000) "A note on the benefit of homeownership" *Journal of Urban Economics*, 47(3): 356–369

Abelson, P. and R. Joyeaux, R. (2007) "Price and Efficiency Effects of Taxes and Subsidies for Australian Housing," *Economic Papers* 26 (2): 147-169

Apgar, W. (2004) "Rethinking Rental Housing: Expanding the Ability of Rental Housing to Serve as a Pathway to Economic and Social Opportunity", Joint Center for Housing Studies, Harvard University, Working Paper w04-11, http://www.jchs.harvard.edu/publications/markets/w04-11.pdf. Downloaded 28th April 2009

Arnott, R. (1989) "Housing vacancies, thin markets, and idiosyncratic tastes", *The Journal of Real Estate Finance and Economics*, 2 (1): 5-30

Australian Bureau of Statistics (ABS)(2007) *Household Income and Income Distribution, Australia, 2005-06*, Cat. No. 6523.0

Australian Bureau of Statistics (ABS)(2010) *Taxation Revenue, Australia, 2008-09*, Cat. No. 55060DO001_200809.

Australian Institute of Health and Welfare (AIHW) (2007). Private rent assistance 2005–06: Commonwealth State Housing Agreement national data reports. Housing assistance data development series. Cat. no. HOU 167. Canberra: AIHW.

Australian Institute of Health and Welfare (AIHW) (2008) *Housing assistance in Australia*, Cat. no. HOU 173, Canberra: AIHW

Australian Taxation Office (ATO)(undated) *Taxation Statistics 2005-06,* At http://www.ato.gov.au. Downloaded 13th May 2010.

Buiter, W. (2008) "Housing wealth isn't wealth", NBER Working Paper 14204, revised 9 Nov 2008. At http://www.nber.org/~wbuiter/wealth.pdf. Downloaded 28th November, 2008.

Commonwealth Grants Commission (2008) *Land Tax*. At http://www.cgc.gov.au/__data/assets/file/0019/10666/04_U2008_Land_Tax_Results.pdf. Downloaded 12th October, 2009.

Dietz, R. and Haurin, D. (2003) "The social and private micro-level consequences of homeownership", *Journal of Urban Economics*, 54(3): 401-450

DiPasquale, D. and Wheaton, W. (1994) "Housing Market Dynamics and the Future of Housing Prices", *Journal of Urban Economics*, 35(1):1-27

Ellis, L. (2006) 'Housing and housing finance: the view from Australia and beyond', *Reserve Bank of Australia Research Discussion Papers*, RDP no. 2006-12, December

Ellis, L. (2010) "Recent Developments in the Housing Market and its Financing", speech to the Financial Review Residential Property Conference 2010, Sydney - 18 May 2010. At http://www.rba.gov. Downloaded 19th May 2009

Freebairn, J. (2009) "Tax Breaks for Owner Occupied Housing" paper presented to the Housing and Taxation Symposium, Australian Tax Research Foundation, Melbourne, February 11, 2009

Lawson, J. and Milligan, V. (2007) *International trends in housing and policy responses*, Australian Housing and Urban Research Institute Final Report no. 100. At http://www.ahuri.edu.au. Downloaded 12th November 2007

Muth, R. and Goodmand, J. (1989) *The Economics of Housing Markets*, London: Harwood Academic Publishers

National Housing Supply Council (NHSC) (2010) *2nd State of Supply Report*, Canberra: National Housing Supply Council. At http://www.nhsc.org.au. Downloaded 31st May 2010.

National Housing Supply Council (NHSC) (2009) *State of Supply Report*, Canberra: National Housing Supply Council. At http://www.nhsc.org.au. Downloaded 20th March 2009.

Productivity Commission (various years) *Report on Government Services*. At http://www.pc.gov.au/gsp. Downloaded 20th March 2010

Productivity Commission (2004) *First Home Ownership*, Report no. 28, Melbourne: Productivity Commission. At http://www.pc.gov.au. Downloaded 23rd June 2004.

Renaud, B. (1989) "Affordable housing and housing sector performance: the housing price-to-income ratio as a summary indicator", mimeo. At http://lookup.lib.hku.hk/lookup/bib/b38632779. Downloaded 26th May 2010

Richards, A. (2009) "Conditions and Prospects in the Housing Sector", address to the 4th Annual Housing Congress, Sydney, 26 March 2009. At http://www.rba.gov. Downloaded 25th November 2009

Richards, A. (2008) "Some observations on the cost of housing in Australia", address to 2008 Economic and Social Outlook Conference, The Melbourne Institute, Melbourne, 27 March 2008. Reserve Bank of Australia, *Bulletin*, April 2008: 26-36

Rohe W., McCarthy G., Van Zandt S. (2002), "The Social Benefits and Costs of Homeownership" in Retsinas, N. and Belsky, E. (eds) *Low-income Homeownership: Examining the Unexamined Goal*, Washington, DC: The Brookings Institution

Seelig, T., Thompson, A., Burke, T., Pinnegar, S., McNelis, S. and Morris, A. (2009) "Understanding what motivates households to become and remain investors in the private rental market", *Australian Housing and Urban Research Institute Final Report, No. 130*. At http://www.ahuri.edu.au. Downloaded 14th April 2009

Senate Select Committee on Housing Affordability in Australia (2008) *A good house is hard to find: Housing affordability in Australia*, At http://www.aph.gov.au/Senate/committee/hsaf_ctte/report/report.pdf. Downloaded 11th June 2008

Shlay, A. (2006) "Low-income homeownership: American dream or delusion?" *Urban Studies*, 43 (3): 511 - 531

Sørenson, P. and Johnson, S. (2009) "Taxing capital income - options for reform in Australia", paper presented at the Australia's Future Tax System Conference, University of Melbourne, 18 – 19 June, 2009. At http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/conference.htm. Downloaded 20th August 2009.

Stewart, M. (2010) "Housing and Tax Policy: New Directions for Old (and some New) Problems" in Stewart, M. (ed) *Housing and Tax Policy*, Conference Series No 26, Australian Tax Research Foundation, pp1-38

Swan, W. (2010) Media release no. 028, May 2, 2010. At http://www.treasurer.gov.au/. Downloaded 31st May 2010

Swan, W. (2008) Media release no. 036, May 13, 2008. At At http://www.treasurer.gov.au/. Downloaded 31st May 2010

Treasury (2008a), *The Architecture of Australia's Tax and Transfer System*. At http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm. Downloaded 10th December 2008

Treasury (2008b), *Australia's Future Tax System Consultation Paper*. At http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm. Downloaded 10th December 2008

Treasury (2008c), *Tax Expenditures Statement 2008.* At http://www.treasury.gov.au/contentitem.asp?NavId=&ContentID=1465. Downloaded 9th May 2009

Treasury (2009a), *Australia's Future Tax System: Final Report to the Treasurer, Part 1: Overview*. At http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm. Downloaded 2nd May 2010.

Treasury (2009b), *Australia's Future Tax System: Final Report to the Treasurer, Part 2: Detailed Analysis (volume 1 and volume 2).* At http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm. Downloaded 2nd May 2010.

Treasury (2010), *Tax Expenditures Statement 2009.* At http://www.treasury.gov.au/contentitem.asp?ContentID=1719&NavID=. Downloaded 31st May 2010

Tsatsaronis , K. and Zhu, H (2004) "What drives housing price dynamics: cross-country evidence", BIS Quarterly Review, March 2004. At www.bis.org/publ/qtrpdf/r_qt0403f.pdf. Downloaded 4th January 2005

Van den Noord, P. (2005), "Tax Incentives and House Prices in the Euro Area: Theory and Evidence", Economie Internationale, No. 101: 29-45.

Wood, G. and Ong, R. (2010) "Factors shaping the decision to become a landlord and retain rental investments", *Australian Housing and Urban Research Institute Final Report, No. 142*. At http://www.ahuri.edu.au. Downloaded 1st March 2010

Wood, G. and Tu, Y. (2004) "Are There Clientele Groups Among Investors In Rental Housing?", *Real Estate Economics*, 32(2), 413–36

Wulff, M., Dharmalingam, A., Reynolds, M. and Yates, J. (2009) "Australia's private rental market: changes (2001-2006) in the supply of, and demand for, low rent dwellings", *Australian Housing and Urban Research Institute Positioning Paper, No. 122*. At http://www.ahuri.edu.au. Downloaded 16th September 2009

Yates, J. (2010) "Tax Expenditures and Housing", in Stewart, M. (ed) *Housing and Tax Policy*, Conference Series No 26, Australian Tax Research Foundation, pp39-91.

Yates, J. (2008) "Australia's Housing Affordability Crisis", *Australian Economic Review*, 41(2):200-214

Yates, J. and Bradbury, B. (2010) "Home ownership as a (crumbling) fourth pillar of social insurance in Australia", *Journal of Housing and the Built Environment*, v25(2): 193-211

Yates, J., Kendig, H. and Phillips, B. with Milligan, V and Tanton, R. (2008) "Sustaining fair shares: the Australian housing system and intergenerational sustainability", Australian Housing and Urban Research Institute, Final Report No. 111, http://www.ahuri.edu.au

Yates, J. and Wulff, M. (2005) "Market Provision of Affordable Rental Housing: Lessons from Recent Trends in Australia", *Urban Policy and Research, 23(1):5-19*

Zodrow, G. (2000) "Reflections on the Consumption Tax Option", in Head, J. and Krever, R. (eds) *Taxation towards 2000*, Australian Tax Research Foundation Conference Series No. 19, Melbourne: Deakin University Press: 45-82

Appendix

Table A. 1: AFTS Review Recommendations Relevant to Housing and Government response

Recommendation	Government response[28]
A1. Personal taxation: Personal income tax	
Recommendation 1: (pix) (a) Revenue raising should be concentrated on four robust and efficient broad-based taxes: • personal income, assessed on a more comprehensive basis; • business income, designed to support economic growth; • rents on natural resources and land; and • private consumption. (b) Additional specific taxes should exist only where they improve social outcomes or market efficiency through better price signals. Such taxes would only be used where they are a better means to achieve the desired outcome than other policy instruments. The rate of tax would be set in accordance with the marginal spillover cost of the activity. (c) User charging should play a complementary role, as a mechanism for signalling the underlying resource cost of publicly provided goods and services. (d) With both specific taxes and user charges, revenue would be a by-product of the tax or charge, not the reason for it. (e) Other existing taxes should have no place in the future tax system and over time should be abolished.	.. a long term plan to apply a Resource Super Profits tax to the profits earned from resources that are owned by all Australians
Recommendation 2: (p22) Progressivity in the tax and transfer systems should be delivered through the personal income tax rates scale and transfer payments. A high tax-free threshold with a constant marginal rate for most people should be introduced to provide greater transparency and simplicity.	Not addressed

[28] Government responses refer to Treasurer's Press Release 028 of 2 May 2010. The press release also indicated there would be "more to say on a number of other areas considered by the review, especially .. improving incentives to save. This would represent a full second term agenda." Responses announced in the 2010-2011 budget are taken from the Budget Speech and from Budget Papers.

Recommendation	Government response
Recommendation 14: (p70) Provide a 40 per cent savings income discount to individuals for non-business related: (a) net interest income; (b) net residential rental income (including related interest expenses); (c) capital gains (and losses); and (d) interest expenses related to listed shares held by individuals as non-business investments. In conjunction with introducing the discount further consideration should be given to how the boundaries between discounted and non-discounted amounts are best drawn to achieve certainty, reduce compliance costs, and prevent labour and other income being converted into discounted income. Further consideration should also be given to addressing existing tax law boundaries related to the treatment of individuals owning shares in order to address uncertainties about when the shares are held on capital account (and subject to capital gains tax) and on revenue account (and taxed as ordinary income).	.. will not implement the following policies at any stage. • Reduce the CGT discount, apply a discount to negative gearing deductions, or change the grandfathering arrangements for CGT (see Rec 14 & 17c) 2010-2011 Budget • Will provide 50 per cent discount on up to $1,000 of interest income from July 2011)

A1. Personal taxation: Personal income tax

Recommendation 15: (p71) When the 40 per cent savings income discount is introduced a smooth transition should be provided to minimise any disruption that may arise. The transition to a savings income discount for net residential rental income should only be adopted following reforms to the supply of housing (Section E4 Housing affordability) and reforms to housing assistance (Section F5 Housing assistance).	Not addressed
Recommendation 17: (p80) The capital gains tax regime should be simplified by: (a)… (b) … (c) removing current grandfathering provisions relating to assets acquired before the commencement of capital gains tax, with a market value cost base provided for those assets when the exemption is removed, or before the end of previous indexation arrangements. A relatively long lead-time should be provided before these removals take effect; and (d) rewriting the capital gains tax legislation using a principles-based approach that better integrates it with the rest of the income tax system.	.. will not implement the following policies at any stage. • Reduce the CGT discount, apply a discount to negative gearing deductions, or change the grandfathering arrangements for CGT (see Rec 14 & 17c) (d) Not addressed

Recommendation	Government response
A3. Personal taxation: Wealth Transfer Taxes	
Recommendation 25: (p144) While no recommendation is made on the possible introduction of a tax on bequests, the Government should promote further study and community discussion of the options.	.. will not implement the following policies at any stage. • Introduce a bequests tax (see Rec 25)
C1. Land and Resources Taxes: Land tax and conveyance stamp duty	
Recommendation 51: (p263) Ideally, there would be no role for any stamp duties, including conveyancing stamp duties, in a modern Australian tax system. Recognising the revenue needs of the States, the removal of stamp duty should be achieved through a switch to more efficient taxes, such as those levied on broad consumption or land bases. Increasing land tax at the same time as reducing stamp duty has the additional benefit of some offsetting impacts on asset prices.	Not addressed
Recommendation 52: (p263) Given the efficiency benefits of a broad land tax, it should be levied on as broad a base as possible. In order to tax more valuable land at higher rates, consideration should be given to levying land tax using an increasing marginal rate schedule, with the lowest rate being zero, with thresholds determined by the per-square-metre value.	.. will not implement the following policies at any stage. • Introduce land tax on the family home – this is a state tax and thus an issue for the states (see Rec 52 & 53)
Recommendation 53: (p263) In the long run, the land tax base should be broadened to eventually include all land. If this occurs, low-value land, such as most agricultural land, would not face a land tax liability where its value per square metre is below the lowest rate threshold.	As above
Recommendation 54: (p263) There are a number of incremental reforms that could potentially improve the operation of land tax, including: (a) ensuring that land tax applies per land holding, not on an entity's total holding, in order to promote investment in land development; (b) eliminating stamp duties on commercial and industrial properties in return for a broad land tax on those properties; and (c) investigating various transitional arrangements necessary to achieve a broader land tax.	As above

Recommendation	Government response
E4. Housing Affordability	
Recommendation 69: (p422) COAG should place priority on a review of institutional arrangements (including administration) to ensure zoning and planning do not unnecessarily inhibit housing supply and housing affordability.	Not addressed
Recommendation 70: (p428) COAG should review infrastructure charges (sometimes called developer charges) to ensure they appropriately price infrastructure provided in housing developments. In particular, the review should establish practical means to ensure that these changes are set appropriately to reflect the avoidable costs of development, necessary steps to improve the transparency of charging and any consequential reductions in regulations.	Not addressed
F2. The Transfer System: Means Testing	
Recommendation 88: (p540) The current income and asset tests for income support payments should be replaced with a comprehensive means test based on a combined measure of employment income, business income and deemed income on assets. The comprehensive means test would: (a) extend deemed income on assets in addition to financial assets, including superannuation income streams, rental housing and other asset classes (whether income-producing or not). Superannuation income streams where deeming income would be difficult to apply would be tested on gross income but with an actuarially fair deduction for capital; (b) have low and high deeming rates based on the returns expected from a portfolio of assets held by a prudent investor. These rates should be set by reference to an appropriate benchmark; (c) continue the means test exemption for owner-occupied housing up to a high indexed threshold; …..…	(a) Not addressed (b) Not addressed (c) .. will not implement the following policies at any stage. • Include the family home in means tests (see Rec 88c)
Recommendation 90: (p576) Current family payments, including Family Tax Benefit Parts A and B, should be replaced by a single family payment. The new family payment should: (a) cover the direct costs of children in a low-income family (that is, the costs associated with food, clothing, housing, education expenses); and (b) assist parents nurturing young children to balance work and family responsibilities.	Not addressed 2010-11 Budget Reduced indexation for FTB-A

Recommendation	Government response
F5. The Transfer System: Housing assistance	
Recommendation 102: (p610) The maximum rate of Rent Assistance should be increased to assist renters to afford an adequate standard of dwelling. To ensure that Rent Assistance can be maintained at an adequate level over time, the rent maximum should be indexed by movements in national rents, which could be measured by an index of rents paid by income support recipients.	Not addressed
Recommendation 103: (p610) To better target an increase in the maximum rate, Rent Assistance should be part of the income support system, with eligibility based on rent paid and the income support means test, rather than on eligibility for another payment (for example, Family Assistance).	.. will not implement the following policies at any stage. • Restrict eligibility to rent assistance for families (see Rec 103)
Recommendation 104: (p610) Mechanisms should be developed to extend Rent Assistance equitably to public housing tenants along with removing income-linked rent setting in public housing.	Not addressed
Recommendation 105: (p610) A high-need housing payment should be paid to social housing providers for their tenants who have high or special housing needs or who may face discrimination in the private market. This payment should be funded by the Australian government. The Commonwealth and the States should retain the option of providing capital for social housing construction.	Not addressed
Recommendation 106: (p610) Income-linked rents should be phased out in social housing, with providers charging their tenants rents linked to the market rate, with existing rent-setting for current tenants phased out using grandfathering or other transitional arrangements. However, continued use of income-limited rents is appropriate in some circumstances, such as in remote Indigenous communities.	.. will not implement the following policies at any stage. • ask the States to charge market rents to public housing recipients (see Rec 106)

Recommendation	Government response
G2. Institutions, Governance and Administration: State tax reform	
Recommendation 119: (p684) Reforms to State taxes should be coordinated through intergovernmental agreements between the Australian government and the States to provide the States with revenue stability and to facilitate good policy outcomes.	Not addressed
G3. Institutions, Governance and Administration: Local government	
Recommendation 120: (p695) States should allow local governments a substantial degree of autonomy to set the tax rate applicable to property within their municipality.	Not addressed
Recommendation 121: (p695) Over time, State land tax and local government rates should be more integrated. This could involve: (a) moving to a joint billing arrangement so that taxpayers receive a single assessment, but are able to identify the separate State and local component; and (b) using the same valuation method to calculate the base for local government rates and land tax (with this method being consistent across the State).	Not addressed
G5. Monitoring and reporting on the system	
Recommendation 132: (p729) The government should, every five years, publish a Tax and Transfer Analysis Statement that analyses and reports on the overall performance and impact of the system, including estimates of efficiency costs and distributional impacts.	Not addressed
Recommendation 135: (p729) The Australian government should ensure that the rules governing the development of the Budget encourage trade-offs between tax expenditures and spending programs. Budget decision-making processes should measure and treat tax expenditures and spending programs symmetrically, to ensure that there is no artificial incentive to deliver programs through one mechanism rather than another.	Not addressed
Recommendation 137: (p729) The government should ensure that reporting standards are independently developed for the identification and measurement of tax expenditures in the Tax Expenditures Statement. In addition, the standards should establish a basis for reporting the broader economic and distributional effects of tax expenditures in the periodic Tax and Transfer Analysis Statement (see Recommendation 132).	Not addressed
Recommendation 138: (p729) The Council of Australian Governments should examine the ways in which the States could uniformly report tax expenditures annually according to the independent standards developed under Recommendation 137.	Not addressed

Box A. 1: Main directions and proposals for more affordable housing

Over the past decade, large parts of Australia have experienced worsening housing affordability problems. Rising housing prices have been underpinned mainly by rising residential land values (with high construction costs contributing in some cases, particularly in remote areas). While the overall demand for housing is increased by favourable tax and transfer provisions particularly for owner-occupied housing, these provisions are of very long standing and have deep community support. The sharp deterioration in affordability in recent times is more likely to reflect demand and supply factors such as high rates of immigration and household formation and government land use policies. The Review anticipates continued strong population growth and continued overall favourable tax-transfer treatment of owner-occupied housing. On that basis it has considered whether other features of the tax and transfer systems are appropriately configured to maintain fairness and efficiency in housing markets. It proposes a series of changes that would improve equity and market efficiency — but policy changes outside the tax and transfer systems will be necessary to better match aggregate housing supply and demand if overall housing price pressures are to be alleviated.

Key directions

• Maximum rates of Rent Assistance for income support recipients should be substantially increased and linked to movements in market rents.

• Subject to transition arrangements, public housing rent concessions should be replaced by Rent Assistance and a new form of assistance for high-needs tenants, to improve equity and work incentives.

• Over a long transition period, a land tax should be introduced on all land on a more efficient and uniform basis linked to unit land values, removing disincentives for institutional investment in rental property and integrated over time with property rate assessments.

• Over a similar period, transfer taxes on property should be reduced, and ultimately removed, with revenues replaced by efficient taxes, preferably annual land tax.

• Subject to transitional provisions, and following action to improve the current shortfall in housing supply, a more neutral personal income tax treatment of private residential rental investment should be introduced, with less volatile market effects, through a 40 per cent discount on all net residential rental income and losses, and capital gains.

Source: Treasury (2009a: xxiii)

Box A. 2: The taxation treatment of housing

The imputed rent and capital gains of 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 CGT and are eligible for a 2.5 per cent annual depreciation allowance on the construction cost of the building. Further, the cost of financing is deductible and can be offset against income from other sources. It is not included as part of the cost of the asset when determining the net capital gain for CGT purposes.

Investment in residential property is taxed in the same way as some other assets, but the returns vary [depending on the way in which the investment is financed].

Residential property is also subject to a range of state taxes, with a range of rates and thresholds. Sales of residential properties are taxed through stamp duty on conveyances, and rental properties are subject to ongoing land taxes. Local governments (and the Australian Capital Territory) also tax residential property through municipal rates.

Stamp duty is levied on housing transactions. While paid by the buyer, the incidence of stamp duty is likely to be shared and partly fall on sellers by lowering the after-tax price received though sale. As a tax on transactions, stamp duties can discourage turnover and influence housing decisions. They may also encourage some home-buyers to buy larger houses in order to avoid further stamp duty from subsequent moves into family-sized homes. Similarly, stamp duties may affect decisions of existing home owners. Some people wishing to upsize may choose to renovate their existing home rather than move. For those who would prefer downsizing to a smaller house, stamp duties can pose an additional difficulty in the relocation process, by increasing the required return on the property sale before they are able to move. These impacts are partly ameliorated by concessions that the States offer to first home buyers and to pensioners who move to homes that better suit their needs.

Other aspects of the tax-transfer system can also generate ‘lock-in’ effects that may discourage sales of housing. The principal place of residence is generally given a concessional treatment under income support assets tests. This means that moving from owner-occupied housing to rental accommodation can lead to lower pension payments for older people, as their assets are reallocated into non-concessionally treated categories.

Land tax is levied on the unimproved value of land, with investment properties subject to the tax and owner-occupied property exempt. In addition to favouring owner-occupied housing over investment housing, land taxation affects housing investment decisions in two ways. Most land tax regimes have progressive scales, which can discourage large scale investment in land. This impact can be significant. Averaging across jurisdictions, a single company holding ten land parcels worth $300,000 would pay five times more land tax than if the same parcels were held in separate hands. This encourages property investment by small-scale investors, who pay less tax per property than larger entities. Land tax is also likely to encourage greater investor participation in properties where land is a low proportion of total property value (such as apartments) than in detached houses.

Source: Treasury (2008a: p253)

Box A. 3: Housing affordability

Access to affordable housing is a key policy issue for the Australian community that is likely to grow in importance. Government policies have traditionally treated owner-occupied housing as a preferred housing tenure. This approach reflects the desire of most Australians to own their home and recognises the benefits ownership can deliver to both the community and owners, such as through greater security in retirement. The approach in this Report is consistent with this policy goal. On that basis the Review has considered whether other features of the tax and transfer system are appropriately configured to meet pressures in the housing market.

Measures of housing affordability emphasise different aspects of the problem, but all reflect the price of housing and people's means to pay for it. The transfer system has a key role in ensuring that low-income earners can access an adequate standard of housing, and reforms to housing assistance will promote affordability in this regard. For purchasers, affordability is constrained by prices that are high relative to average income levels. While high prices can result from increases in housing demand, they can only be sustained when supply is not responsive. Evidence suggests that the current supply of housing is at insufficient levels, placing ongoing pressure on house prices.

The recommended reforms to stamp duties and land tax in particular should reduce current impediments to housing supply generated by the tax system. However, as taxation is not the major source of supply constraints in the Australian housing market, housing affordability would be best promoted through wider reforms that facilitate housing supply. Following these reforms and improvements to housing assistance, the taxation of investment housing should be reformed to ensure a more neutral treatment of rental property investment. While these reforms will address the significant distortions the tax system has on the housing market, a range of non-tax policies have a more significant impact on housing supply and affordability.

Housing supply can be restricted through a range of policies, such as planning and zoning regulations, as well as the approvals processes that govern them. However, such policies are designed to achieve a range of policy objectives, against which their impact on the price of housing should be assessed. The use of infrastructure charges has the potential to improve the allocation of infrastructure. However, where they are not set appropriately, infrastructure charges can reduce the supply of housing, and increase overall house prices.

While they may promote housing affordability, proposals that increase housing supply may reduce existing home values and change the shape of Australian cities in ways that many existing residents do not desire. This suggests a serious community dialogue is needed on the distribution and quality of housing across Australia. As a first step, the Council of Australian Governments should review zoning, planning and development approval policies and infrastructure charges to ensure they do not unnecessarily reduce housing supply.

Source: Treasury (2009a: 50)

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 the nominal capital gains
Tax treatment of losses on rental property (negative gearing)	Investors can deduct 100 per cent 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 per cent of all Australian households - in most cases at below market rents.
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 land 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 Joyeaux (2007)

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[d]	no	half[c]	limited	yes
Canada	no	no	yes	yes[e]	yes	no	half[c]	yes	yes
France	no	no	yes	limited[g]	yes	no	no[f]	limited	limited
Germany	no	no	no	yes	yes	no[f]	no[f]	limited	limited
Netherlands[a]	yes	yes	na	na	no	na	na	yes	yes
NZ	no	no	yes	yes	yes	no	no	limited	limited
Sweden		yes	yes	yes	no	limited	limited	yes	yes
Switzerland[b]	yes	yes	yes	no	outlays	yes	yes	yes	yes
UK	no	no	no	no	no	limited	yes	yes	yes
USA	no	yes	yes	limited[h]	yes	no	yes	limited	yes

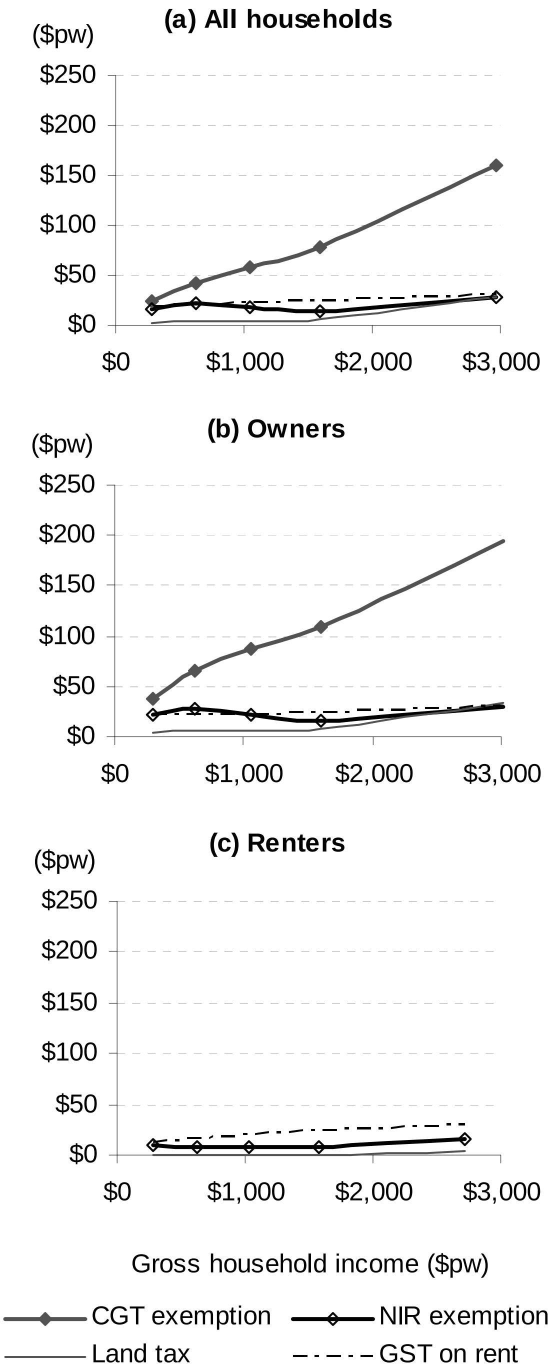
Sources: Ellis (2006: 11); Lawson and Milligan (2007: 46).

Table 3: Estimates of aggregate values of taxes, tax expenditures and transfers

	Yates		Official			
	2005-6		2005-06		2007-8	
Income base	$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					
Consumption base						
owner-occupied housing						
non taxation rental services	4.8					
rented housing						
non taxation rental services	1.6					
all new housing						
GST on land and new housing			-6.0		-6.0	
Property base						
owner-occupied housing						
less FHB concessions					1.7	
exemption from land tax	3.5				3.6	
pensioner exemptions from rates					0.2	
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	c
other (incl user charges)	-0.9		-0.9		-1.1	c
Transfers						
private renters						
CRA (private)	2.1		2.1		2.1	
subsidised rent (public)	1.2				1.6	
owner-occupiers						
FHOG (purchaser)	1.0		1.0		1.0	
assets test exemption (owners)	0.7		0.7		0.7	
Total	36.0		23.3		36.0	

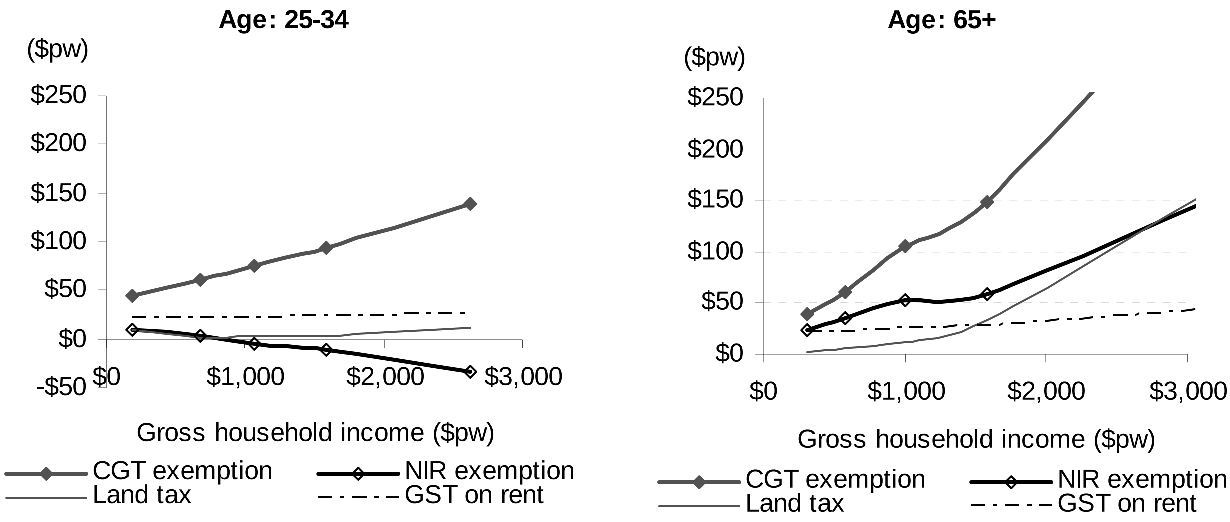
Sources: Taken where available from Treasury (2010, 2009b, 2008a), ABS (2010), ATO (undated), Commonwealth Grant Commission (various years) and AIHW (2007, 2008). Supplemented with GST estimates from Freebairn (2009) and Abelson and Joyeaux (2007); asset text exemption estimates from Wood (personal communication).

Figure 1: Tax expenditures by household income and tenure



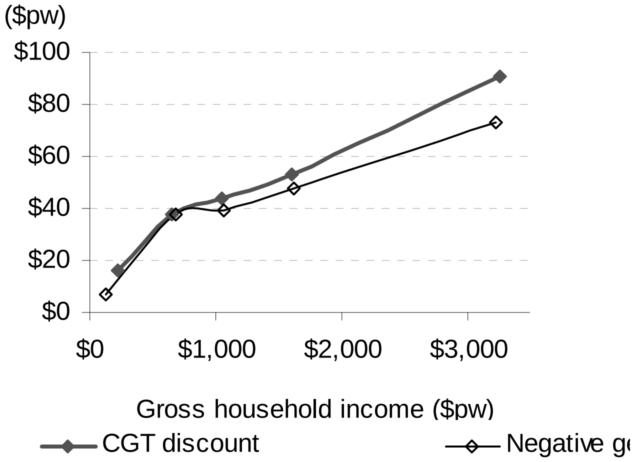
Source: Australian Bureau of Statistics Survey of income and housing, 2005-06. Results derived from ABS Basic CURF data

Figure 2: Tax expenditures by income, tenure and selected age groups, owners: 2005-06



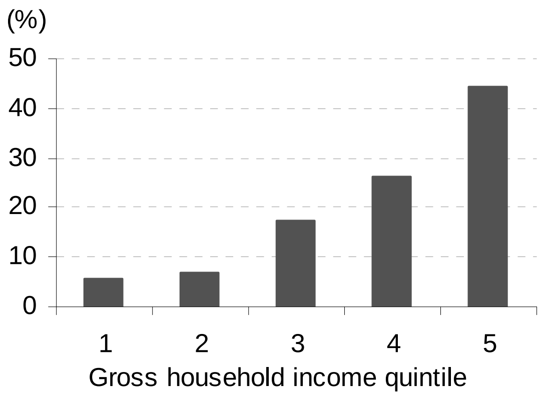
Source: Australian Bureau of Statistics Survey of income and housing, 2005-06. Results derived from ABS Basic CURF data

Figure 3: Tax expenditures by income, investors: 2005-06



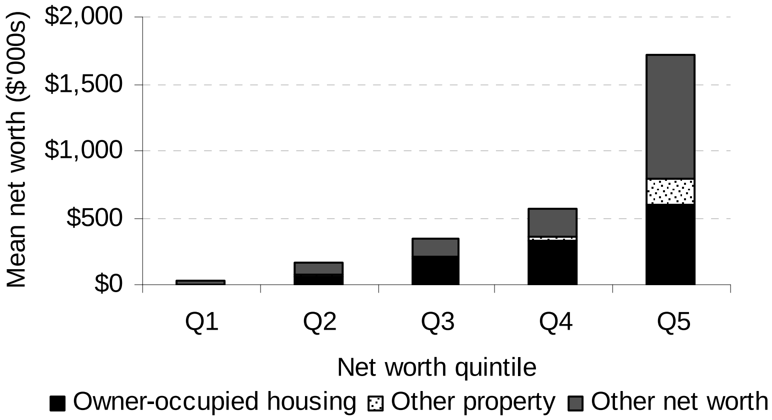
Source: Australian Bureau of Statistics Survey of income and housing, 2005-06. Results derived from ABS Basic CURF data

Figure 4: Proportion of households with rental losses by household income: 2005-06



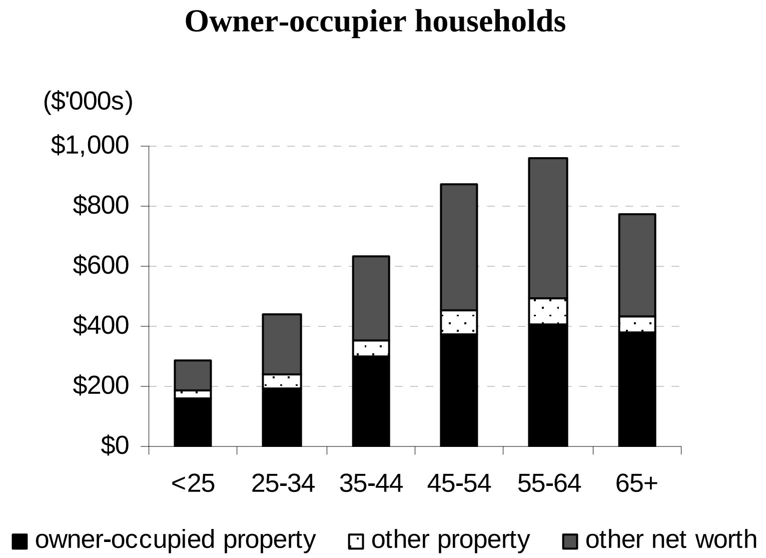
Source: Australian Bureau of Statistics Survey of income and housing, 2005-06. Results derived from ABS Basic CURF data

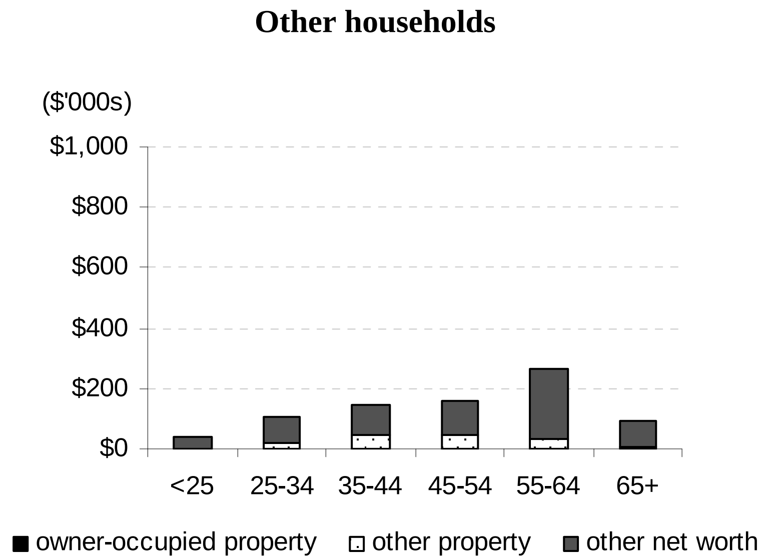
Figure 5: Distribution of household wealth by net worth quintile: 2005-06



Source: Australian Bureau of Statistics Survey of income and housing, 2005-06. Results derived from ABS Basic CURF data

Figure 6: Distribution of household net worth by age and tenure: 2005-06



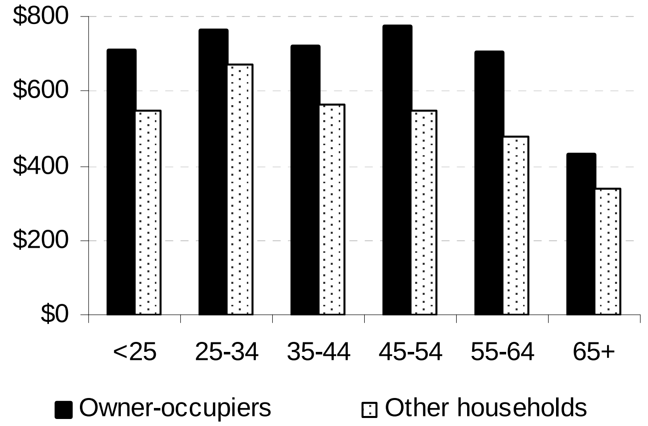


Source: Australian Bureau of Statistics Survey of income and housing, 2005-06. Results derived from ABS Basic CURF data

Figure 7: Distribution of household income by age and tenure: 2005-06

Gross household income

Equivalised disposable income



Source: Australian Bureau of Statistics Survey of income and housing, 2005-06. Results derived from ABS Basic CURF data