Four tax policies Australian house prices rest on

By Warwick Smith

Originally published at The Conversation

The issues of tax and house prices are colliding in new ways ahead of the release of the government's options paper on tax reform later this year.

Treasurer Joe Hockey is ramping up discussion of tax reform, but at the same time, the Reserve Bank among many others are calling for tax reform with respect to housing.

Would be first home buyers are being increasingly priced out of the market, particularly in capital cities, and many are resigned to a lifetime of renting.

To say that taxation has a profound effect on investment decisions is to make a gross understatement. In Australia, real estate is very favourably taxed. This results in a skew towards real estate investment that lifts prices. Most investment is in existing housing stock - proof that the resulting impact on supply is minimal.

There are many tax policies that impact on real estate investment and prices but the four most important are negative gearing, the concessional treatment of capital gains, stamp duties and land taxes.

Negative gearing

"...negative gearing is entirely dependent on investors making unearned income (economic rent)."

A negatively geared property loses money with respect to cash flow. The costs (primarily, but not restricted to, interest payments) exceed the income (rent). Negative gearing provisions mean that these losses can be offset against other income.

The fact that negative gearing is so popular should ring alarm bells. Investment properties are operated at a loss only on the assumption that the real return will come from capital gains when the property is sold. In other words, negative gearing is entirely dependent on investors making unearned income (economic rent).

Capital gains are unearned income because the owner of the property does nothing to create the extra value. Buildings depreciate in value over time but land tends to rise in value. This is where capital gains come from, land value increases. Land values increase due to community and government action; including the provision of infrastructure and services and population growth.

Capital gains tax

One of the reasons negative gearing is so popular is because of the concessional taxation of capital gains.

No capital gains tax is paid on a primary residence and, for individuals, only half of a capital gain is taxed for investment properties. Capital gains tax is levied at the owner's marginal tax rate but, because of the concession, the maximum tax on capital gains is 22.5 per cent (half the top marginal tax rate). As a result of negative gearing and the concessional treatment of capital gains real estate is an artificially attractive investment class.

Stamp duties

Stamp duties are state based taxes that are levied at the time of purchase and are based on the sale price. Economists overwhelmingly consider stamp duties to be inefficient and undesirable. The primary reason for this is because they are a barrier to the efficient allocation of housing stock.

The large cost of stamp duties acts as a disincentive for people to move to properties that better suit their needs. The classic example is that of parents remaining in a large family home after their children have left because stamp duties would erode much of the financial benefit of moving to a smaller home.

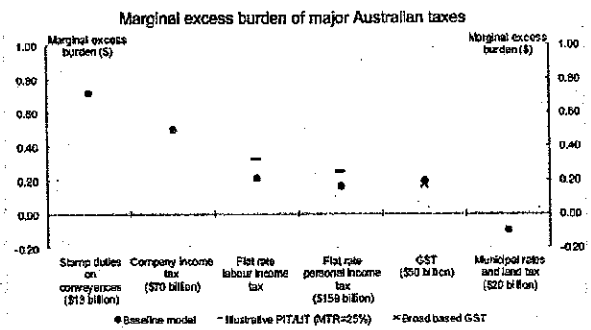
Stamp duties do, to some extent, discourage investment in real estate. However, this effect is small when compared to the impact of the concessions described above.

Land taxes

There are currently two types of land taxes in all Australian jurisdictions; local government rates and state or territory government land taxes. Both taxes are levied on investment properties but owner-occupied housing is exempt from state and territory land taxes. Land taxes are among the most economically efficient taxes.

A recent report by the Commonwealth Treasury showed that land taxes actually create a net economic benefit whereas all other taxes examined created additional costs in excess of the taxes themselves (referred to as marginal excess burden) with stamp duties being the worst of those examined.

Stamp duties are the least efficient of the taxes examined while land taxes were the most efficient; actually generating net economic benefits instead of losses.



Treasury estimates, Author provided

> *"Not only is the current taxation of real estate economically inefficient and results in artificially high prices, it is also inequitable."*

Social justice

The overwhelming majority of tax concessions go to the wealthiest 20% of citizens. Concessions on real estate are no different. Meanwhile, stamp duties create a substantial barrier to lower income Australians purchasing a home while wealthy investors can afford the stamp duties with the expectation that they will be recovered through capital gains.
Not only is the current taxation of real estate economically inefficient and results in artificially high prices, it is also inequitable. State and federal governments have created benefits that substantially favour those with high incomes and wealth and costs that disproportionately disadvantage the rest.

Reform options

A recent Grattan Institute report suggested cash strapped state and territory governments could generate an extra A$7 billion per year by switching from stamp duties to a low rate annual land tax. Not only would this help state governments fill their revenue holes but it would also create a more efficient economy. The ACT is leading the way and is making this transition in slow increments over the next 20 years.

I would go further and suggest that negative gearing should also be abolished and the concession on capital gains tax for real estate should be removed. Land taxes should replace many minor and inefficient state and territory taxes including insurance taxes. Well targeted land taxes could also be used to fund substantial infrastructure investment.

The often stated purpose of concessional taxation of real estate is that it encourages the supply of housing. However, the overwhelming majority of these concessions go to investors who are buying existing housing stock. At the very least these generous concessions should be quarantined to only apply to new housing stock.

The barriers to reforming real estate taxation arrangements are significant. Around two million Australian taxpayers have investment properties and would likely oppose reform. In addition, the imposition of a significant land tax would cause a one-off fall in land prices, potentially leaving some recent buyers with mortgages higher than the value of their properties. In order to make the reform palatable it would have to be either phased in slowly (as the ACT is doing) or grandfathered so that existing investments operate under the old tax provisions.

Serious tax reform is notoriously politically difficult but the benefits can be enormous. The reforms outlined above would significantly contribute to the repair of both state and federal budgets, result in a more efficient tax system and a more efficient economy.