Research Paper

Tax expenditures and housing

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EXECUTIVE SUMMARY

This paper assesses the scale and distribution of key tax expenditures associated with the way in which housing is treated in the Australian tax system and indicates some changes that would make it more efficient and equitable. The relevant key tax bases are, at a federal level, the (individual) income and consumption (GST) tax and, at a state or local level, transactions (stamp duties) and wealth (land taxes and rates) taxes. This paper focuses only on the equity implications of the tax expenditures that arise with these tax bases.

Tax expenditures arise when departures from the generally accepted or benchmark tax structure produces a favourable tax treatment of particular types of activities or taxpayers. Examples of the ways in which tax expenditures arise are through tax exemptions, concessions, and deductions which reduce taxable income; preferential tax rates, allowances, rebates or offsets that reduce the tax payable on income; tax credits which are subtracted from taxes due; and tax deferrals arising from delayed recognition of income or from allowing in the current year deductions that are properly attributable to a future year.

Aggregate estimates of tax expenditures

Chapter 2 summarises the estimates of tax expenditures for 2005-06, based on data from the 2005-06 Survey of Income and Housing. These consist of

→ $45b in indirect assistance to owner-occupiers, made up of

- $29.8b from the capital gains tax exemption of the family home;

- $6.9b from the non-taxation of imputed rent (in turn, made up of a benefit from the non-taxation of imputed rent less operating costs and a cost from the non-deductibility of mortgage interest costs);

- $4.8b from the exemption of imputed rent from the GST; and

- $3.5b in exemption from state-based land taxes.;

→ $2.8b in indirect assistance to renters from the non-taxation of imputed rent (arising from subsidies which result in them paying less than market rent for their dwellings) and exemption of rent from the GST; and

→ $5.4b in indirect assistance to investors, made up of

- $4.2b from the discount on capital gains tax provided to individual investors; and

- $1.2b from the ability of investors to deduct the costs of earning rental income from other source income (that is, from their ability to negatively gear.

These estimates are broadly consistent with those presented in Treasury's annual Taxation Expenditures Statement for 2009 and with those reported in the overview of the Australian tax-transfer system provided as background to the Henry review of Australia's Future Tax System. Reasons for any differences in estimates in different sources are provided in Appendix B.

At an aggregate level, these tax expenditures provide an average annual subsidy of almost $7,000 per household per year although the subsidies are not equitably distributed. By tenure, they are equivalent to a subsidy to:

→ owner-occupiers of more than $8,000 per household per year;

- → investors (most of whom are also owner-occupiers) of more than $4,000 per household per year; and to
- → renters of just over $1,000 per year.

These estimates exclude direct subsidies to first home owners (for example, through first home owners grants) and to private renters (for example, through rent assistance).

Distribution of benefits of tax expenditures

The value of these subsidies varies by income and by age as well as by tenure. Estimates of the distributional impact of the indirect assistance provided through tax expenditures are provided in Chapter 3. These show that, in 2005-06:

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

The overall distribution of tax expenditures to owners and renters by household income and tenure are shown in the chart below. More detailed breakdowns showing the distribution by tenure are provided in Chapter 3. These illustrate the extent to which outright owners benefit vis-a-vis owner-purchasers and renters.

Figure 1: Tax expenditures by household income and tenure, 2005-06
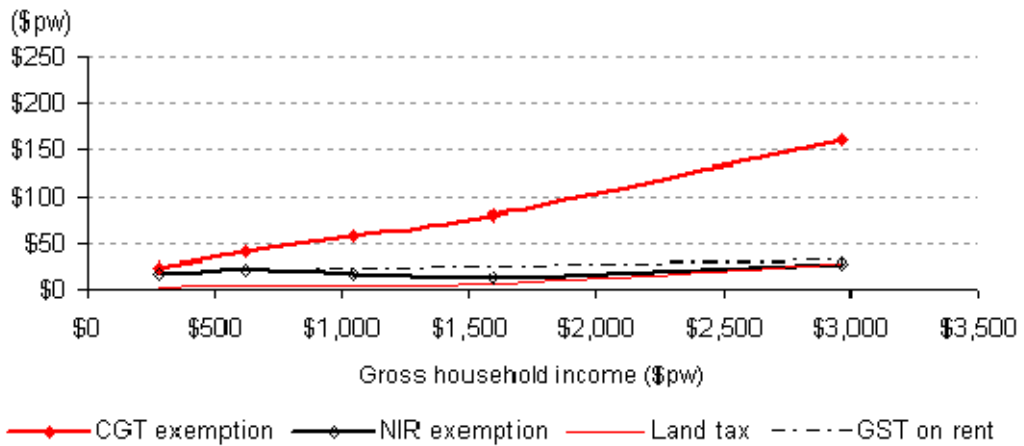
Source: Australian Bureau of Statistics, Survey of income and housing, 2005-06. Results derived from ABS Basic CURF data.

Further disaggregation by age highlights the perverse distribution by age and income. For older, outright owners, the combined average annual benefit of the capital gains tax exemption, the land tax exemption, the exemption of net imputed rent from the income tax, and the exemption of gross imputed rent from the GST varies from:

→ less than $4,500 for those in the lowest income quintile to

→ over $20,000 per year for those in the highest income quintile.

For younger home purchasers, the combined average annual benefit varies from:

→ $2,500 for those in the lowest income quintile to

→ $6,500 for those in the highest income quintile.

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 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.

Figure 2: Key tax expenditures for owner-occupiers by household income and age, 2005-06
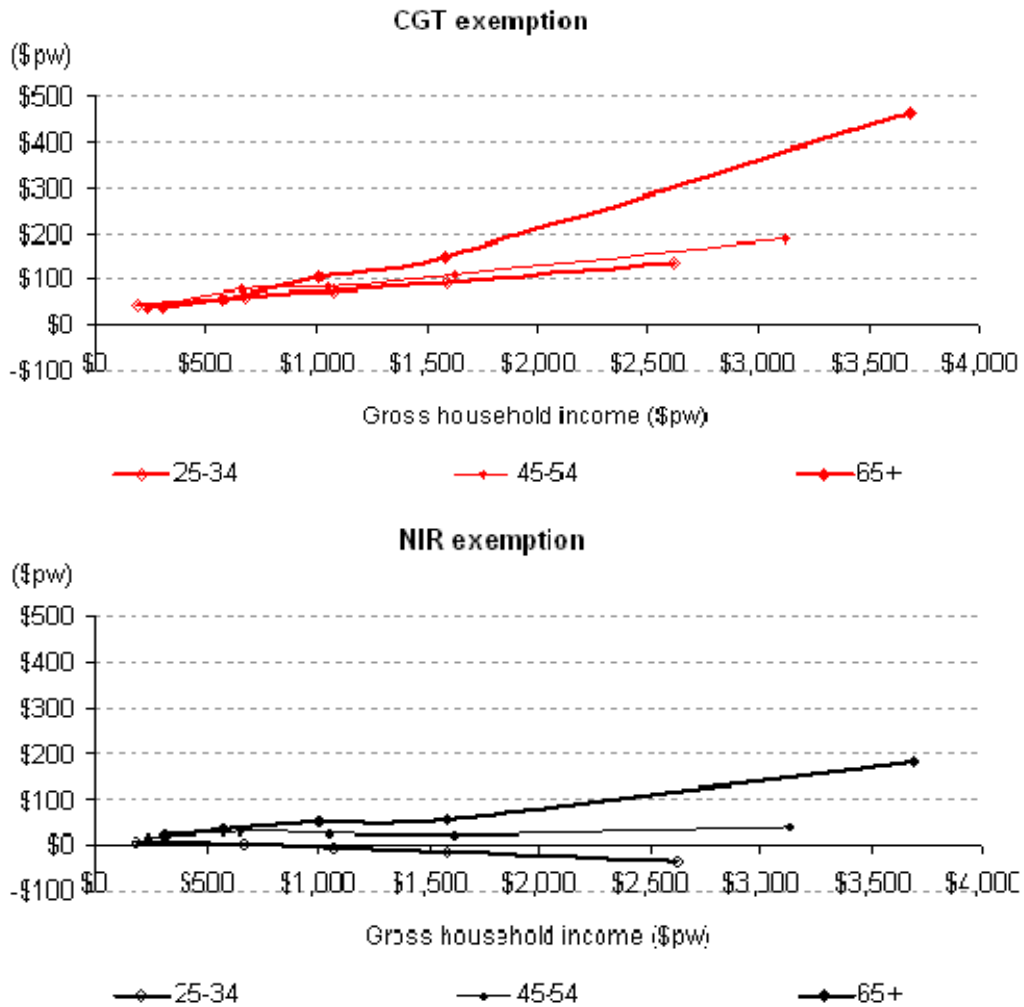
Source: Australian Bureau of Statistics, Survey of income and housing, 2005-06. Results derived from ABS Basic CURF data.

Benefits of tax expenditures for investors

Many of the high income households who benefit from tax expenditures for owner-occupiers are investors in rental housing and also benefit from the tax expenditures associated with this investment. In 2005-06:

→ 16.8 per cent of households in Australia owned rental property. However,

→ almost 40 per cent of households in the top income quintile were rental investors, and

→ only 7 per cent of those in the lowest income quintile were rental investors.

A disproportionate share of high income investor households declared losses and thereby took advantage of the benefits of negative gearing.

Figure 3: Proportions of investors owning and negatively gearing by household income, 2005-06
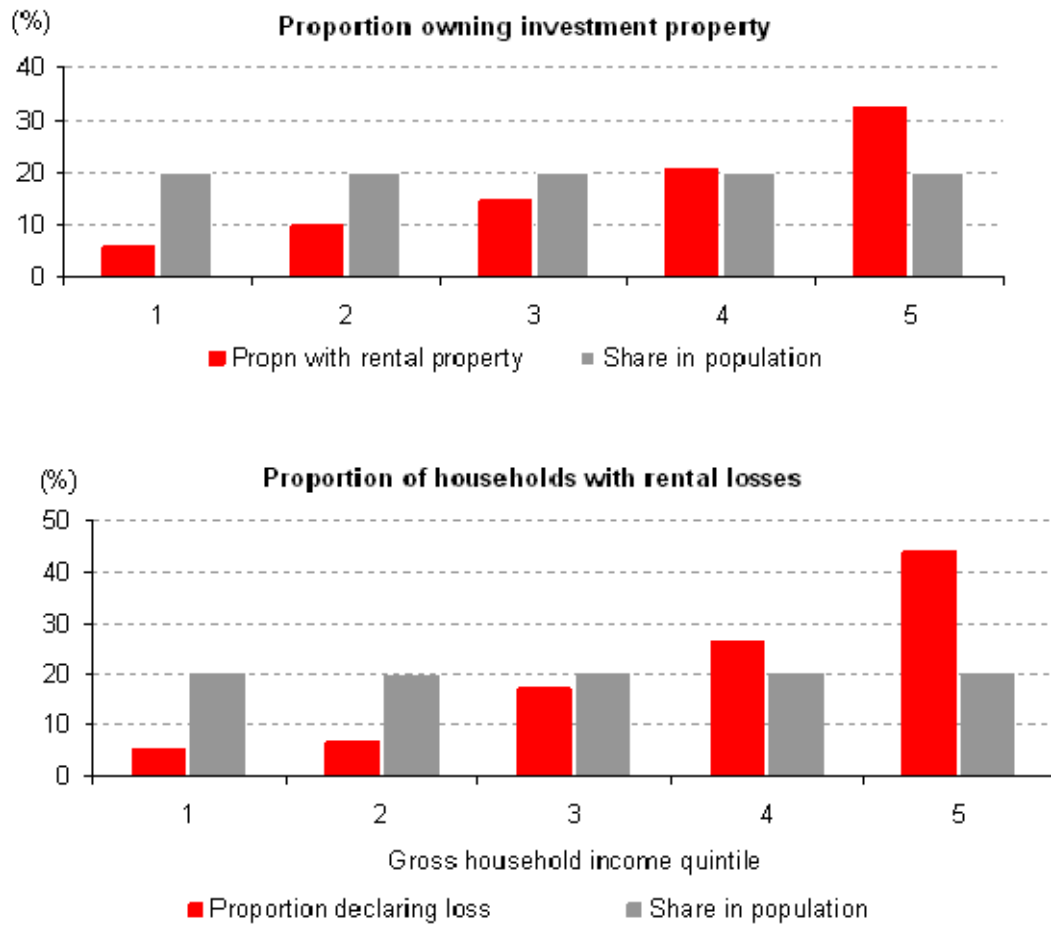
Proportion owning investment property

Propn with rental property ■ Share in population

Proportion of households with rental losses

Gross household income quintile

■ Proportion declaring loss ■ Share in population

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

Figure 4: Tax expenditures for investors by household income, 2005-06
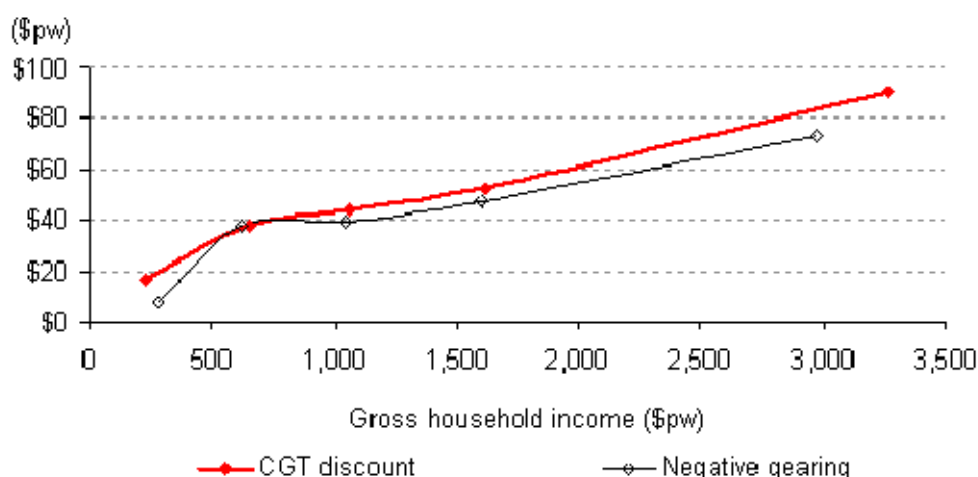
Note: CGT tax expenditures are averaged only over investors in rental housing, and benefits of negative gearing averaged only over those investors who declare rental losses. Data in previous charts are averaged over all households.

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

This distribution of ownership means that the benefits of the tax expenditures to rental investors are skewed towards high income investors. As with tax expenditures for owner-occupiers, within each income quintile, this benefit increases with the age of the household.

Conclusions and policy implications

The results presented in this paper show that the failure to address the question of housing taxation in the tax reforms that have occurred in Australia in the past two decades have resulted in perverse outcomes becoming more pronounced. The indirect assistance provided through tax expenditures has increased. It continues to be poorly targeted, providing the greatest assistance to established home owners and the least to renters and to young purchasers. On average, it continues to provide most assistance to those households who need it least.

These subsidies potentially have a number of adverse effects. The tax concessions to owner-

occupiers:

> → increase investment in owner-occupied housing and the expense of more productive investment;

> → provide an incentive for renters to become owner-occupiers sooner than might be appropriate; and

> → subsidise home-owners, not home ownership.

Subsidies to rental investors are also significant and perversely distributed and potentially have perverse effects. They:

> → are pro-cyclical in their impact; and

> → add to upward pressures on dwelling prices and so contribute to affordability constraints faced by would be first home buyers.

A number of policy options might be considered to address the inequitable impact of these subsidies and to ameliorate their adverse effects. Besides the need to improve ways of estimating the extent of tax expenditures and to continually report on their size and impact, among these are:

- → combine introduction of taxation of imputed rent and capital gains with mortgage interest deductibility;
- → remove owner-occupied housing from land tax exemptions;
- → tax capital gains over a given limit;
- → re-introduce death duties; and/or
- → ring fence losses on income earned from rental property.

These options focus only on the tax expenditures covered in this report; they have not considered some of the taxes that apply to housing. Removal of both taxes and tax expenditures might be one way of packaging what are otherwise seen as unpalatable options. Reduction of stamp duties is an obvious contender for such packaging.

Further packaging might be considered by tying the removal of tax expenditures on housing to increased direct expenditures for housing. An ideal opportunity was lost because of the speed with which the current fiscal stimulus package needed to be introduced. The massive increase in direct housing expenditures provided an excellent opportunity to introduce some of the proposals outlined above. First home owner grants, for example, could have been recouped against future capital gains. New tax expenditure incentives (in the form of tax credits for investors in rental housing) could have been replaced by reductions in stamp duties and packaged with reductions in negative gearing and/or changes in land taxes on rental housing. These examples are intended to highlight the importance of timing in the introduction of significant changes and the importance of having workable proposals in place when the time is right.

While taxing housing will not be easy, the broadening of the tax base by removing the existing significant tax expenditures means that tax rates can be cut at the same time. This provides some opportunity for ensuring that there will be fewer losers than might otherwise be the case.

1   INTRODUCTION

The aim of this paper is to assess the scale and distribution of the key tax expenditures associated with the way in which housing is treated in the Australian tax system and to indicate some of the changes that would make the tax treatment of housing more efficient and equitable.

The terms of reference for the current tax review (the Henry review) require (inter alia) that it take into account the relationships of the tax system with the transfer payments system, that it take into account recent international trends to lower headline rates of tax and apply them across a broader base, and that it incorporate consideration of all relevant tax expenditures (Treasury, 2008b, p261). Each of these requirements are particularly relevant in relation to housing.

1.1   Past tax reviews

Australia has experienced a number of important reforms to its tax system in the past few decades as a result of a number of major and wide-ranging inquiries into the tax system. Of these, the two most recent and relevant for the housing focus of this paper are the Reform of the Australian Tax System (RATS) released in 1986 and A New Tax System (ANTS) released in 1998 and supplemented with a Review of Business Taxation (the Ralph review) in 1999. The current review, Australia's Future Tax System (AFTS, or the Henry review), follows in the tradition of these significant historical inquiries.

The major thrust of RATS was to broaden the income tax base in an attempt to move to a more comprehensive definition of income where all types of economic gain are treated consistently. Among other changes, this reform resulted in capital gains being taxed for the first time in Australia (on a real, realised basis). This was seen as important for equity and efficiency purposes regardless of the weight that is ultimately placed upon the income tax base in any tax package (Head 1991). The major thrust of ANTS was to reduce reliance on the income tax system (and, with this, to reduce some of the disincentives associated with high marginal income tax rates). This was achieved by the introduction of a broad based consumption tax in the form of the current goods and services tax (the GST). A key outcome of the Ralph Review was to change the form of the capital gains tax from a real or indexed base to a nominal base, with a 50 per cent discount introduced for individuals.

Despite the major tax reforms of the 1980s and 1990s, there are many unresolved issues surrounding the appropriate tax treatment of housing in general and owner-occupied housing in particular. One of these is the vexing question of the appropriate tax treatment of housing.

1.2   Defining tax expenditures

This paper provides a distributional analysis of some of the key tax expenditures associated with housing under both the federal and state taxation systems. 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' (Organisation for Economic Cooperation and Development 1984, p. 7). Examples of the ways in which tax expenditures arise are through tax exemptions, concessions and deductions which reduce taxable income; preferential tax rates, allowances, rebates or offsets which reduce the tax payable on income; tax credits which are subtracted from taxes due; and tax deferrals arising from delayed recognition of income or from allowing in the current year deductions that are properly attributable to a future year (Gravelle, 2005; Smith, 2003).

In relation to the income tax base, owners of rental property pay tax on rental income (after interest and operating costs) and they also pay tax (at a 50 per cent discount on their marginal tax rate) on realised capital gains. This discount, along with the deferral of an income tax liability until capital gains are realised, creates an asymmetry in the treatment of income and costs for landlords. It has the potential to encourage speculative investment in assets expected to generate significant capital gains. Australia is one of the few countries that allows deductions of losses on property against income from other sources. As in most countries, owners of owner-occupied property pay no tax on rental income and no tax on realised capital gains. However, they are also unable to deduct interest and operating costs. These aspects of the income tax system give rise to some of the major tax expenditures associated with housing.

The concept of tax expenditures was first raised in the context of the income tax base but it has long been recognised that it applies equally well to any of the tax bases in use.

Box 1 describes the key characteristics of the tax expenditures associated with these tax bases and briefly outlines some of the possible effects of them. The focus in Box 1 is primarily on the ways in which the current tax system of housing distorts choices; that is, on the issue of efficiency. The data presented later in this paper focuses primarily on equity issues associated with the tax expenditures that currently exist. In general, both equity and efficiency issues are likely to be improved by reducing the size of these tax expenditures.

Within the main tax bases (income, consumption, wealth or transactions) currently in use in Australia, however, the question of what constitutes tax expenditures is not clear cut because of the difficulties in defining the benchmark. This can be illustrated by the differences in the international tax treatment of housing shown in Table A1 in Appendix A.

Box 1: 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)

1.3 Estimating tax expenditures

1.3.1 Practical issues

Surrey, the architect of the tax expenditure concept, measured tax expenditures against a comprehensive income tax base, commonly described as the Haig-Simons or Schanz-Haig-Simons definition of income. Under this definition, income is defined as consumption plus the change in the real value of net wealth. While a seemingly straightforward definition in principle, it raises a number of practical issues. In principle, it suggests that income should be defined in real terms – in other words, the effects of inflation should be removed. In practice, the vast majority of income tax systems in the world are not indexed for inflationary effects. In principle, it suggests that increases in net wealth should be taxed as they are accrued. In practice, administrative difficulties associated with estimating capital gains on an accrual basis generally have led to them being taxed on realisation. In principle, it suggests that income should be treated the same, regardless of its source. In practice, corporate income is treated differently from individual income and income from labour and income from capital are often treated differently. All of these examples relate to problems of identifying the relevant benchmark for defining the income tax base.

Other practical issues arise because there is no guidance provided by the commonly employed income tax base definition. One obvious example relates to identifying the appropriate benchmark for the rate structure to be applied. A simple illustration is whether a tax free threshold, which introduces an element of progressivity into the rate structure, could or should be regarded as a tax exemption. A broader question arises in relation to the choice of the individual as the tax unit for income tax, rather than the income unit or family, or in relation to the tax treatment individuals vis-a-vis trusts, partnerships or companies. Other equally fundamental issues arise in relation to the choice of tax bases to be used and to the relative weights that should be applied to the tax bases available. These choices have significant implications for the standard equity, efficiency and simplicity criteria against which tax policies are conventionally evaluated.

Many of these issues arise in Treasury's annual Tax Expenditure Statement (TES) which provides details and estimates of concessions, benefits, and charges provided through the Australian Government's tax system. The publication of information on the Australian Government's tax expenditures is a requirement under the Charter of Budget Honesty Act 1998 (Treasury, 2009, p1). Tax expenditures are defined in the TES as deviations from a taxation benchmark that neither favours nor disadvantages similar activities or classes of tax payer. However, not all concessional elements of the tax system are classified by Treasury as tax expenditures because they are considered a structural component of the benchmark (Treasury, 2009, p2). As in a number of countries, the 'normal' income taxation benchmark used by Treasury excludes some income (imputed rent, accrued capital gains) and includes some items (inflationary gains) that are not defined as income in the Schanz-Haig-Simons definition.

As argued in the Treasury background paper (2008a), both the non-taxation of net imputed rent (that is, the gross rental value of owner-occupied housing less interest and operating costs) and accrued (real) capital gains are components of income that are explicitly included in the Schanz-Haig-Simons definition of comprehensive income. While it may be administratively pragmatic to exclude net imputed rent from the list of tax expenditures identified by Treasury, its omission does violate the principle of neither favouring nor disadvantaging similar activities or classes of tax payers.

State budget papers also provide a list of tax expenditures and provide similar examples of the judgment required in deciding what constitutes a tax expenditure or concession and what constitutes a structural feature of the underlying taxation or service delivery system. In NSW and Queensland, for example, the exemption of the principal residence from land tax is regarded as a structural feature of the tax system and the revenue foregone is not included in estimates of tax expenditures for land tax. In Victoria, however, land tax expenditure estimates include those associated with the exemption of the principal place of residence.

Similar subjective judgments need to be made in relation to tax scales. In NSW, for example, stamp duty on property transfers is charged at different marginal rates according to the value of the property involved. While this could be interpreted as providing a concessional rate of taxation for lower valued properties, the different rates are regarded as a structural feature of the tax system and the revenue lost as a result of these lower marginal rates is not classified here as a tax expenditure (NSW Treasury, 2008, p5-2).

1.4   Estimation approach

Most official estimates of tax expenditures both at central and state level (as in this paper) are based on a revenue foregone approach. They are derived by estimating the amount of tax that would be due from taxpayers currently in receipt of the concession if they were treated in the same way as those who currently are taxed. This approach provides an estimate of the benefit to the tax payer of the particular tax expenditure, but it does not provide an estimate of the cost to government of providing it, nor does it provide an estimate of how much revenue would be obtained if the relevant concession was removed. Tax concessions are likely to induce behavioural responses by their beneficiaries. Their removal, therefore, also is likely to result in a behavioural response which can affect the tax base from which revenue is raised. Estimates also do not take into account the impact of changes in one tax base on another tax base. Removal of the land tax exemption for owner-occupied property, for example, would increase the land tax base but would reduce the income tax base if owner-occupiers are to be treated the same as other land owners since land tax paid is an allowable deduction from income.

Estimates of tax expenditures, therefore, need to be treated with some caution. They reflect subjective judgments; they ignore changes in the rate structure that might follow from changes to the tax base; they ignore changes in the tax rates that individual tax payers might face if a progressive tax rate structure is in place and their tax base is increased; and they ignore behavioural changes that might arise from the removal of an existing concession.

These qualifications notwithstanding, the estimates in the following two sections provide a broad indication of the relative importance of the key tax expenditures that arise in relation to housing and of the way in which the benefits of those tax expenditures are distributed across households with different household characteristics.

2 AGGREGATE ESTIMATES OF TAX EXPENDITURES ON HOUSING

2.1 Summary of results

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.[1] Table 1 provides indicative estimates of the extent of the tax expenditures associated with these bases (negative values indicate a tax rather than a tax expenditure). These have been estimated by aggregating estimates generated from the individual data available in the ABS Survey of Income and Housing (SIH) for 2005-06. The basis of these estimates is explained in the following section.

Table 1: Aggregate tax expenditures by tax base

	2005-6	*1999*
Income base	**$b**	**$b**
owner-occupied housing		
net imputed rent exemption	6.9	8
non-taxation of imputed rent		13
non-deductibility operating costs		-5
non taxation capital gains	29.8	13
investor housing		
discount on capital gains	4.2	
rent less deductions (neg. gearing)	1.2	
net imputed rent exemption	1.2	
Consumption base		
owner-occupied housing		
non taxation rental services	4.8	
rented housing		
non taxation rental services	1.6	
Wealth tax base		
owner-occupied housing		
exemption from land tax	3.5	
Total tax expenditures		
owner-occupied housing	45.0	21.0
investor/rented housing	8.2	

Source: Australian Bureau of Statistics Survey of income and housing, 2005-06. Results derived from ABS Basic CURF data. 1999: Yates (2003a).

In total, the tax system in 2005-06 delivered at least $45b in subsidies to owner-occupiers and a further $5b to investors in rental housing and $3.2b to renters. This

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[1] Yates (1997) provides a detailed overview of taxes and tax expenditures associated with housing in Australia in relation to the tax system as that time.

amounts to an average subsidy of almost $7,000 per household per year. Concessions to owner-occupiers as a result of the tax expenditures associated with owner-occupied housing provide an average annual subsidy of more than $8,000. Concessions to investors (most of whom are also owner-occupiers) provide an average annual subsidy of more than $4,000. Tax expenditures benefiting renters provide an average annual subsidy of just over $1,000 per renter household.

Not all taxes on housing are reported in Table 1 because of the limitations of the survey data used in this study. Aggregate estimates for the key taxes that need to be borne in mind (primarily stamp duties and rates) are included in Table B1 in Appendix B, which provides both a comparison of recent estimates for the major taxes and tax expenditures from a number of sources and an analysis of the factors that contribute to the variability in these estimates. Appendix B also provides a discussion of the assumptions made in generating these estimates.

2.2 Data used

The estimates presented in Table 1 are derived from the confidentialised unit record file for the 2005-06 Survey of Income and Housing conducted by the ABS. This provides data on 9,961 households and 19,212 individuals aged 15 or more. Details of the survey and a summary of some of the key results relevant for this paper can be found in ABS (2007a, 2007b, 2008).

2.2.1 Tax expenditures for owner-occupied housing

Data on gross and net imputed rent for owner-occupied dwellings are the experimental estimates released by the ABS in May 2008 (and discussed in ABS, 2008). They include imputed rent estimates both for owner-occupiers and for renters paying subsidised rents (such as is likely to be the case for those renting from a social landlord or those living rent free). Thus, the data in Table 1 includes estimates for the tax expenditures from the non-taxation of imputed rent for owner-occupiers but also for renters.

These ABS estimates for imputed rent for owner-occupied dwellings are conservative. Figure A1 in Appendix A shows the estimation procedures used have generated a distribution of imputed rents for owner-occupied dwellings that is more concentrated than that for private rents. In particular, there is a smaller proportion of dwellings with low imputed rents (which is consistent with a priori expectations) but, despite the generally higher quality of owner-occupied compared with rental housing, there is also a smaller proportion with high imputed rents (which is not consistent with a priori expectations) given the higher quality and large size of owner-occupied housing.

Because there are no data in the SIH from which realised capital gains on owner-occupied dwellings can be derived, these have been approximated by a conservative estimate of average annual accrued capital gains applied to the current market value of the dwelling. Both realised and annual average accrued capital gains will vary with the state of the house price cycle. Realised gains have the potential to be more volatile because the decision whether or not to sell introduces an additional factor that affects gains. Averaging capital gains over a longer term is likely to reduce this volatility, but cyclical variations in the estimated value of owner-occupied housing will provide an offset to this.

Figure A2 in the Appendix provides data on actual (nominal) dwelling price inflation in the capital cities in Australia over the period from 1986 to 2009. Over this period, there have been significant spikes in house price inflation (in the first instance immediately following the introduction of a tax on real capital gains in 1986 from which owner-occupied housing was exempted and, in the second instance, immediately following the 1999 tax reforms which changed the tax base to nominal capital gains but

introduced a 50 per cent discount for individuals). Over this period (which takes into account the current downturn), average house price inflation was just under 8 per cent at a time when average price inflation was just under 3.5 per cent.

The estimates reported in Table 1 are based on an extremely conservative figure of nominal capital gains of 4 per cent per annum. This has been chosen partly to minimise any claim that the reported estimate is too high, partly because gains based on the actual figure of 8 per cent can be obtained simply by doubling the reported estimates, and partly because 4 per cent could be regarded as an approximation of the real capital gains on which the comprehensive Schanz-Haig-Simons income tax is predicated. A figure of 3 per cent was used in the 1999 estimates (Yates, 2003a). Use of the marginally higher rate for 2005-06 pays lip service to the significant increases in real house prices since 1999.

For both imputed rent and capital gains, tax expenditures are estimated by applying the marginal tax rate of the higher income earner in the primary income unit in the households to the untaxed income. At an aggregate level, these estimates are 30/23 higher than those that would be obtained if the marginal tax rate of the lower income earner was used. At a disaggregate level, the differences are minimal for households in the lowest income quintile (because of the preponderance of single income households at these income levels) but increase as income increases. In practice, of course, adding imputed income to the tax base of a low income individual is likely to mean that the disparity between the marginal tax rates of lower and higher individuals would be reduced.

Details for the approach to estimating the tax expenditures recorded under the consumption and wealth tax bases are provided in Appendix B. In brief, the magnitude of the GST exemption for owner-occupiers is estimated by applying the GST rate (or 10 per cent) to gross imputed rent less non-interest operating costs; that for renters is applied to actual rent paid. The value of the land tax exemption for owner-occupiers is derived from applying the current land tax rate schedule in each state to the combined estimate of the land value of owner-occupied and investor housing owned by each household.

2.2.2 Overview

Table 1 highlights the scale of the tax expenditures that accrue to owner-occupied housing as a result of the exemption of capital gains from the capital gains tax base. Even on the conservative assumptions employed in the above estimates, the value of this tax expenditure exceeds the tax expenditures for superannuation which are the largest of the measured tax expenditures reported in the TES. In 2005-06, tax expenditures arising from the concessional taxation of superannuation entity earnings and of employer contributions amounted to $21b (and had increased to $22b by 2008-09). In 2005-06, tax expenditures arising from the exemption of the family home from capital gains taxes amounted to almost $30b on the basis of the conservative assumptions employed in this study (and to $39.5b on the basis of Treasury's estimates of realised capital gains reported in Table B1 and discussed in Appendix B).

These estimates do not take into account the benefits that arise because owner-occupied housing is exempted from the asset test for the age pension. The Senate Select Committee on Housing Affordability in Australia (2008, p.60) estimated that, in addition to the tax expenditures for owner-occupied housing, its exemption from the assets test costs around $10 billion. This estimate was derived by scaling up the Productivity Commission (2004, p.109) estimated the cost at about $8 billion in 2003.

The magnitude of the tax expenditures that arise from exemption of both capital gains and imputed rent from owner-occupied housing from the income tax base suggests

that these are likely to result in considerable distortions in favour of owner-occupied housing. They are likely to increase demand for owner-occupied housing at the expense of investment in other assets. In light of the inherent supply constraints that arise when urban settlement patterns are highly concentrated, any such increase in demand will contribute to the pressures on house prices that have helped make housing unaffordable for many lower income households. They are also inequitable in that they benefit existing owners at the expense of renters and new entrants into the housing market.

They are reinforced by the effect of the exemption of owner-occupied property from the state-based land taxes. The estimated revenue foregone from this particular exemption (of $3.5b in 2005-06) is relatively modest compared with the exemptions from the income tax because of the significant thresholds that are part of the structure of the land tax and because of the fragmented nature of holdings of residential land that, presumably, can be attributed to the impact of a progressive rate structure on cumulative holdings of land.

2.2.3 Rental housing tax expenditures

The structure of land taxation is particularly relevant for investment in rental housing. Some of the effects of the land tax as it currently operates were commented on in Box 1 above. Small scale investment is encouraged over large scale investment which means that many of the economies of scale that can arise with management and maintenance of larger dwelling portfolios are not always available. Also, it means that landlords are likely to invest in properties where land is a low proportion of property value. To the extent that this encourages investment in apartments rather than detached houses, it means that households with a preference for a detached house (as might be the case for households with children) may be forced into ownership whether or not this is their preferred tenure because of relatively little choice in the private rental market.

To some extent, the disincentive effects on landlords investing in rental property are offset by the tax expenditures associated with the discount on capital gains for individuals and by their ability to negatively gear. These concessions, however, are available for individual investment in all forms of income producing non-financial assets (and, in particular for shares). They are likely to encourage investment in speculative activity and, because the benefit of the distortion created by the asymmetric treatment of gains and losses is greatest when expected capital gains are greatest, they are likely to contribute to considerable pro-cyclical behaviour. The contribution that investors appear to have made to the current housing cycle provides some support for this concern (for example, Stevens, 2002). Any factor that contributes to instability in housing markets adds to inefficiency because of the impact it has on skilled labour in the building industry.

The distortions created by these particular tax expenditures differ from the remaining exemption not yet discussed: viz., the exemption of rents and imputed rents from the GST. They differ because this particular distortion is tenure neutral. In other words, it treats consumers of the services provided by owner-occupied and rental housing identically. By providing a tax-wedge between rents and all other goods and services, it does encourage consumption of housing services at the expense of other goods and services and, as such, is likely to add to the demand for housing services in general in the same way that the income tax exemptions add to the demand for investment in owner-occupied housing in particular.

In general, therefore, these efficiency effects encourage investment in owner-occupied housing over other forms of investment; encourage speculative investment in rental investment; discourage large scale investment in rental housing; and favour

consumption of housing over consumption of other goods and services. These distortions need not be inefficient if there are benefits of owner-occupation (such as providing security, stability and control) that are not always available from rental housing and if they encourage increased housing consumption by those who are most likely to consume less than is seen as socially desirable.

Whether or not these qualifications are met is likely to depend on the way in which the tax expenditures identified in Table 1 are distributed. This is the focus of the following section.

3   DISTRIBUTIONAL ESTIMATES OF TAX EXPENDITURES ON HOUSING

3.1   Distribution of tax expenditures by household income

Table 2 shows how the $52.5b in tax expenditures identified in Table 1 is distributed according to gross household income. Overall, households in the top income quintile receive an average benefit of $161 per week (equivalent to over $8,000 per year) for the largest of these tax exemptions (the exemption of the family home from the capital gains tax). This is more than seven times the average net benefit received by households in the lowest income quintile.[2]

Table 2: Tax expenditures by tax base and household income quintile

	Gross household income quintile						Agg
	1	2	3	4	5	All	tax exp.
	$pw	$pw	$pw	$pw	$pw	$pw	$b
Gross household income	285	623	1,048	1,595	2,967	1,304	
Income tax base							
Owner-occupied housing							
CGT exemption	23	41	57	79	161	72	29.8
NIR exemption	21	29	23	16	31	24	6.9
Rental housing							
CGT discount	1	4	6	11	30	10	4.2
Tax benefit of negative gearing[a]	7	38	39	47	73	54	1.2
NIR exemption	10	8	7	8	17	9	1.2
Consumption tax base							
GST exemption of imputed rents[b]	15	15	16	17	20	17	4.8
GST exemption of actual rents[c]	8	11	14	16	21	13	1.6
Wealth tax base							
Land tax exemption	3	4	4	6	28	9	3.5

[a] weekly benefit from negative gearing is averaged over only those investor households with negative rental income; [b,c] GST exemption of imputed rents and rent averaged, respectively, only over owner-occupied and rented households; all other benefits are averaged over all households.

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

Large disparities in the benefits also arise from the land tax exemption and the taxes associated with the asymmetric treatment of income from rental housing (viz., the

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[2] However, the average gross income of households in the top income quintile is more than ten times that of households in the lowest income quintile (and average disposable income is eight times that of households in the lowest income quintile). Technically, therefore, this distribution of tax expenditures does not reduce the progressivity of the tax system as currently constituted. Their removal, in fact, would be regressive. A tax is regressive if the tax rate is higher for low income households than it is for high income households. If the results in Table 3.1 were (incorrectly) interpreted as the amount of tax received by removal of the exemption of the tax expenditures identified, the ratio of the additional tax paid as a result of their removal would be 30 per cent for low income households and only 13 per cent for high income households. In practice, however, any broadening of the respective tax base would provide revenue capacity to achieve a desired element of progressivity in the tax system.

discount on capital gains and the benefit associated with negative gearing). Households in the top income quintile receive a benefit of $28 per week (approximately $1,500 per year) from the exemption of the principal residence from land tax, more than nine times the benefit received by households in the lowest income quintile. High income households who can afford to invest in rental housing receive a tax benefit from the capital gains tax discount of $30 per week (a further $1,500 per year) which is thirty times that received by low income households who have retained their investment in rental housing. The smaller number of these who negatively gear their investment are able to increase this tax advantage by a further $54 per week (close to $3,000 per year) – an amount that is more than seven times the benefit received by lower income households who are negatively geared. All of these benefits are derived from the taxes that are associated with housing as an asset rather than with the taxes associated with the rental services that housing provides.

Concessions to the consumption services provided by housing – through the income tax concession provided by the non-taxation of net imputed rent for owner-occupiers and the consumption tax concession provided by the exemption of rents from the GST show less disparities. This arises partly because the gross rental rate of return on housing tends to decline as dwelling value increases.

Interpretation of many of these aggregate estimates is confounded by their aggregation over households of different ages and in different tenures. The following sub-sections provide a clearer picture by disaggregating further by tenure and age as well as by income.

3.2   Distribution of concessions by household income, tenure and age

A visual representation of how the more important of these tax expenditures (viz. those to owner-occupiers) are distributed across households according to household tenure is provided in Figure 5 below. In this Figure, the data are plotted for mean income in each of the five quintiles. The markers on the charts represent each of these quintile means (which vary by tenure within each quintile although the quintiles themselves have been defined over all households). The tax expenditures associated with the non-taxation of capital gains and the exemption from land tax benefit only owner-occupiers; those associated with the non-taxation of net imputed rent and, with the exemption of imputed rent or actual rent paid from the GST, benefit all consumers of rental services (that is, both owner-occupiers and renters).

The top chart in the first set of three charts in the first part of Figure 5 replicates the data in Table 2. It highlights the dominating effect of the value of the exemption of the family home from the capital gains tax, even when this is estimated on the basis of an average value for nominal gains that is half that which has been experienced since the introduction of the capital gains tax in the 1980s and more than half of the average annual nominal capital gains since the 1999 reforms to capital gains tax (up to, and including, the downturn in house prices to March 2009). It also clearly shows the extent to which high income households benefit from this particular tax expenditure. The second and third charts in the first part of Figure 5 disaggregate the results according to household tenure in order to reinforce the horizontal inequities associated with this particular tax expenditure.

The second set of three charts in the second part of Figure 5 begins by repeating the chart for owners (the middle chart in the first set of three) and disaggregates this according to whether the owners owned their dwelling outright (that is, without a mortgage) or whether they were still purchasing it (that is, had a mortgage).

Figure 5: Tax expenditures by household income and tenure, 2005-06
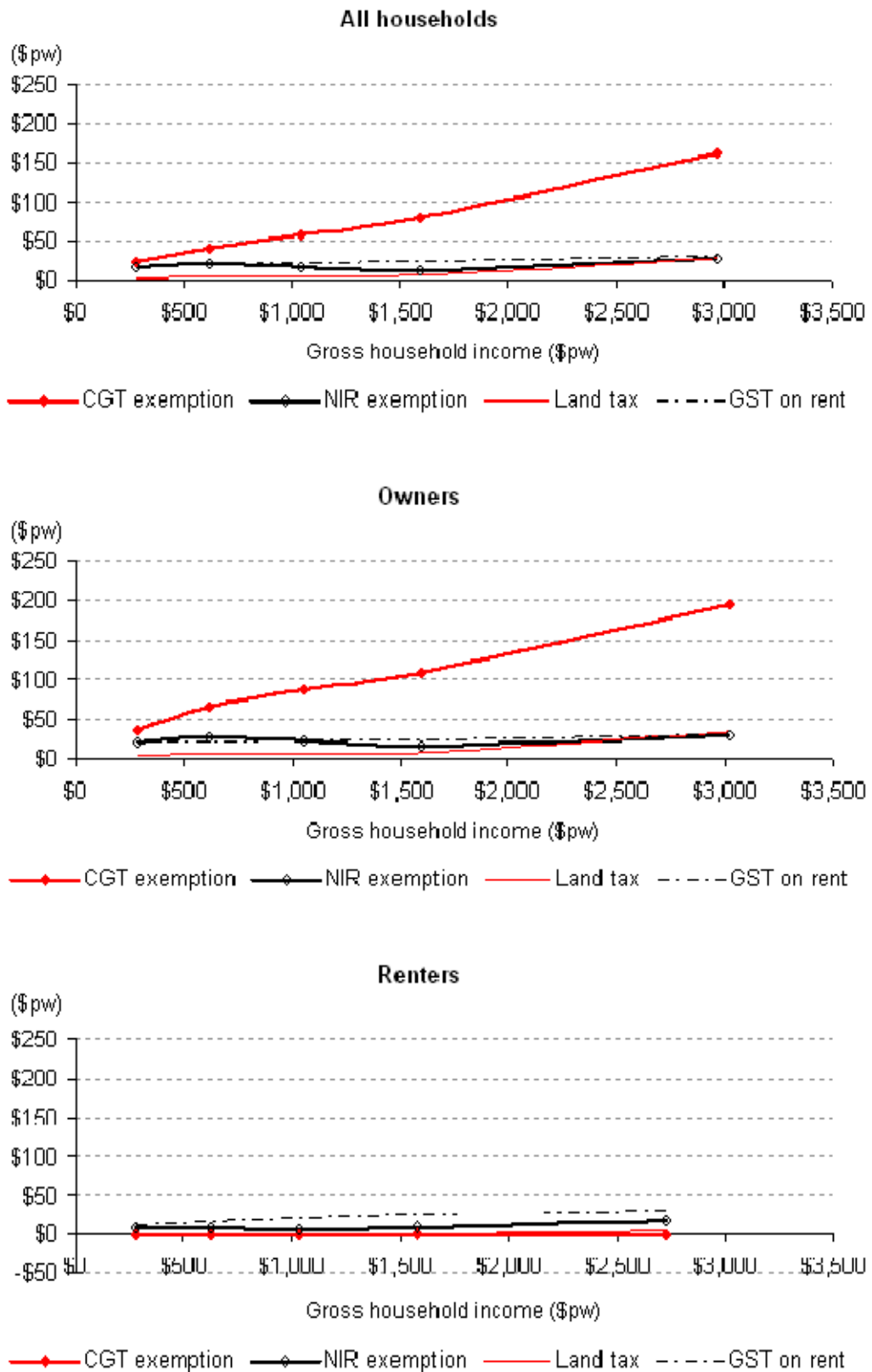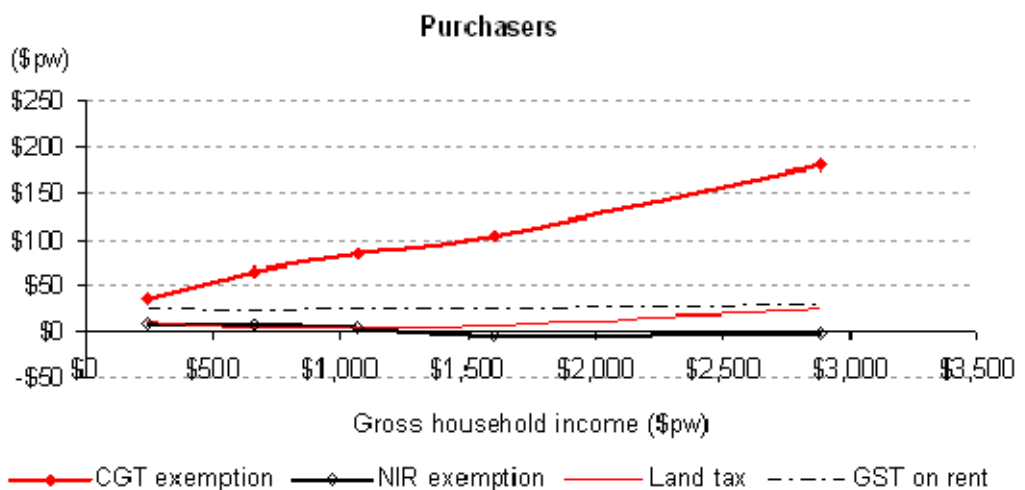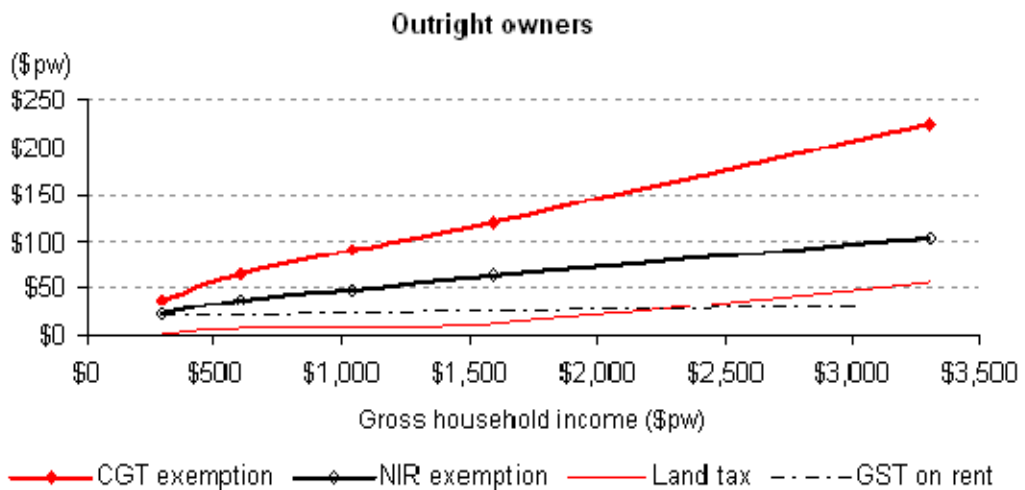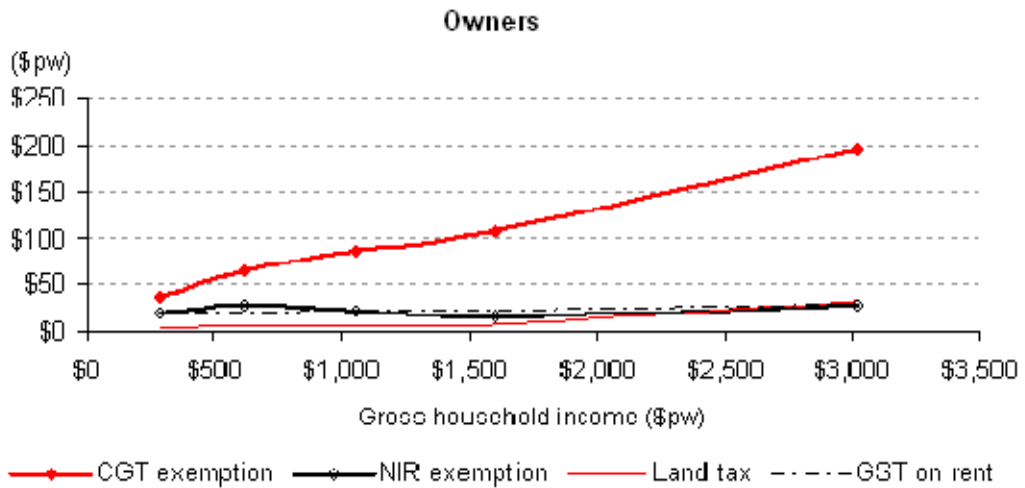
All households

($pw)

CGT exemption — NIR exemption — Land tax — GST on rent

Owners

($pw)

CGT exemption — NIR exemption — Land tax — GST on rent

Renters

($pw)

CGT exemption — NIR exemption — Land tax — GST on rent

Owners

Outright owners

Purchasers

This second set of three charts highlights the far greater extent to which outright owners benefit from the charted tax expenditures (with the exception of the exemption

of rents from the GST) than do purchasers. This arises primarily because of their higher dwelling values and the higher gross imputed rent. Purchasers are disadvantaged by the exemption of gross imputed rent from taxable income because they are unable to deduct their costs which, in the early years of home ownership, can exceed the rental benefits derived. Table A2 in Appendix A summarises some of the key gross and net housing wealth data that lead to these outcomes. These are illustrated in Figure A2.

Tables 3, 4 and 5 provide details on tax expenditures for owners, outright owners and purchasers by household income and by age. Sample sizes are also reported in these tables. Estimates based on samples of less than 20 households should be treated with some caution. The variation due to small sample sizes explains some of the patterns in the data illustrated in Figures 6 to 8. Nonetheless, the results in Figures 6 to 8, respectively for all owners, outright owners and purchasers are disaggregated by household income and by age of the reference person in the household. These figures highlight the relative disadvantage faced by younger (aged less than 45) purchasers because of their inability to access the benefits of negative gearing that are available to their rental investor counterparts. These are considerably greater for higher income households, reflecting their greater borrowing capacity. They also show the significant life-cycle impacts of the existing structure of tax expenditures as dwelling values increase as households age.

Table 3: Tax expenditures for owners by household income and age, 2005-06

| | Household income quintile | | | | | |
	1	2	3	4	5	All
Age < 25						
Gross household income	269	667	1,062	1,591	2,402	1,432
CGT exemption	18	62	64	72	118	76
NIR exemption	-3	-10	-6	-18	-10	-11
Land tax	0	0	1	2	15	4
GST on rent	16	22	21	21	25	21
sample size	3	16	33	34	17	103
Age 25 - 34						
Gross household income	191	676	1,073	1,586	2,619	1,601
CGT exemption	44	61	75	94	138	96
NIR exemption	10	3	-5	-12	-33	-14
Land tax	9	2	3	4	11	6
GST on rent	22	21	21	23	25	23
sample size	29	104	198	259	215	805
Age 35 - 44						
Gross household income	214	669	1,073	1,600	2,981	1,757
CGT exemption	31	65	82	111	195	122
NIR exemption	7	14	7	2	11	8
Land tax	12	2	3	6	28	12
GST on rent	22	21	22	24	29	24
sample size	59	168	311	408	431	1377
Age 45 - 54						
Gross household income	239	656	1,051	1,625	3,123	1,885
CGT exemption	34	79	83	108	188	125
NIR exemption	16	30	25	24	40	30
Land tax	8	14	3	7	32	16
GST on rent	22	23	22	24	29	25
sample size	115	195	325	423	553	1611
Age 55 - 64						
Gross household income	270	627	1,059	1,586	3,119	1,397
CGT exemption	35	71	95	112	213	110

NIR exemption	21	37	39	53	71	45
Land tax	6	6	9	10	36	14
GST on rent	21	22	24	25	31	25
sample size	251	286	311	236	263	1347
Age 65+						
Gross household income	311	581	1,009	1,582	3,687	639
CGT exemption	39	60	105	149	464	71
NIR exemption	24	35	52	58	182	37
Land tax	2	6	12	33	203	12
GST on rent	21	22	25	28	49	23
sample size	828	572	192	77	52	1721
All owners						
Gross household income	290	621	1,055	1,601	3,018	1,423
CGT exemption	37	65	87	108	194	104
NIR exemption	21	29	23	16	31	24
Land tax	4	6	6	8	34	12
GST on rent	21	22	23	24	29	24
sample size	1285	1341	1370	1437	1531	6964

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

Figure 6: Tax expenditures for owners by household income and age, 2005-06
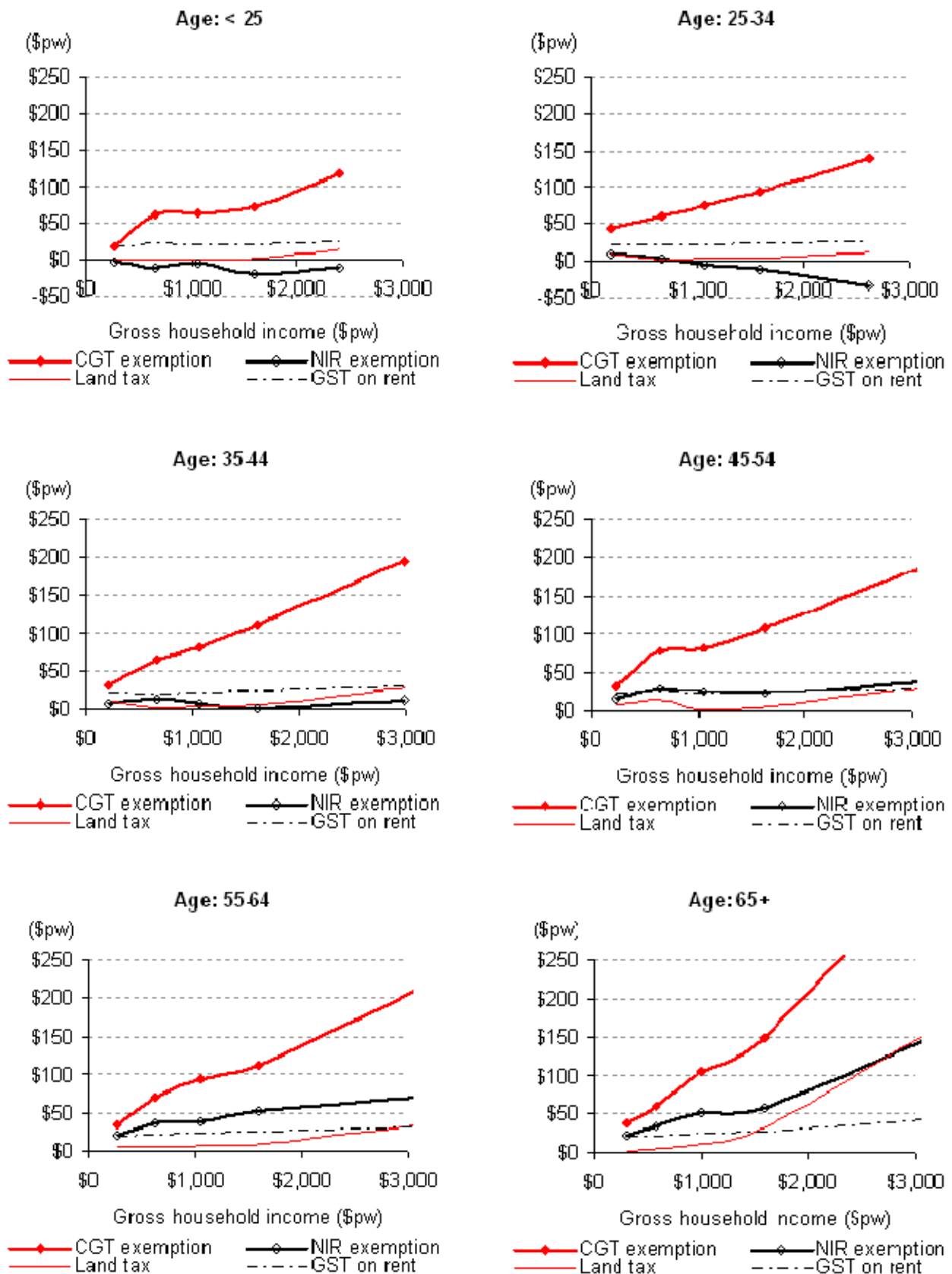
Source: Australian Bureau of Statistics, Survey of income and housing, 2005-06. Results derived from ABS Basic CURF data.

Table 4: Tax expenditures for outright owners by household income and age, 2005-06

| | Household income quintile | | | | | |
	1	2	3	4	5	All
Age < 25						
Gross household income	0	706	1,033	1,570	2,444	1,473
CGT exemption	0	88	67	81	225	108
NIR exemption		60	51	53	96	62
Land tax	0	0	0	0	75	16
GST on rent	0	25	22	23	38	26
sample size	0	2	4	3	3	12
Age 25 - 34						
Gross household income	225	683	1,044	1,563	2,738	1,506
CGT exemption	96	82	71	109	142	102
NIR exemption	42	55	42	62	73	57
Land tax	36	8	1	12	9	9
GST on rent	26	24	20	25	26	24
sample size	7	19	30	23	22	101
Age 35 - 44						
Gross household income	159	670	1,064	1,594	3,684	1,852
CGT exemption	19	62	81	125	224	127
NIR exemption	15	40	45	62	108	65
Land tax	3	4	2	13	54	20
GST on rent	21	20	21	24	31	24
sample size	19	39	53	61	72	244
Age 45 - 54						
Gross household income	255	642	1,054	1,602	3,253	1,798
CGT exemption	31	94	78	117	184	121
NIR exemption	22	47	46	61	90	62
Land tax	2	24	2	7	37	18
GST on rent	21	25	22	24	28	25
sample size	68	92	119	133	178	590
Age 55 - 64						
Gross household income	278	619	1,054	1,591	3,157	1,257
CGT exemption	36	69	89	115	215	100

NIR exemption	22	39	48	64	100	53
Land tax	6	6	9	13	40	13
GST on rent	20	22	23	26	31	24
sample size	215	211	183	143	146	898
Age 65+						
Gross household income	312	581	1,006	1,589	3,848	631
CGT exemption	39	60	105	141	513	71
NIR exemption	24	35	54	68	201	38
Land tax	2	6	12	31	232	12
GST on rent	21	22	25	27	52	23
sample size	779	541	177	65	45	1607
All owners						
Gross household income	299	602	1,039	1,593	3,306	1,117
CGT exemption	38	66	90	120	225	92
NIR exemption	24	38	49	63	104	49
Land tax	3	8	7	13	56	14
GST on rent	21	22	23	25	31	24
sample size	1088	904	566	428	466	3452

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

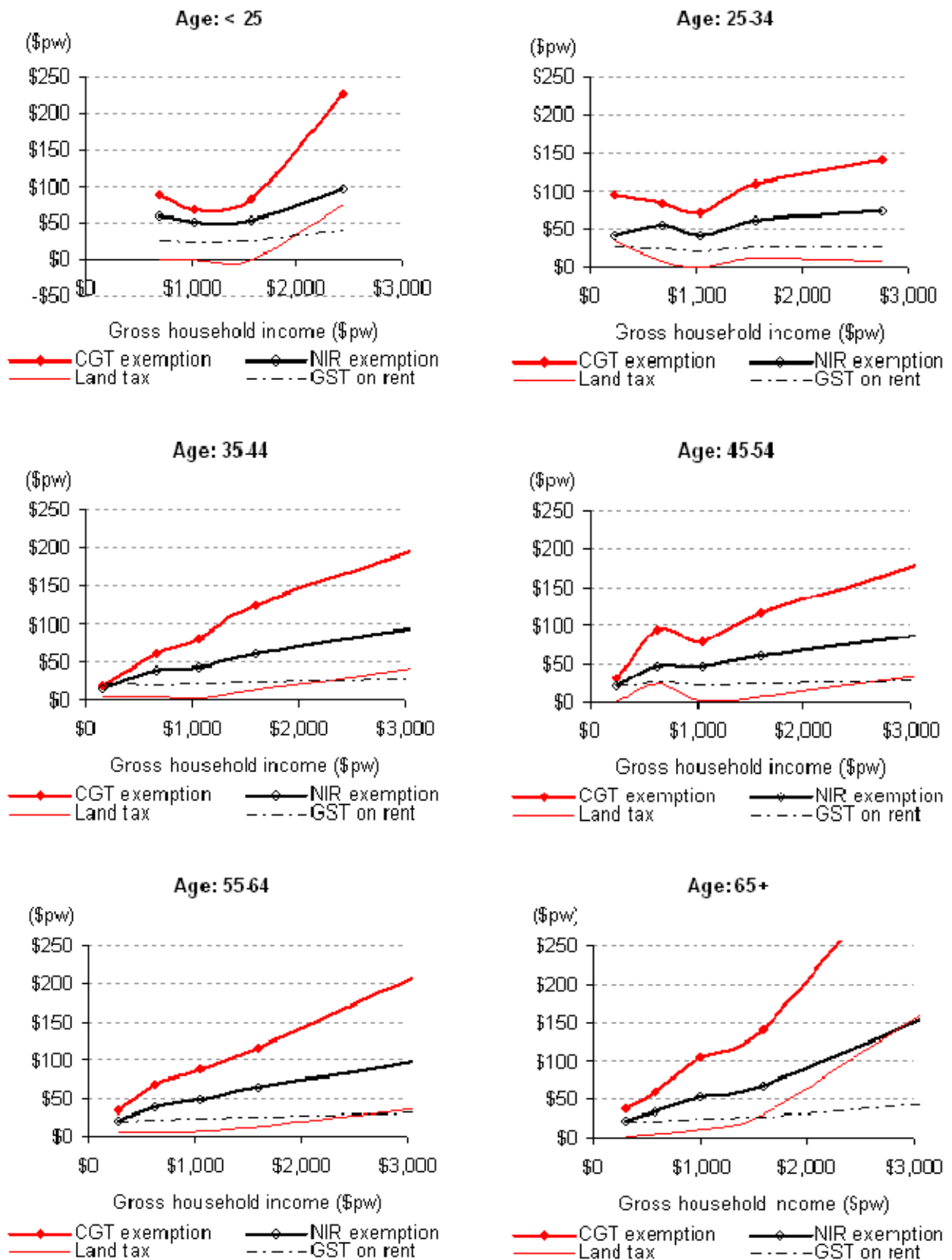**Figure 7: Tax expenditures for outright owners by household income and age, 2005-06**

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

Table 5: Tax expenditures for purchasers by household income and age, 2005-06

	Household income quintile					
	1	*2*	*3*	*4*	*5*	*All*
Age < 25						
Gross household income	269	662	1,067	1,594	2,395	1,426
CGT exemption	18	58	63	70	100	71
NIR exemption	-3	-19	-16	-29	-27	-22
Land tax	0	0	1	3	5	2
GST on rent	16	21	20	20	23	21
sample size	3	14	29	31	14	91
Age 25 - 34						
Gross household income	180	675	1,078	1,588	2,603	1,616
CGT exemption	27	56	76	92	138	95
NIR exemption	0	-8	-14	-21	-48	-25
Land tax	2	0	4	3	11	5
GST on rent	20	21	22	23	25	23
sample size	22	85	168	236	193	704
Age 35 - 44						
Gross household income	243	668	1,075	1,601	2,830	1,735
CGT exemption	38	65	82	108	188	121
NIR exemption	3	6	-2	-9	-9	-5
Land tax	17	2	4	4	23	10
GST on rent	22	21	22	24	28	24
sample size	40	129	258	347	359	1133
Age 45 - 54						
Gross household income	216	669	1,049	1,636	3,054	1,937
CGT exemption	38	64	85	104	190	128
NIR exemption	8	14	13	5	14	11
Land tax	17	4	3	6	29	15
GST on rent	24	22	23	24	29	25
sample size	47	103	206	290	375	1021
Age 55 - 64						
Gross household income	222	650	1,066	1,577	3,075	1,670
CGT exemption	31	78	105	107	209	129

NIR exemption	13	29	24	33	38	30
Land tax	8	5	9	6	32	14
GST on rent	24	24	25	23	30	26
sample size	36	75	128	93	117	449
Age 65+						
Gross household income	293	574	1,056	1,550	2,624	770
CGT exemption	36	53	95	187	143	74
NIR exemption	15	30	28	12	58	23
Land tax	4	16	3	37	6	12
GST on rent	23	21	27	34	28	25
sample size	49	31	15	12	7	114
All owners						
Gross household income	238	661	1,067	1,605	2,886	1,723
CGT exemption	35	64	85	103	181	116
NIR exemption	8	9	3	-4	-3	0
Land tax	10	3	4	5	23	11
GST on rent	23	21	22	24	28	25
sample size	197	437	804	1009	1065	3512

Figure 8 : Tax expenditures for purchasers by household income and age, 2005-06
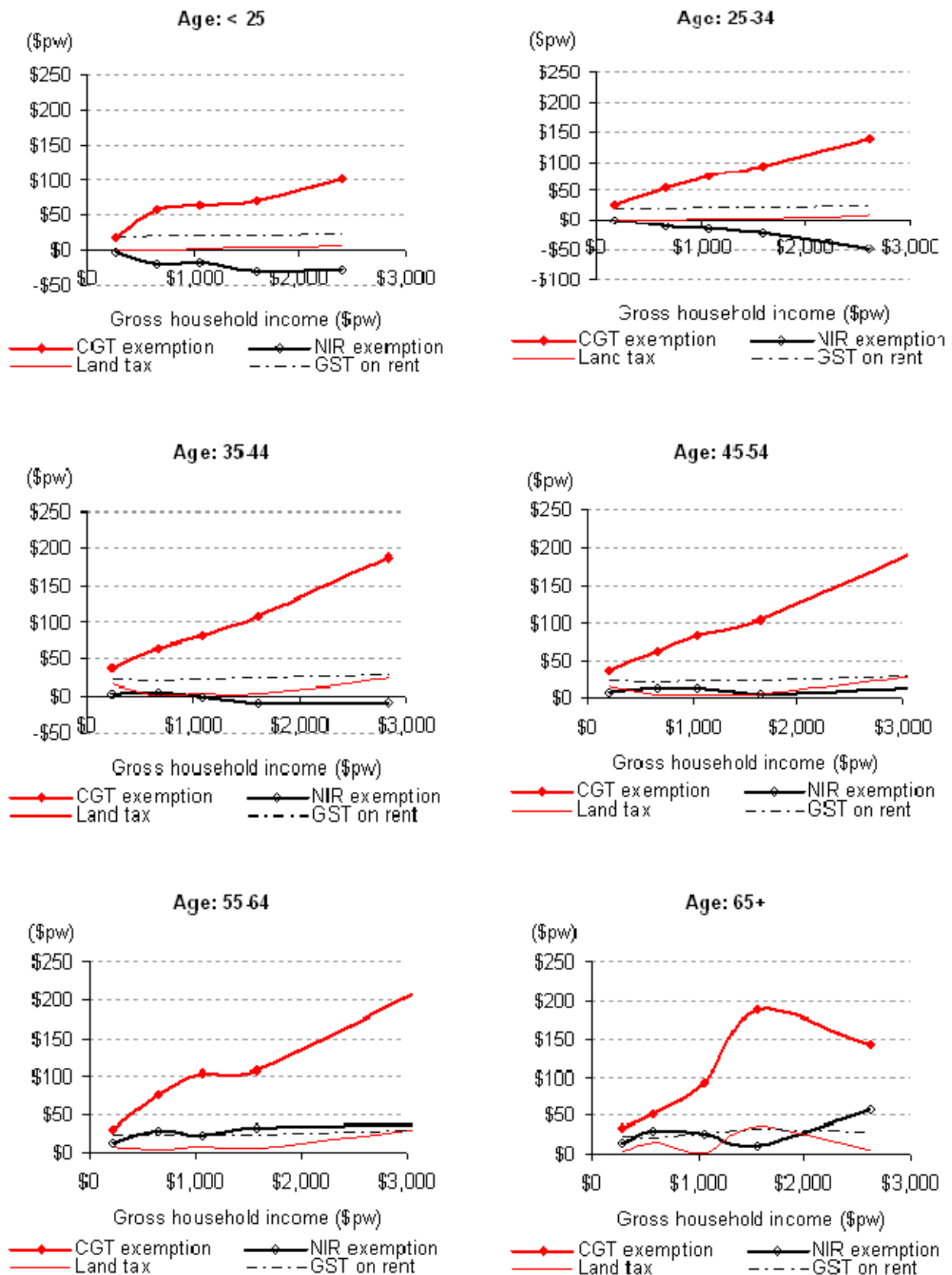
Source: Australian Bureau of Statistics, Survey of income and housing, 2005-06. Results derived from ABS Basic CURF data.

3.3   Tax expenditures for investors

The final set of distributional data to be presented here relates to the tax expenditures enjoyed by investors as a result of the capital gains tax discount and the fact that they can deduct costs associated with income from rental housing from other sources of income.

Figure 9 shows the proportion of households who own investment property, disaggregated by household income and age of the household reference person. Overall, 16.8 per cent of all households in 2005-06 owned rental property. These rental investors, however, are disproportionately households in the highest income quintile. Almost 40 per cent of households in the top income quintile (that is, among those with household incomes in the top 20 per cent of the income distribution); only 7 per cent of those in the lowest income quintile own rental property.

Disproportionate shares of rental investors are also found among households with a reference person in the middle age groups, reflecting the greater likelihood that these households have of being in the asset accumulation phase of their life-cycle.

Figure 9: Proportion of households owning investment property by household income and age, 2005-06

Source: Australian Bureau of Statistics, Survey of income and housing, 2005-06. Results derived from ABS Basic CURF data.
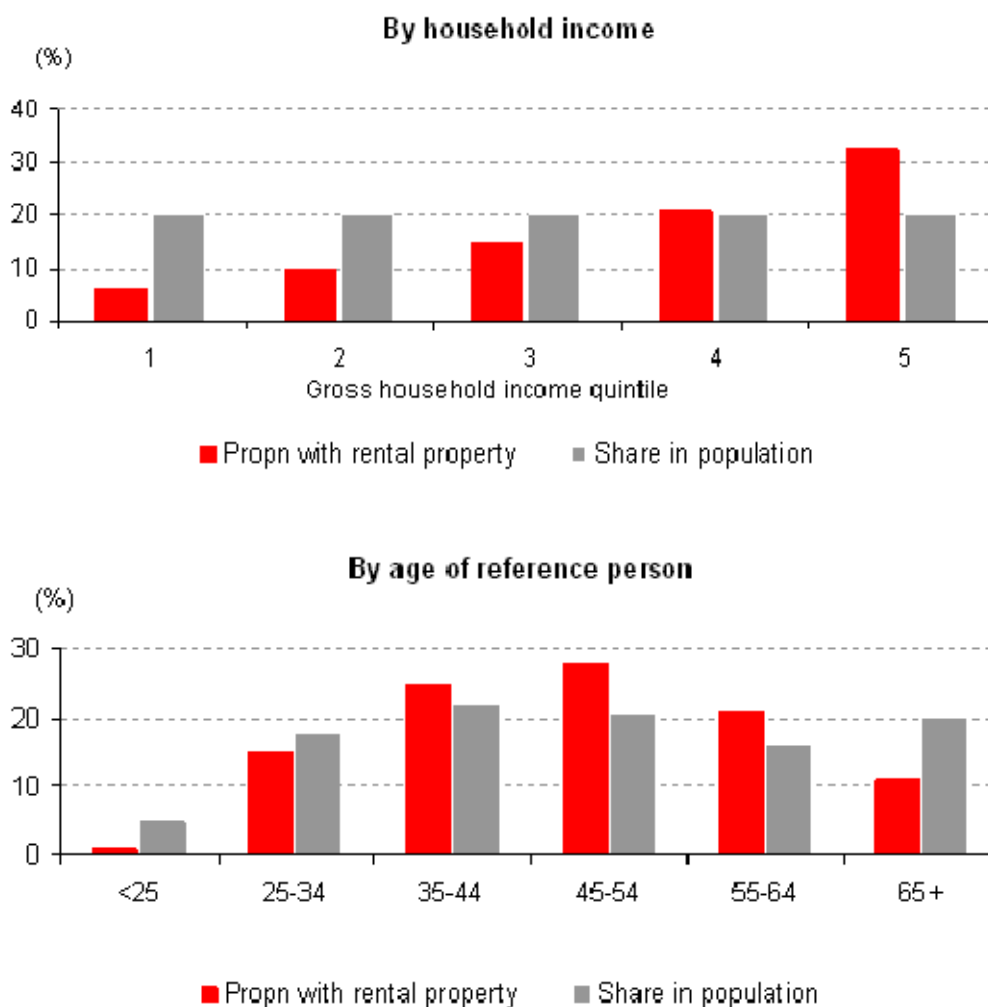
Figure 10 illustrates the net benefit that these households gain from the 50 per cent capital gains tax discount. The top half of the chart provides the benefit averaged over all households (and so reflects the different incidence of investor households for different ages and incomes). The bottom half of the chart indicates the benefit that accrues to those who are investors. As with the gains from the exemption of owner-occupied housing from the capital gains tax, the benefits of the discount on gains on investment housing accrue disproportionately to older, high income households.[3] Table 6 provides the relevant data.

Figure 10: Tax benefit arising from discount of capital gains for all households and investor households by household income and age, 2005-06
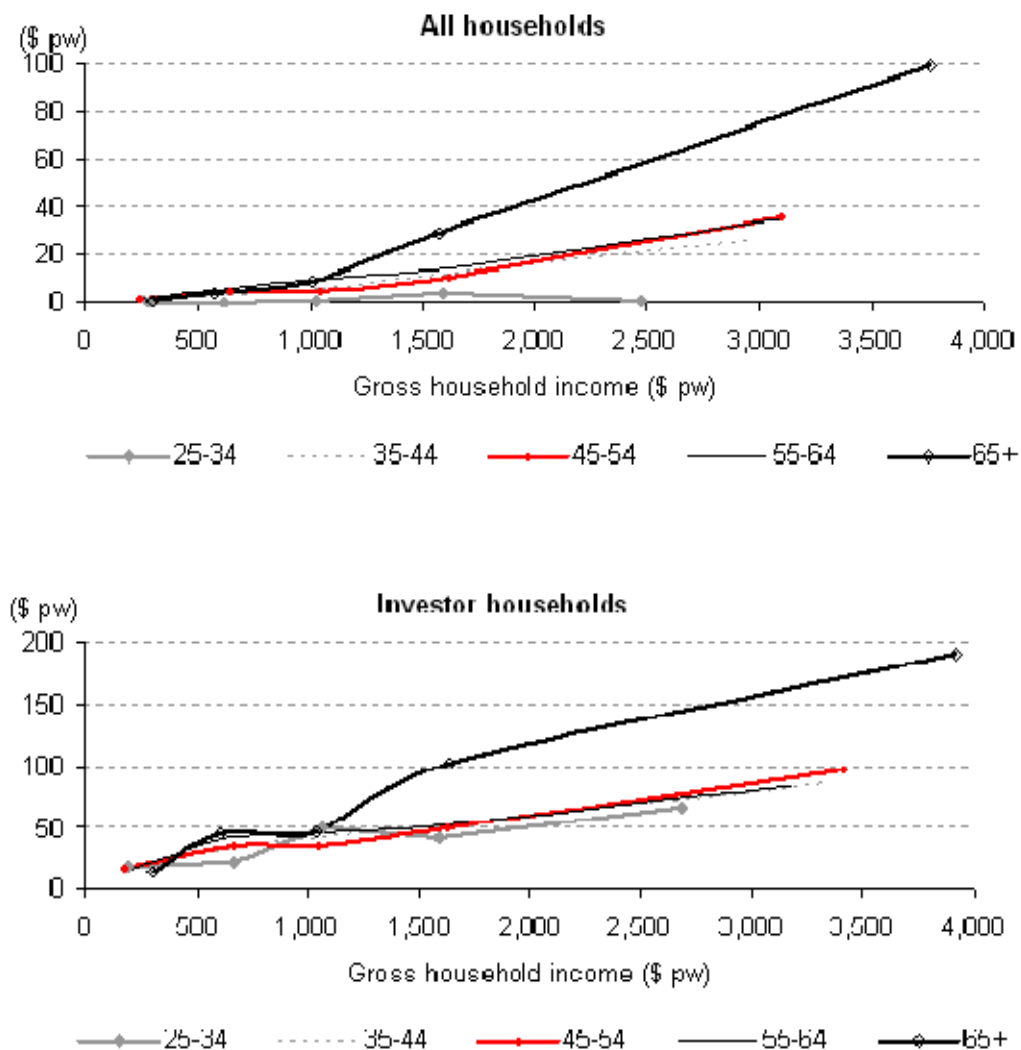
Source: Australian Bureau of Statistics, Survey of income and housing, 2005-06. Results derived from ABS Basic CURF data.

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[3] The estimates here are based on average accrued capital gains. Estimates based on realised gains may show even greater benefits to older households who are more likely to dispose of their assets than are households in the younger age groups. As with all other charts, data are plotted by the mid points of the incomes for households within each income quintile. The top income quintile (defined over all households) has a lower bound of just under $2,000 pw. The chart above shows that younger households in the top income quintile, on average, have considerably lower household incomes than do the older households in the same income quintile.

Table 6: Tax benefit arising from discount of capital gains for all households and investor households by household income and age, 2005-06

| Gross household income quintile							Agg
	1	2	3	4	5	All	tax exp.
Age household	$pw	$pw	$pw	$pw	$pw	$pw	$b (pa)
reference person	285	623	1,048	1,595	2,967	1,304	
All households							
<25	0	0	0	0	0	1	0.0
25-34	1	2	6	7	15	7	0.5
35-44	2	3	6	11	26	12	1.0
45-54	2	5	5	11	36	16	1.3
55-64	1	6	10	14	35	13	0.8
65+	1	4	9	29	99	6	0.5
All households	1	4	6	11	30	10	4.2
All investor households							
<25						47	0.0
25-34	20	22	50	42	67	49	0.5
35-44	19	34	42	52	86	61	1.0
45-54	18	36	36	49	96	70	1.3
55-64	15	42	46	52	84	58	0.8
65+	14	45	47	102	190	67	0.5
All investor households	16	38	44	53	91	62	4.2

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

The final two charts below illustrate the benefits derived from those who are able to deduct losses associated with investment in rental housing against income from other sources. As with the ownership of rental property, the proportion of households where at least one member of the primary income units reported a loss on rental investment increases with income. In part, this reflects their ability to carry the loss (until compensated by the asymmetric treatment of gains and losses in investment income); in part it reflects the greater benefit they receive from the practice of negative gearing.

Figure 11 shows that almost 40 per cent of households in the top income quintile take advantage of negative gearing, compared with less than 5 per cent in the lowest income quintile. Overall, only 434,500 households in 2005-06 had at least one member of the primary income unit reporting negative rental income. This equates to 674,000 individuals, which is considerably lower than the 1.5m reported by the ATO (see Appendix B).

Figure 12 illustrates how average reported investment losses and the associated tax benefit per household increase with household income. This has an inverted scale, so that the amounts reported are negative values, and shows the benefit averaged only over those investors who report losses on their rental investment.

Figure 11: Proportion of households declaring losses on investment property by household income, 2005-06
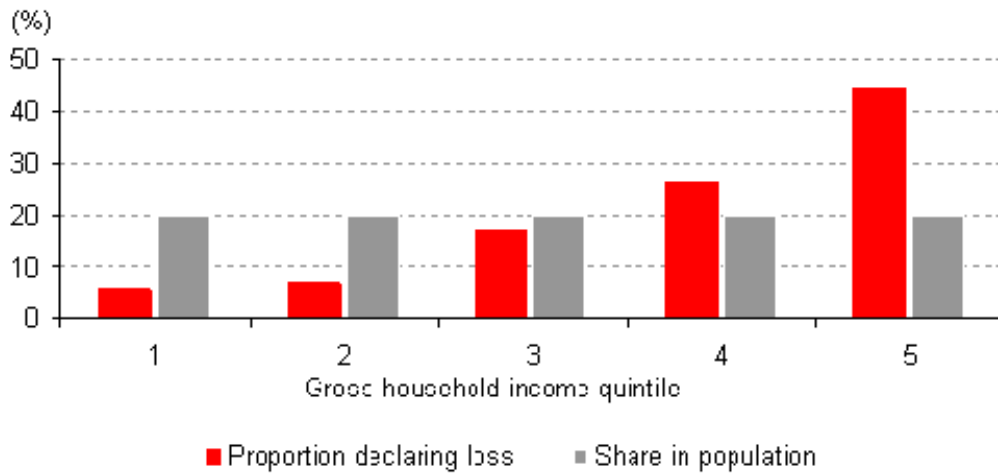
Source: Australian Bureau of Statistics, Survey of income and housing, 2005-06. Results derived from ABS Basic CURF data.

Figure 12: Tax benefit for negatively geared investors by household income, 2005-06
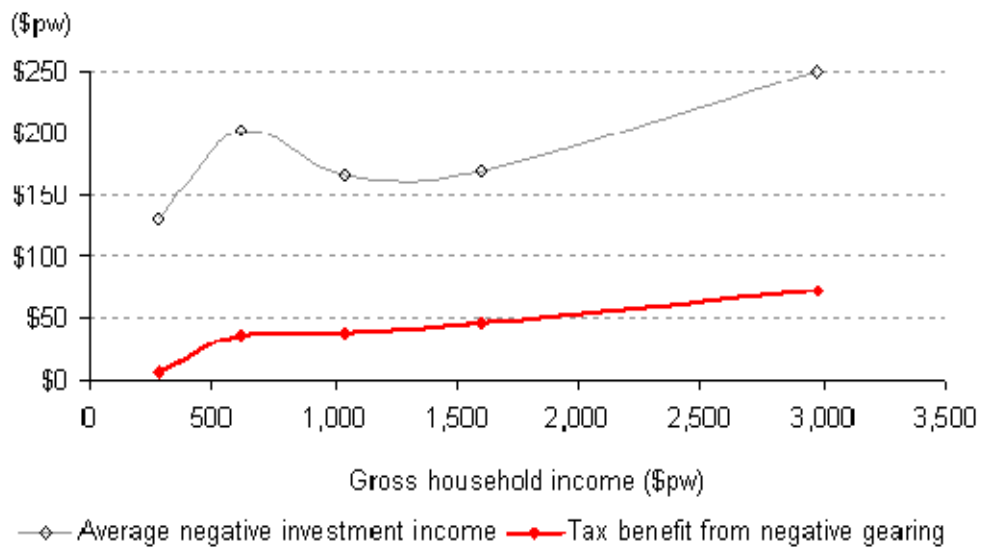
Note: axis reports negative rental income.

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

4   CONCLUSIONS AND POLICY IMPLICATIONS

4.1   Overview

This paper has highlighted the significant size of the tax expenditures associated with housing. In total, the tax system in 2005-06 delivered at least $45b in subsidies to owner-occupiers and a further $5b to investors in rental housing and $3.2b to renters. These subsidies to housing have increased since similar studies undertaken a decade ago, primarily as a result of the significant inflation that has taken place in housing assets in the decade since 1999, the downturn in house prices in the last 12 months or so notwithstanding.

Over two decades ago, Flood and Yates (1989) concluded that, as a result of the tax benefits provided to homeowners, indirect housing assistance had increasingly overwhelmed the housing assistance programs that represent formal housing policy. In large part, this arose from assistance to outright owners rather than to purchasers. The benefits were poorly targeted, with most of the assistance going to higher income households. This conclusion was reinforced by the Yates (2003a) study based on data from a decade ago.

This paper shows that the failure to address the question of housing taxation in the tax reforms that have occurred in Australia in the past two decades has resulted in the perverse outcomes. These led to concerns about the structure of housing assistance well over two decades ago and are now more pronounced. The indirect assistance provided through tax expenditures has increased. It continues to be poorly targeted, providing the greatest assistance to established home owners and the least to renters and to young purchasers.[4] On average, it continues to provide most assistance to those households who need it least.

4.2   Potential effects of subsidies to housing

Such indirect assistance provides significant subsidies to housing. The adverse effects of such subsidies have been well rehearsed in the economics literature. They tend to be cyclical, with the result that they contribute to the boom bust cycle in housing as highlighted by the Productivity Commission (2004, p.xxv) in relation to the capital gains tax provisions. Listokin (2009) suggests that they have contributed to the reduced effectiveness of automatic stabilisers in government budgets. This is of particular concern in the current economic environment with its return to fiscal stimulation to reduce the impact of impending recession.

4.2.1   Subsidies and owner-occupied housing

Subsidies such as those covered in this paper have the capacity to lead to increased investment in housing, and particularly in owner-occupied housing, at the expense of investment in more productive areas. In principle, this leads to a lower rate of economic growth than would otherwise be possible. McCarthy et al (2001) provide a review of some of the literature on this issue. They also add to the economic incentive for a renter to become a homeowner sooner than they otherwise might. Dietz and Haurin (2003) suggest that this might generate impacts on labour supply, wealth, fertility, investment risk and mobility.

The key arguments for such assistance generally rely on the perceived social benefits associated with home ownership (and, to a lesser extent, investment in rental

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[4] Both of these groups, of course, are directly assisted through rent assistance targeted to those on social security levels of income, through the current generous (and untargeted) grants to first home buyers and through concessions on transaction costs.

housing). An overview of social benefits of home ownership can be found in Rohe et al (2002) or Dietz and Haurin (2003). Increasingly, however, the methodologies that have led to these conclusions are being questioned. Aaronson (2000) and Apgar (2004) point to omitted variable biases as does Shlay (2006, p.511) who suggests that '[the] alleged effects of homeownership may be artefacts of self-selection and the conflation of homeownership with unobserved characteristics coincident with buying homes'.

To the extent that any of these arguments can be supported, they provide an argument in favour of using subsidies to assist those who would otherwise not become home owners into home ownership. The structure of assistance provided by indirect tax expenditures to owner-occupiers does not do this. As summarised at the start of this section, the greatest support goes to established home owners. The least support goes to young home purchasers or to renters.

As recognised by the Senate Select Committee on Housing Affordability, (2008, 4.38), these subsidies favour home owners, not home ownership. As demand side subsidies that create an economic incentive to increasing consumption of housing through home ownership, they add to price pressures in the housing market and thereby contribute to the affordability constraints faced by aspiring home owners. This is particularly likely in areas where the supply of land is restricted as is the case in the more central of the built-up areas of major metropolitan regions. As such, they contribute to the forces that push lower income households to residential location and dwelling quality decisions that are likely to be riskier in terms of the potential they provide for economic gain (Shlay, 2006, pp.522-524).

Recent events following the sub-prime crisis in the US have highlighted the economic and social costs (at both an individual and economy-wide level) of encouraging home ownership by lower and moderate income households and of failing to recognise the risks associated with such a policy.

4.2.2   Subsidies and investor housing

As argued at the start of this paper, the key taxation issue with respect to rental housing is one that is structural within the current taxation system and one that applies to investment in all income producing assets. It arises from the asymmetry in the tax treatment of gains and losses as a result of the capital gains discount to individual investors and their ability to deduct nominal costs associated with earning income from a particular asset against income earned from any source.

At a superficial level, subsidies to investors in rental housing might be regarded differently from subsidies to owner-occupiers although they are also inequitably distributed as the bulk of these go to older, high income households who also tend to be owner-occupiers.[5]

It has been argued, for example, that they contribute to keeping rents lower than they otherwise might have been. An illustration of this is given in a booklet by The Property Council of Australia which states that 'negative gearing encourages private investment in rental housing stock. Without this encouragement, effective yields on most rental housing would be prohibitively low, and investors would quite the market. ... Negative

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[5] Most assertions that the subsidies associated with negative gearing rely on ATO data on individuals (and many do not separate out data on negative gearing on real estate from that on other income producing assets). The Property Council of Australia (PCA) show that the peak tax foregone is greatest for tax payers with taxable incomes in the $40,000 to $80,000 range (for example, PCA, 2007, p.22). Because taxable income is reduced by any losses on rental property tax, this underestimates income in the absence of investment in rental property. The data reported in this study examines the impact at a household level and shows that the tax expenditure is greatest for households in the top income quintile (with a mean household income of $154,000 in 2005-06).

gearing also serves to place a lid on rental pressure by increasing the stock of rental housing and taking pressure off rents'. (PCA, 2007, p.22)

Subsidies to investors, however, act in the same way as subsidies to owners. They are demand side subsidies that increase the demand for housing (in this case rental housing) and, as such, demand from investors competes with demand from owner-occupiers for what, at least in the short term, is a relatively fixed housing stock. Demand from investors increases the supply of housing only in the same way as demand from owner-occupiers does. It encourages a supply response by pushing up prices to the point where developers are prepared to increase their output. Britten-Jones and McKibbin (1989) provide an early, formal analysis of these processes.

The return on investment in housing will depend both on the rental rate of return received and on expected capital gains. Ironically, it is high rates of house price inflation that have been most effective in keeping gross rental yields low. However, when house prices are high, low gross rental yields do not necessarily imply low rents. With lower house prices, current rent levels would provide higher gross rental yields.

4.3 Summary

By subsidising owners of housing (whether as owner-occupiers or investors), the demand for housing is increased and the value of the subsidy is capitalised into higher house prices. Owners are compensated for this by the subsidies they receive; renters are not. Overall, therefore, the subsidies provided to housing through the tax expenditures covered in this 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.

4.4 Policy options

Yates (2003a) provided a number of policy options than might address some of the issues raised by the current structure of indirect assistance to housing provided by a number of tax expenditures. Those that remain relevant are repeated unaltered in the list below.

The magnitude and the perverse distribution of these tax expenditures also suggests that some consideration could, or should, be given to reducing the budgetary costs associated with this form of indirect assistance and replacing it with policies that redirect benefits to those most in need of assistance. In general, this will require a reduction of the benefits to high-income households and outright owners and an increase in the level of assistance to lower income households – either first home buyers at their point of entry into the housing market or renters affected by the effects on the housing market of subsidies to owners. Broadly, the policy options identified below aim to improve the equity and efficiency of the subsidies associated with existing tax expenditure while recognising the political constraints associated with removing concessions to a politically powerful group – high income older households.

In general, it is likely that any successful policy proposal will need to be based on a package of initiatives, possibly covering changes at both Commonwealth and State level, which adds to the challenges of bringing change about.

The first policy option proposed by Yates (2003a) was an annual assessment of the tax expenditures associated with housing. The fact that a start has been made to address this proposal with the estimates provided in Appendix C of the TES provides an element of optimism that the time is now right for some of the more difficult issues to be addressed.

4.4.1 Ongoing assessment of the value of tax expenditures to housing

The size and distribution of the benefits provided to home owners suggests that, in the first instance, any government concerned with fiscal responsibility and accountability should at least have regular estimates of the extent of the assistance provided. As an indirect form of assistance, tax expenditures do not appear in annual budget papers and, until the 2008 TES, the indirect assistance provided to owner-occupied housing did not appear in annual Tax Expenditures Statements, despite the requirement that such estimates be provided as a requirement of the Charter of Budget Honesty Act 1998. Experimental estimates of the value of the exemption of imputed rent from the income tax benchmark and the value of the tax exemption of the taxpayer's main residence from the capital gains tax are now available, although they have been relegated to an Appendix at this stage.

The sheer magnitude of the aggregate values of the tax expenditures provided to owner-occupied housing through both the Commonwealth and State tax systems highlights the importance of regularly monitoring them.

4.4.2 Mortgage interest deductibility and taxation of imputed rent and capital gains

One possible policy package that can be done entirely within the range of instruments under Commonwealth control (and so does not involve Commonwealth-State negotiations) is to implement what some might regard as a Faustian bargain. In the same way that capital gains taxes were implemented in Australia in 1985, this could involve retaining the existing income tax base for current homeowners but removing the exemptions for all new entrants into home ownership. This would mean that young households could claim mortgage interest deduction when assistance was most needed. In return, however, they must pay an imputed rent tax once the net effect is positive (as it will become as equity builds up) and a capital gains tax (either on realisation of any increase in the value of their dwelling or, preferably, on an annual accrual basis with capital gains estimated on the basis of local dwelling price indexes). Such a policy, of course, could induce behavioural responses, with households using debt for non-housing purposes. It is critical, therefore, that the potentially adverse effects of such responses are dealt with through appropriate regulation (such as once off access to deductibility up to a fixed mortgage amount for first home buyers as was imposed when mortgage interest deduction was temporarily introduced in 1982).

Imposing an annual tax on homeowners as they age may be seen as negating one of the significant benefits of the high home ownership rates that persist in Australia (namely that of protecting older households on pension levels of income from living in after housing poverty). For asset rich income poor households, cash flow problems can be dealt with by deferral of liabilities until the asset is sold. A policy such as that suggested above could encourage home ownership by helping to reduce the financial burden at the early stages of home purchase. It could also assist in reducing the upward pressure on house prices as a result of the capitalisation of current subsidies.[6]

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[6] Any concern that a reduction in the indirect assistance provided to home ownership would reduce the incidence of home ownership and place upward pressure on rent assistance for aged pensioners needs to be assessed against this countervailing impact of a reduced pressure on dwelling prices and improved affordability at the point of entry into the housing market. Such an assessment is beyond the scope of this paper. However, such a result is possible anyway if younger households are excluded from home ownership because of the constraints imposed by ever increasing house prices (increases to FHOG notwithstanding). Yates et al (2008) outline such a scenario using trend house price data with real house prices as at 2001 as the benchmark.

4.4.3 Taxation of owner-occupier land values

A simpler alternative to the above could be to use the existing land tax base as a substitute for taxing the income from housing. An advantage of this is that it would avoid the complexities associated with having to allow deductibility of difficult to identify costs and, as an annual tax it would effectively tax gains on accrual, thereby avoiding the issues associated with not taxing capital gains until realised. Because land is ultimately in fixed supply, land taxes create few distortions and are one of the most efficient of all taxes. Taxing the unimproved value of land also encourages most productive use of land, particularly in regions (such as inner urban areas) where supply elasticities are extremely low. It could, for example, discourage costly urban sprawl by encouraging more intensive use of existing urban land.

Consideration would need to be given to the rate structure for land taxes and to the setting of the threshold below which no land taxes apply. The 2005-06 thresholds in most states varied from 0 in the ACT to $450,000 in Queensland. Setting a threshold in a way that the majority of home owners are not affected significantly (at least in the first years of its operation) would seem to be politically sensible.

A broadening of the land tax base to include owner-occupied housing would also open the possibility of revising the way in which land tax is currently applied. A progressive tax on the basis of the cumulative value of land holdings has a significant impact in discouraging large-scale investors in rental housing – a policy direction seen as being important for the expansion of affordable rental housing.

If such a tax were to be introduced, there would need to be some agreement between the states as to how the tax schedule would be determined (and changed over time) and the question of how taxes raised from land were treated by the Commonwealth Grants Commission in determining its allocations to the states would also need to be addressed.

4.4.4 Taxation of owner-occupier capital gains over a given limit

An alternative approach to taxing the income generated from owner-occupied housing could be to ignore the potentially controversial and conceptually difficult taxes on net imputed income and focus, instead, on what are effectively unearned capital gains arising from increases in land values associated with spatially concentrated demand pressures, particularly in metropolitan housing markets. While capital gains taxes are politically unpopular, there is scope for introducing these in an incremental fashion by including only those real gains over a high value (such as $500,000 or $1m in 2009 prices). Indexation of this to a general dwelling price level would ensure that only owners of dwellings with real capital gains would be caught in the tax net. Imposing a life time cap on the total amount paid in capital gains would be a further option, although it is one that would limit the capacity of the tax to have a strong redistribution effect. As above, deferral of any tax liability until death would provide a further softener to asset rich income poor households.

4.4.5 Re-introduction of estate duties

An obvious alternative to deferral of income tax liabilities until death is to replace the above income tax based proposal with the reintroduction of death duties from which the family home would not be exempt (except for obvious transition arrangements as deferral until the death of a surviving spouse).[7]

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[7] Bellettini and Taddei (2009) have highlighted the role of bequests on real estate prices and have argued that abolition of the taxation of these (in Italy in 2001) alone led to an appreciation of residential real estate in excess of 10 per cent.

Given the history of death duties in Australia, such a proposal would need to be negotiated between the states to avoid the same competition that led to their demise in the mid to late 1970s.

4.4.6 Capital gains tax discount and negative gearing

The tax expenditures associated with investment in rental housing arise from structural flaws in the tax system as a whole and the tax treatment of investment in rental housing cannot be treated separately from the tax treatment of income from other forms of capital. This raises a range of issues: key examples are whether income from capital should be treated in the same way as income from labour; whether income should be indexed or not; or whether costs incurred in earning income from a particular activity should be deductible only from the income from that activity.

This suggests that the issue of the capital gains discount for individuals needs to be set in a broader context than that covered in this paper. However, regardless of the outcomes in relation to any of the examples given above, an argument can be made for ring fencing (or quarantining) losses associated with a particular income producing activity to the income earned from that activity.

4.5   Conclusions

The above policy options have focused only on the tax expenditures covered in this study; they have not considered some of the taxes that apply to housing. Removal of both taxes and tax expenditures might be one way of packaging what are otherwise seen as unpalatable options. Reduction of stamp duties is an obvious contender for such packaging.

Further packaging might be considered by tying the removal of tax expenditures on housing to increased direct expenditures for housing. An ideal opportunity was lost because of the speed with which the current fiscal stimulus package needed to be introduced. The massive increase in direct housing expenditures provided an excellent opportunity to introduce some of the proposals outlined above. First home owner grants, for example, could have been recouped against future capital gains. New tax expenditure incentives (in the form of tax credits for investors in rental housing) could have been replaced by reductions in stamp duties and packaged with reductions in negative gearing and/or changes in land taxes on rental housing. These examples are intended to highlight the importance of timing in the introduction of significant changes and the importance of having workable proposals in place when the time is right.

While taxing housing will not be easy, the broadening of the tax base that would result from removal of the significant tax expenditures that currently exist means that tax rates can be cut at the same time. This provides some opportunity for ensuring that there will be fewer losers than might otherwise be the case.

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APPENDIX A: SUPPLEMENTARY DATA

This Appendix provides additional data to place into context some of the material used to generate the tax expenditures presented in the text.

Table A1: 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	limited	yes
Canada	no	no	yes	yes[e]	yes	no	half	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

Notes: Under CGT, 'limited' means homeowners may defer payment provided the proceeds of sale are reinvested in housing. Under land/property tax, 'limited' refers to property owner charges along the lines of council rates, which are linked to local services and need not move proportionately with property values.

(a) The Netherlands levies a tax on net wealth using an assumed rate of return, so negative gearing is not possible.

(b) Swiss homeowners pay tax on imputed rental income, net of interest and renovation costs.

(c) CGT is levied in Australia and Canada at half the taxpayer's marginal rate if the holding period exceeds one year, but in Canada gains resulting from changes in the cost base due to depreciation are levied at the full rate.

(d) For buildings constructed after 1985.

(e) Only cash expenses, not depreciation, can be negatively geared in Canada.

(f) Provided property owned for at least 15 years (France) or 10 years (Germany).

(g) Negative gearing allowed up to a set limit and interest costs may not exceed gross rent.

(h) Rental property expenses cannot be deducted against unrelated labour income in the US, which effectively limits negative gearing to professional investors and developers.

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

Figure A1: Distribution of private rents and gross imputed rents: 2005-06
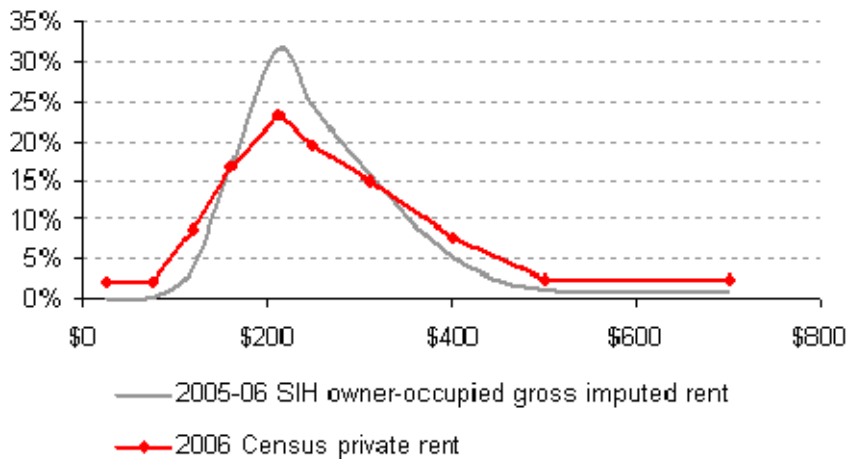
Source: Australian Bureau of Statistics, 2006 Census Community Profile Series, Australia, Table 34 (private rents include rented from real estate agent + person not in same household; not stated data excluded).

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

Figure A2: Annual dwelling price inflation: 1986-2009
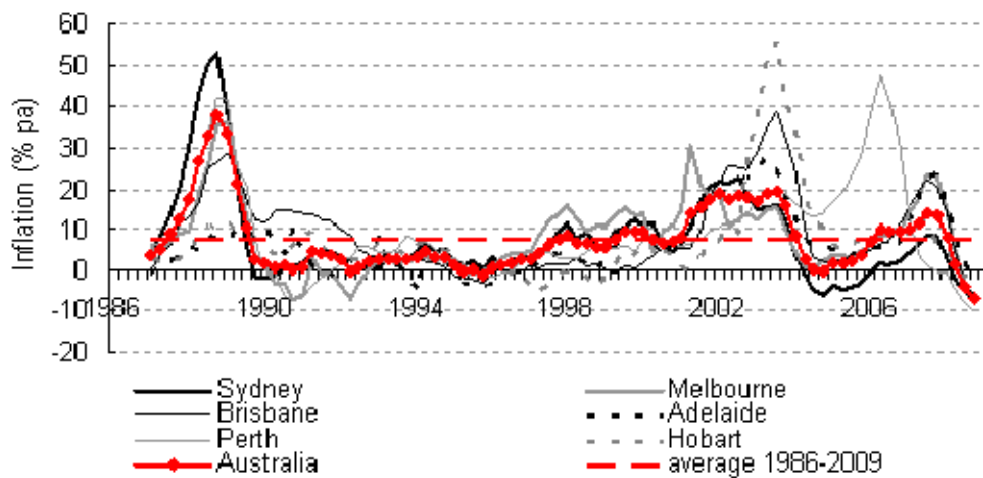
Source: ABS House Price Indexes: Eight Capital Cities, Cat. No. 6416, Table 1 and Table 10.

Table A2: Gross and net income and wealth by household income and tenure, 2005-06

| | *Gross income quintile* | | | | | |
	1	*2*	*3*	*4*	*5*	*All*
All households						
Household gross income ($pw)	285	623	1,048	1,595	2,967	1,304
Household disposable income ($pw)	283	581	897	1,307	2,257	1,065
Dwelling value ($)	197,867	217,391	242,421	293,699	478,919	286,056
Equity ($)	188,054	198,506	197,099	220,148	376,826	236,123
Outstanding debt ($)	9,813	18,885	45,322	73,551	102,093	49,932
Imputed capital gains ($pw)	152	167	186	226	368	220
Gross imputed rent ($pw)	166	160	167	185	248	185
Net imputed rent ($pw)	106	88	59	41	66	72
% all households	100	100	100	100	100	100
All owners						
Household gross income ($pw)	290	621	1,055	1,601	3,018	1,423
Household disposable income ($pw)	289	585	907	1,319	2,294	1,156
Dwelling value ($)	318,696	342,577	369,060	403,221	578,609	412,481
Equity ($)	302,874	312,864	300,208	302,261	455,330	340,497
Outstanding debt ($)	15,823	29,713	68,852	100,960	123,279	71,984
Imputed capital gains ($pw)	245	264	284	310	445	317
Gross imputed rent ($pw)	209	219	228	241	292	241
Net imputed rent ($pw)	133	120	78	48	71	88
% all households	62	63	66	73	83	69
Outright owners						
Household gross income ($pw)	299	602	1,039	1,593	3,306	1,117
Household disposable income ($pw)	299	580	914	1,337	2,528	941
Dwelling value ($)	308,335	357,346	394,581	456,087	664,406	407,570
Equity ($)	308,282	357,344	394,348	455,349	663,464	407,277
Outstanding debt ($)	53	2	233	738	942	293
Imputed capital gains ($pw)	237	275	304	351	511	314
Gross imputed rent ($pw)	206	221	232	252	314	236
Net imputed rent ($pw)	147	159	167	183	239	172
% all households	53	43	28	22	26	34
Owners purchasers						
Household gross income ($pw)	238	661	1,067	1,605	2,886	1,723
Household disposable income ($pw)	234	596	902	1,311	2,187	1,367
Dwelling value ($)	377.119	311,599	350,153	379,989	539,511	417,297
Equity ($)	272,380	219,568	230,467	234,986	360,482	275,015
Outstanding debt ($)	104,739	92,030	119,685	145,003	179,029	142,282
Imputed capital gains ($pw)	290	240	269	292	415	321
Gross imputed rent ($pw)	227	215	225	236	282	245
Net imputed rent ($pw)	52	38	12	-11	-5	5
% all households	9	20	38	51	57	35
Renters						
Household gross income ($pw)	278	627	1,033	1,579	2,726	1,035
Household disposable income ($pw)	274	574	878	1,275	2,081	860
Dwelling value ($)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Equity ($)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Outstanding debt ($)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Imputed capital gains ($pw)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Gross imputed rent ($pw)	96	58	50	38	38	60
Net imputed rent ($pw)	61	31	23	21	38	36
% all households	38	37	34	27	17	31

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

Figure A3: Gross and net housing income by household income and tenure, 2005-06
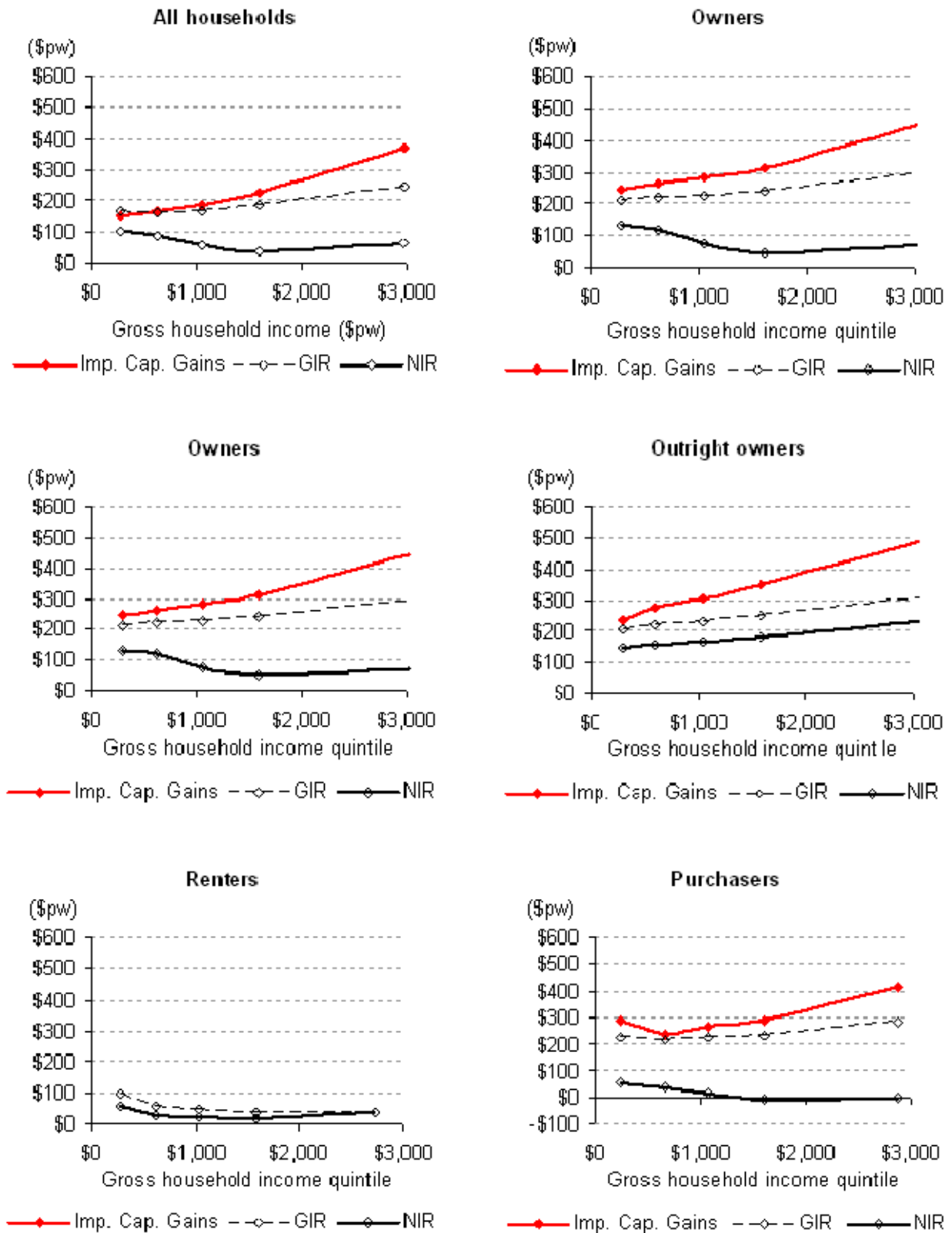
Source: Australian Bureau of Statistics Survey of income and housing, 2005-06. Results derived from ABS Basic CURF data

APPENDIX B: EXPLAINING DIFFERENCES IN ESTIMATES OF TAX EXPENDITURES

This appendix provides an overview of recent estimates of the tax expenditures (and income cases taxes) associated with housing. These are summarised in Table B1 below. The highlighted results in column 5 are based on the same assumptions employed in the distributional analyses presented in the body of the text.

The notes to the table provide a brief description of the methodologies employed in the various studies. The text following the notes discusses the main factors that contribute to the variations in the results reported in Table B1. The variability in these aggregate estimates, which cover a three to four year period, indicates some of the difficulties that arise in attempting to estimate the extent of the tax expenditures associated with the various tax concessions that are available to owner-occupied housing.

Increases in the number of households would result in an upward trend in estimated aggregate tax expenditures from 2004 to 2007-08 even if these did not change at an individual household level. Increases in dwelling values (offset by increases in mortgage debt) over the period for which estimates are reported in Table B1 also add to a general increase over time. Neither of these explanations, however, explains the wide discrepancies in the key estimates for the tax expenditures arising from the non-taxation of imputed rent and the exemption of the family home from the capital gains tax. To explain these differences it is necessary to turn to the differences in assumptions and/or in the methodologies employed in their estimation.

Table B1: Comparative estimates of tax expenditures

	AFTS TES[1][2] 2007-8	Senate Select C'tee[3] 2007-8	Freebairn[4] 2006-7	TES[2] 2005-6	Yates[5] 2005-6	Abelson Joyeux[6] 2004	PC[7] 2004
Income base	$b	$b	$b	$b	**$b**	$b	$b
owner-occupied housing							
net imputed rent exemption	4.0 [a]		9.2 [i]	2.5 [a]	**6.9** [p]	8.0 [q]	8.0 [w]
non-taxation of imputed rent	21.0	15.0 [d]	25.8 [i]	19.0 [a]			
non-deductibility operating costs	-17.0		-16.6 [i]	-16.5 [a]			
non taxation capital gains	43.5 [b]	20.0 [e]	21.0 [j]	39.5 [b]	**29.8** [p]	7.2 [q]	
investor housing							
discount on capital gains	3.6 [b]	6.0 [f]	3.4 [k]	2.0 [b]	**4.2** [p]		
rent less deductions (neg. gearing)		2.0 [g]	>0		**1.2** [p]	1.6 [r]	
net imputed rent exemption					**1.2** [p]		
Consumption base							
all housing							
non taxation rental services			8.6 [l]		**6.4** [p]	9.9 [s]	10.0 [w]
tax on new housing			-6.2 [m]			-6.0 [s]	
Transactions base							
owner-occupied housing							
stamp duties on conveyancing	>-13.0 [c]		-9.1 [n]			-9.0 [t]	-9.0 [w]
less FHB concessions	1.7 [c]		-0.4				
Wealth tax base							
owner-occupied housing							
exemption from land tax	3.6 [c]	10.0 [h]	7.0 [o]		**3.5** [p]	n.a. [u]	7.0 [w]
pensioner exemptions from rates	0.2 [c]		>0				
rates	-9.4 [c]					-7.2 [v]	

Data sources:

1. Treasury AFTS (2008a, Table 2.6, p34; Table 2.7, p.35)

2. Treasury TES (2009, Table 2,3, p12; Table C.1, p.214)

3. Senate Select Committee (2008)

4. Freebairn (2009)

5. Yates – this paper

6. Abelson and Joyeux (2007, Table 3, p.54)

7. Yates (2003a,b)

Notes:
(a) Imputed rent data obtained from National Accounts data (ABS Cat. No. 5204.0. 2006-07 Australian System of National Accounts, Table 49). Tax expenditures calculated by applying appropriate average marginal tax rates to net imputed rent (gross operating surplus) and to operating costs and interest payable. Appropriate tax rates assessed on basis of individual and joint ownership (derived from (HILDA) survey data).

(b) Realised capital gain was approximated from HILDA data by taking change in (nominal) dwelling prices in year of sale and year of purchase (and adjusted for cumulative capital works deductions claimed at time of realisation). Tax expenditures derived as in note (a) above. Survey estimates scaled up to population equivalent by average turnover of owner-occupied stock.   Total tax expenditures from 50 per cent discount on capital gains for individuals and trust in TES apply to all income; share due to gains in real estate estimated from tax office data on tax payable by source of income (Taxation Statistics 2005-06, p77 give capital gains from real estate as $11.3m from a total of $31.9m for 2005-06).

(c) Stamp duty on conveyancing covers revenue from all property for 2006-07, not just from owner-occupied housing. Tax expenditure from land tax exemptions reported in Treasury (2008a) was taken from State Treasury Tax Expenditures statements and is not consistently defined across states. In most states it includes exemptions for non-residential properties. In NSW at least it excludes the main exemption for owner-occupied property.

(d) Based on applying a 20 per cent rate to National Accounts gross rent data; no deductions allowed for costs.

(e) The capital gains tax exemption was derived initially by scaling up the Yates (2003a) estimate of $13 billion by the increase in dwelling prices since 2001 to give an estimate of $26 billion). This was cross checked using two independent approaches. The first (which also gave an estimate of $26 billion) began by taking the $3,300 billion value of the housing stock, allowing for two-thirds of this to be owner-occupied, and assuming (conservatively) that over the long term houses prices grow four per cent a year (the sum of inflation and productivity growth). An average marginal tax rate of 30 per cent was then applied. The second check (which gave a slightly lower estimate of $17 billion in 2005-06) was derived by scaling up the total capital gains tax discount claimed by individuals for real estate of $14.3 billion in 2005-06 reported in the Australian Tax Office's Taxation Statistics 2005–06 reports (ATO, 2008). In the first instance this was doubled to allow for the discount (to give a total of $28.6 billion). In the second instance, it was doubled again to allow for the fact there are twice as many owner-occupied homes as investor properties. The resultant derived figure for realised capital gains was around $57 billion. If taxed at a marginal tax of 30 per cent, this would have raised $17 billion in 2005-06. This was assumed to have increased (to $20 billion) in subsequent years (Senate Select Committee on Affordable Housing, 2008, p.61).

(f) The capital gains tax discount claimed by individuals was $14.3 billion in 2005-06 (ATO Taxation Statistics 2005–06, p.80). As real estate accounts for about ⅓ of capital gains of individuals (p.77), the discount for investor property was $5 billion in 2005-06 and it is likely to have grown since. Alternatively, taking the $3,300 billion value of the

housing stock, of which two-thirds is owner-occupied, conservatively assuming that over the longer term houses prices grow at an annual rate of 4 per cent (sum of inflation and productivity growth), and assuming an average marginal tax rate of 30 per cent, gives an estimate of $6.6 billion. (Senate Select Committee on Affordable Housing, 2008, p.61.)

(g) The ATO's Taxation Statistics 2005-06 reports 1.6 million taxpayers had rental income in 2005–06 with an aggregate net loss of $5.1 billion. A conservative assumption of a 30 per cent marginal tax rate would cost negative gearing at $1.5 billion. Since 2005–06, both rents and interest rates have increased. (Senate Select Committee on Affordable Housing, 2008, p.61.)

(h) Derived from the Productivity Commission (2004, p.109) estimated cost of about $7 billion in 2003. Scaling up on the conservative assumption that land prices grew at the same rate as house prices would give an estimate of over $10 billion. Alternatively, land taxes raised $4.4 billion in 2006-07 (ABS cat. no. 5506.0). As two-thirds of homes are owner-occupied, adding them into the net would at least triple the revenue, implying revenue foregone is well over $8.8 billion. (Senate Select Committee on Affordable Housing, 2008, p.61.)

(i) Gross imputed rent tax expenditure derived from National Accounts estimate of $86 billion for 2006-07 (ABS cat. no. 5206.0, Table 43); tax expenditure derived by applying an average marginal tax rate of 30%. Housing costs derived from ABS Household Expenditure Survey (ABS cat. no. 6530.0, Table 1) of $135 pw per household, converted to annual figure by multiplying by 52 and to 2007-08 by scaling up by 1.12 to account for inflation. Converted to aggregate figure by multiplying by 7.1 million households; tax expenditure derived by applying an average marginal tax rate of 30%.

(j) Capital gains derived by applying an assumed rate of nominal gains of 3.5 per cent (1% real based on Abelson and Chung, 2005 plus 2.5% RBA target inflation rate) to an estimate of gross owner-occupied housing wealth of $2,000 billion (based on Headey, Marks and Wooden, 2005 and Abelson and Chung, 2005); tax expenditure derived by applying an average marginal tax rate of 30% (Freebairn, 2009, p.4).

(k) Capital gains derived as in (j) above using Abelson and Joyeaux (2007) estimate of investor housing wealth of $650 billion as a base; tax expenditure derived by applying an average marginal tax rate of 30% and halving result (Freebairn, 2009, p.4).

(l) Tax expenditure associated with exemption of rents from GST estimated by applying GST of 10 per cent to ABS estimates of gross operating surplus for all dwellings (owner-occupied and rented) of $86 billion in June 2008 (Freebairn, 2009, p.4).

(m) Offsetting tax of GST on new construction derived by applying a factor of 1/11 of private expenditure on dwellings of $68 billion in the ABS National Accounts estimates (ABS cat. no. 5206.0) (Freebairn, 2009, p.4).

(n) Estimate based on 70% of total conveyancing duty of $13 billion (Taxation Statistics 5506.0) (based on share of owner-occupied dwellings in total residential stock) (Freebairn, 2009, p.4).

(o) Land tax expenditure set equal to Productivity Commission (2004) estimate.

(p) All estimates derived from the 2005-06 ABS Survey of Income and Housing confidentialised unit record file. More details in text. Imputed rent data based on ABS experimental estimates of imputed rent; capital gains data based on applying an average annual (nominal) capital gain to reported gross housing wealth in 2005-06 (using a 4 per cent figure for capital gains) and by applying the marginal tax rate of higher earner when there was more than one earner in the primary income unit in the household. Non-taxation of rental services derived by applying a flat 10 per cent GST rate to 70 per cent of gross imputed rent (to allow for GST paid on non-interest operating cost).

Details for land tax calculations covered in text below.

(q) Imputed rent estimates derived by applying a gross rental rate of 4 per cent to mean dwelling value derived from Abelson and Chung (2005). Rental values are based on gross rentals at 4 per cent of capital values (Reserve Bank, 2003); tax expenditures derived by applying a marginal tax rate of 40 per cent. Capital gains are based on real capital gains of 1 per cent per annum; tax expenditures are based on a real income tax base and derived by applying a marginal tax rate of 40 per cent to accrued real gains.

(r) Tax concession to investors based on asymmetrical treatment of nominal costs and gains but estimated on a benchmark assumption that only real income should be taxed and real costs should be deductible. Tax expenditure calculated by applying a marginal tax rate of 40 per cent to the amount of loan outstanding by inflation rate and by subtracting the present value of the tax on realised nominal gains. (Abelson and Joyeux, 2007, p.151).

(s) Derived by applying a 10 per cent GST to the gross annual rental value of the housing stock in 2004 (estimated to be $99b for both owner-occupied and rental housing); reduced by estimate of GST paid on gross capital formation (derived from ABS National Accounts data – see note (m) above.

(t) Set equal to Productivity Commission (2004) estimate.

(u) Exemption for owners not regarded as a tax expenditure; tax on land regarded as an 'excess tax'; cost to landlords estimated as $1.2 b derived after applying a 40 per cent deduction to $2b paid in land taxes (Abelson and Joyeux, 2007, p.152).

(v) Based on Productivity Commission (2004) estimate of $8b paid in rates less tax deductions (at 40 per cent marginal tax rate) for landlords.

(w) As reported in Productivity Commission report (2004, pp.81, 100, 109). No details given other than to indicated imputed rent estimates based on a 20 per cent gearing assumption.

Factors contributing to differences in estimates

Imputed rent estimates

Gross imputed rent is the rent that owner-occupiers would pay if they rented the dwelling in which they lived: it represents the amount of rental services provided by their dwelling. Net imputed rent is gross rent net of any expenses incurred: it represents the rental income generated from home ownership.

Estimates of imputed rent are generally based on the data in the ABS National Accounts. The gross rent data are disaggregated into gross imputed rent for owner-occupied housing and actual rent (paid by renters). Over the two decades or so to 2008 gross imputed rent for owner-occupied housing has increased in importance from 72 per cent to 76 per cent of total gross rent.

As the definition moves from expenditure or gross rent data to income or net rent data, the measures employed in the Australian System of National Accounts data become less clearly defined. Gross income from dwellings owned by persons or gross operating surplus is defined as gross rent less operating costs associated with rates, insurance, maintenance etc. where, in principle at least, expenditure on maintenance maintains the dwelling at its original quality.

Income from dwelling rent in the National Accounts, however, is defined as gross operating surplus less consumption of fixed capital (or depreciation on the dwelling structure) and less interest payable (interest on outstanding loans). In other words, the loss of income associated with depreciation of the structure is included, but any gain in income associated with appreciation of the land on which the structure stands is excluded. Capital gains taxes on any such gains (which embody any associated capital depreciation) are included in the relevant sector accounts in the period in which they become payable (ABS, 2000:316).

Treasury's TES estimates of tax expenditures for imputed rent include the ABS estimates of depreciation (or consumption of fixed capital) which are fairly generous (representing more than 1.5 per cent of the current value of land plus building in 2005-06 or more 3 per cent of the current value of the building alone which is the only depreciable component). Investors are able to deduct only 2.5 per cent of the historical building cost. Thus, deduction of depreciation based on current dwelling values is likely to result in a considerable over-estimate of the cost to owner-occupiers of not being able to deduct their operating costs (because they do not pay tax on their imputed income). Freebairn and Yates (and, by implication, Abelson and the Productivity Commission) deduct costs normally paid by landlords. These include property taxes, insurance, mortgage interest, water and sewerage charges and repairs and maintenance, but do not include depreciation. This is consistent with the international standards for household income and expenditure statistics by the 17th International Conference of Labour Statisticians in 2003 (ABS, 2008). The Senate Select Committee estimates are based on gross rather than net imputed rent and, therefore, do not provide an estimate of the offset due to the inability of owner-occupiers to deduct operating costs.

Even if agreement were reached on the appropriate base for measuring net imputed rent, estimates of aggregate tax expenditures will still be approximate because they require an assumption to be made about what would have been the relevant tax rate had this untaxed income from owner-occupied housing been treated in the same way as taxed income from rented housing. Use of the current tax rate scale to determine the appropriate marginal tax rate assumes that the rate structure would not be altered by the broadening of the tax base that would occur if net imputed rent were added to

household income. Choice of the appropriate marginal tax rate is further complicated by the fact that income is taxed at an individual level which means that the income derived from owner-occupied housing has to be assessed at an individual level.

At the aggregate level, a conservative approach is to apply the marginal tax rate that applied to average taxable income for individuals in each of the years under consideration. The Senate Select Committee estimates are based on an average marginal tax rate of 20 per cent; Freebairn employs an average marginal tax rate of 30 per cent; Abelson and Joyeux use 40 per cent. Even with the same base estimate for imputed rent, this range of tax rates would result in estimates of tax expenditures that differ by 100 per cent. The Treasury and Yates estimates both use marginal tax rates derived from the distribution of individual income within the household from survey data. Details are not available for the rates used by Treasury (but they are consistent with an average marginal tax rate of around 25 per cent). Yates estimates tax expenditures according to whether income is taxed at the average marginal rate applicable to the lower of individual incomes within the primary income unit in the household (23 per cent) or at the average marginal rate applicable to the higher of these individual incomes (30 per cent). The estimate reported in Table 1 is based on the higher of these.

Capital gains estimates for owner-occupied housing

The capital gains tax in Australia is based on nominal capital gains and gains are taxed on realisation at the taxpayer's marginal income tax rate, with a 50 per cent discount allowed for individual investors.

The Treasury estimates reported in Table B1 (of $43.5b in 2007-08 and $39.5b in 2005-06) for the tax expenditures associated with the exemption of the family home from the capital gains tax reported were derived from HILDA survey data on realised nominal capital gains adjusted for capital works deductions and scaled by the average turnover of owner-occupied stock. The estimates are equivalent to those that would have been achieved if an average annual accrual rate of around 6-7 per cent had been assumed. This is marginally less that the average annual rate of house price inflation for the 20 years for which ABS house price indexes are available (as shown in Figure A1 in Appendix A).

These estimates have not been reduced by the 50 per cent discount on capital gains that applies to rental housing, despite the fact that offsetting estimates (respectively -$24b for 2007-08 and -$22b for 2005-06) are provided in the TES estimates (Treasury, 2009, p.214). Estimates of approximately half of those reported in Table B1 (because of the 50 per cent discount) implied by the estimates in Appendix C of the TES are inconsistent with Treasury's own definition of tax expenditures based on its recognition of realised nominal gains and losses as the capital gains tax benchmark (Treasury, 2009, p.36) and, in particular, they are inconsistent with its inclusion of the discount on capital gains for individuals as a tax expenditure for rental housing (Treasury, 2009, p.12).

The non-discounted estimates, however, are considerably higher than others presented in the table. Both Freebairn and Yates approximate actual realised gains by average annual accrued gains: the Freebairn estimate is derived from aggregate data; the Yates estimate from disaggregate data. Freebairn applies a conservative (and counterfactual assumption) of an average nominal house price growth of 3.5 per cent as a proxy for realised nominal capital gains (representing a 1 per cent growth in quality adjusted real dwelling prices and an assumed average inflation rate of 2.5 per cent) to an equally conservative estimate of gross owner-occupied housing wealth (of $2,000b in 2005-06). Yates applies a marginally higher rate of capital gains (of 4.0 per

cent) to a 2005-06 estimate of owner-occupied dwelling wealth from the 2005-06 SIH that yields an estimate of total dwelling wealth (made up of $2,267 for owner-occupied wealth and $579b for other housing wealth). This total is consistent with RBA data (of $2794b for December 2005) but is approximately 10 per cent higher than that used by Freebairn. Both studies apply average marginal tax rates of 30 per cent. The differences in the assumptions and benchmarks explain most of the difference in the Freebairn and Yates results. With the higher rate of capital gains and the higher estimate of gross housing wealth, Freebairn's estimate would be revised upwards from $20b to $27b.

The (considerably lower) Senate Select Committee estimate was derived by assuming that the tax liability for owner-occupiers would mirror that paid by owners of rental housing and by applying appropriate scale factors (assumed to be 2 on the assumption that owner-occupied housing represents two thirds of the total stock) to estimate capital gains tax receipts for real estate from total capital gains tax payable by individuals and applying a 30 per cent average marginal tax rate to estimate the associated tax expenditures. Aggregate survey data, however, suggests that, although owner-occupied housing represents approximately two-thirds of the total stock of housing, the value of owner-occupied housing represents 80 per cent of the value of residential dwellings rental housing. Thus, on the logic employed by the Senate Select Committee, the appropriate scale factor should not be 2/3:1/3 but 80:20. Applying this higher scale factor leads to a revision of the Senate Select Committee estimate from $20b to $40b for 2005-06 which is similar to that reported by Treasury.

These observations suggest an aggregate estimate for the tax expenditure associated with the exemption of the family home from capital gain that ranges from $30b to $40b. It also highlights the fact that the Yates estimate for 2005-06 used in the following section is at the conservative end of this range.

Discount on capital gains for rental housing

Official estimates of the tax expenditures associated with the capital gains tax discount for individuals and trusts are provided in Treasury's annual Tax Expenditures Statements. Of the measured tax expenditures reported in the TES, the value of this discount is exceeded only by the concessions to superannuation. These estimates, however, cover the tax expenditures associated with the discount for shares and other assets as well as for real estate.

Differences in the estimates reported in Table B1, which are limited to the tax expenditures associated with rental housing, the key subset of real estate for individual investors, arise primarily from differences in the assumptions made about allocation of the reported tax expenditure to its component parts. The most straightforward approach (which was applied to the TES estimates in Table B1) is to use Australian Taxation Office data on the distribution of capital gains by source. This same approach (with the same proportionality factor) was used by the Senate Select Committee, but it was applied to a higher base estimate of capital gains tax discount claimed (of $14.3b in 2005-06) taken directly from the ATO's report of discount claimed (ATO, 2008, p.80). An arbitrary adjustment was made to increase this to the reported 2007-08 estimate. The difference in this base fully explains the difference in the TES and Senate Select Committee's estimates as the ATO data on the capital gains tax discount for 2005-06 exceeds the TES report of tax expenditures for 2005-06 by a factor of 2.5. It is not obvious why the TES should report a markedly lower value for the discount. ATO data on net capital gains and tax payable on those gains by individuals, indicates an implicit average marginal tax rate of 33.2 per cent in 2005-06 and 31.5 per cent in 2006-07.

The Freebairn estimate is based on applying an estimate of average accrued capital gains (of 3.5 per cent) to an estimate of aggregate investor housing wealth and applying a marginal tax rate of 30 per cent. The Yates estimate is likewise based on applying an estimate of average accrued capital gains (of 4.0 per cent) to the value of investor housing wealth reported in the 2005-06 SIH with an average marginal tax rate of 30 per cent applied.

Negative gearing

The Senate Select Committee estimate is based on ATO Taxation Statistics data for 2005-06 (which generates a value of $1.5b with their assumed 30 per cent average marginal tax rate). The 2005-06 estimate is arbitrarily (and somewhat generously) scaled to $2b to take into account increased rents (which would increase the estimate) and increased interest rates (which would decrease the estimate). Their 2005-06 estimate is similar to that obtained by Yates by applying their relevant marginal tax rates to reported losses on investment in rental housing for the individuals in the primary income unit in the household and then aggregating these to the household level. Abelson and Joyeux obtain a marginally higher estimate based on the use of illustrative parameters.

The estimate used in this paper (derived from the 2005-06 SIH) is likely to underestimate the value of this concession as the person level file in the SIH has only 674,000 individuals (and 435,000 households) recorded as receiving negative net rental income in 2005-06. This is markedly lower than the 1.5 million individuals reported by the ATO (2008, p.12) as having negative rental income in 2005-06.

GST exemption for rental services

This applies both to imputed rents and to actual rents paid. Tax exemption (rather than zero rating), however, means that GST paid on input costs cannot be claimed. Freebairn bases his estimate by applying the 10 per cent GST rate to ABS estimates of gross operating surplus from ownership of dwellings for persons. Although reported as being for 2006-07, Freebairn's estimate applies to the June 2008 data. Yates bases her estimate on 70 per cent of the gross imputed rent data for owner-occupied dwellings in the 2005-06 SIH plus the rent paid by renters. The 70 per cent adjustment was to allow for non-interest operating costs (estimated from the SIH data on gross and net imputed rent for outright owners with no interest costs). This aggregates up almost identically to the ABS data on gross operating surplus for 2005-06. Differences in the estimates reported by Freebairn and Yates, therefore, arise only because of differences in the time period (and can be attributed to the significant increase in rents (imputed or otherwise) over the period. Abelson and Joyeux (and, by implication of the similarity in the reported values, the Productivity Commission) base their estimate on gross rents (and so do not allow for the cost of not being able to claim GST paid on inputs.

Land tax exemption

With the exceptions of the AFTS and Yates estimates, all of the estimates reported are derived from the estimate provided by the Productivity Commission, for which no information is provided in their report. The Senate Select Committee scales this up by the increase in land prices over the period (which is not necessarily appropriate given the progressive structure of the land tax schedule and the significant tax free threshold that applies). They also provide an alternative rationalisation of their estimate based on adjusting total land tax collections by a scale factor based on the proportion of owner-occupied and rental dwellings. This ignores the fact that a considerable proportion of land tax is paid on land used for purposes other than residential dwellings.

The AFTS estimate (Treasury, 2008a) is based on State Treasury Tax Expenditures Statements. Not all of these record the exemption of the family home from land tax as a tax expenditure.

The estimate by Yates is derived from data on gross dwelling values for both owner-occupied and rental dwellings in the 2005-06 ABS Survey of Income and Housing. Land values were estimated by applying scale factors derived from data in the National Housing Supply Council report on the cost of land in average dwelling prices for the major capital cities land (and by applying the minimum of the factors derived to all regions for which no data were available) (NHSC, 2009, Tables A.36, pp,126-128). Tax expenditures were derived by combining the land values for owner-occupied and rental dwellings reported for each household and applying the 2005-06 land tax schedules for each state to these totals.