Comment on First Home Ownership Discussion Draft

by Alan Hall

With the bulk of the Productivity Commission's Discussion Draft (DD) I am in broad agreement. This note is confined to some issues which I believe have not been given the attention they deserve.

The DD makes the distinction between cyclical and structural aspects of first home ownership. The inquiry was prompted essentially by cyclical considerations and most of the discussion is about cyclical issues. It is suggested that rather more attention should be given to structural ones in the final report.

The community preference for home ownership

The DD recognizes that the periodic interest of governments, and the community, in issues relating to first home owners (FHOs) arises from a strong community preference for home ownership. It also recognizes that government responses to this preference can, and do, involve costs for others in the community. It makes the point that these costs mean that there are distinct limits to the extent that governments should support this preference (p. 3).

My objection to this conclusion is that there should not merely be no additional support to home owners but that the current support is excessive. It has been an essential contributor to the cyclical problem at which the DD is primarily directed and to the cyclical problems that will recur if the current structural problems are not addressed.

There is nothing wrong with strong personal preferences for home ownership. Because they are strong does not mean that they should be pandered to. On the contrary if they are strong then individuals will give expression to them without government support.

Key elements of the housing market

The housing market is segmented into two groups:

A - Non-home owners – this is further divided into two groups

(i) Low income earners who, for one reason or another, are never able to enter the home ownership market. [The rough size of this segment can probably be established from census data.] The DD pays little if any attention to this group though the term of reference (f) would appear to require some comment on their situation.

(ii) Mainly younger income earners with higher incomes who have needed time to accumulate a loan deposit and have reached the stage when they can service a housing loan. This is the group that primarily makes the transition from renter to FHOs and who benefit from the First Home Owners Grant. Its effect is to bring forward in time the transition. If maintained continuously at the same amount it would result in a small permanent increase in the proportion of owner-occupiers in the total dwelling stock.

B – Owner Occupiers – also consisting of two groups

(i) Owners in the process of completing purchase (mortgagees)

(ii) Outright owners

Both of these groups benefit from the exclusion of imputed rental income from taxable income and from freedom from capital gains tax on their owner-occupied dwellings. Both groups typically experience rising house prices which, in the first case, gives them increasing access to 'equity' borrowing or, in the second, directly increases their borrowing capacity. Both situations assist them, if they wish to do so, to become members of category C.

C – Investors

Liable for capital gains tax but able to indulge in negative gearing

The blatant anomaly in this bald summary is that the benefits of the taxation concessions for home ownership accrue to the better off proportion of the community. They do so in a highly progressive fashion. The greater the value of the owner-occupied home the greater is the taxation benefit. Most of the poorest section of the community never have an opportunity to participate in this publicly sponsored feeding trough. While most of the poorer renters do get public assistance under State housing schemes that much needed assistance could well be greater if housing subsidies to the well-to-do were abandoned.

Land price differentials and the trend of real house prices

The dynamics of house price formation is extremely complicated but it does contain one basic ingredient. In highly urbanized countries experiencing continuing population growth such as Australia there is a trend increase in the real price of residential land. This increase applies over the whole of major city land price surfaces and periodically extends further afield. This increase accrues to all real property owners but, in the housing market, does so in a highly skewed fashion (see submission 91).

In general the pattern of the increase in real urban land prices is a function of increasing distances from the CBD modified by the physiographic characteristics of the city's landscape. The underlying skewness of this price increase surface is magnified by some of the characteristics of the demand for housing, in combination with the relative stability of real income growth over recent decades. Housing is a product the demand for which rises with increases in real income. As real incomes rise there is not merely an associated increase in demand for housing but an increase in demand which is strongly biased towards more favoured locations. It is this markedly differentiated demand for the differentiated land upon which many urban houses are built, which gives rise to urban house price bubbles. The greater part of the preferred land is in more or less completely inelastic supply which can only be increased, if at all, by building upwards. Typically the price of housing on preferred locations is bid up by existing home owners, whose incomes are rising and who, in recent years, have had 'equity' finance thrust upon them by their bankers. At the same time impetus was given to this process by the then undervalued exchange rate. It is this combination of circumstances that ensured that unto those that hath shall be given and that the rate of price increase was greatest in those locations preferred by the wealthy. It is not surprising, as the DD notes, that it was increases in the prices in these preferred locations in Sydney and Melbourne that triggered the outburst of the recent house price bubble. More recently, high housing price increases are largely the fall-out from this initial disturbance of parts of the house price surfaces of Sydney and Melbourne. Individual owners naturally take advantage of these conditions if they can. When doing so they are riding a wave that is essentially not of their own making.

Bank credit and asset price bubbles

It is reasonable to believe that freely available bank credit is one of the essential ingredients in asset price bubbles, Whether or not this is generally true it certainly is of the recent Australian one which is the principal raison d'etre for this inquiry.

The DD correctly observes 'Cheaper and more accessible housing finance has been an important driver of increased demand and rising house prices over the past seven years.' (p.33). What it does not do is draw attention to the fact that the principal Australian financiers of housing are the major banks which are nominally under the supervision of the Reserve Bank. No one doubts that the Bank has been aware of what has been happening. Indeed it has been the earliest and most consistent institution in drawing attention to the growth of community indebtedness that has been a feature of the housing borrowing spree.

But its consistent message has been about the dangers of too much borrowing not about the irresponsibility of too much lending. One can but wonder whether it, and the rest of the economic establishment, have forgotten Marshall's once well-known observation that it is impossible to tell which blade of the supply and demand scissors is the cutting edge. To scold the borrowers but not the banks is logically unsound.

It is not only the Reserve Bank of Australia that treads lightly around asset price bubbles. In doing so it appears to be in accordance with informed opinion around the world. This judgment depends upon the apparent belief that the only effective weapon in the Bank's policy armoury is the rate of interest and that its use is dedicated to the control of inflation. It was judged, probably correctly, that its use for that purpose was inappropriate during the blow-out of the asset price bubble so that its public policy 'action' was confined to warnings that excessive borrowing is unwise.

There are reasons to believe that this constituted a failure of monetary policy. In the jargon of the trade the Australian bankers have committed 'moral hazard' in their pursuit of easy profits in a socially irresponsible manner. For reasons which no doubt it judged good, the Reserve Bank did not curb them. There was a time in the more distant past, but well within living memory, when the Bank would have instructed the banks to lend in a more restrained fashion. This is, undoubtedly, a second best policy but if used very sparingly is better than no policy at all. The belief that the Bank's only effective policy instrument is interest rates is a matter of fashion not of policy making necessity.

The Productivity Commission will not wish to engage in a monetary policy debate with the Reserve Bank. It is to be hoped that it will recognize that lending, as well as borrowing, has been excessive. It is too much to hope that the lending banks will be clement to borrowers whose fingers will be burnt by not heeding the Reserve Bank's advice.

Direct assistance to FHOs and the need for savings assistance

The DD justifiably concludes that there is no need for additional direct assistance for FHOs. (p. 143). It suggests that if governments wish to continue the First Home Owners Scheme (FHOS) it is preferable that it be limited to buyers on lower incomes.

Potential FHOs will always be with us. What primarily determines the length of the period before they become actual owners is the difficulty of saving the required initial deposit on lower incomes. The FHOS is in effect a once-off savings subsidy which does little positively to encourage the saving habit.

If the national accounts estimates of saving out of disposable income are to be believed (there are some doubts that they should be) people generally, not merely potential home owners, are desperately in need of redeveloping saving habits which are uncommitted to any one specific purpose (such as superannuation). From this perspective what needs thorough examination is the means whereby everyone can be induced to save more. One possibility is to devise a means of encouraging saving by low income earners in the form of an appropriately limited, annual dollar for dollar subsidy. Such a subsidy would involve the progressive phasing out of the existing FHOS, a process which would partly fund the new scheme. The administrative complexities of such a scheme would need detailed examination. If the Commission's final report should include a recommendation for a national review of the housing industry's taxation and subsidies in the context of those of other industries would it not be wise to include saving as well as investment processes in such an inquiry?

The taxation benefits of home owners

The DD's discussion of the incidence of taxation of housing is somewhat misleading as it is confined to analysis of the way it is shared between buyer and seller in a particular market. It does not draw attention to the main issue in the set of markets that provides housing services. This is the fact, noted above, that the main problem with the distribution of the taxation benefits of home ownership is not the ways in which they are shared between buyers and sellers in the home ownership market but that the net benefits of the tax subsidies are limited to home owners and are at the expense of renters who include a large part of the poorest members of the community.

The DD makes rough estimates of the size of these benefits, which make it clear that they are substantial, but avoids addressing the implications of this situation. It does so partly on the legitimate grounds that any improvement in the efficiency and equity of housing-related income and capital gains taxation will have repercussions on the rest of the capital market. These lie outside its terms of reference. It therefore concludes that any decision to neutralise the tax treatment of owner-occupied and investment housing should involve a wider review of its implications than is possible for it to undertake. One aspect of this judgment is examined further below.

The perverseness of the home ownership subsidy

The DP notes that the current extent of home ownership in Australia (nearly 70 per cent) is high by international standards. It also notes that the 'trend in the number of first home buyer approvals has been broadly constant over the past decade', (p.xiii). The fact, to which it does not draw attention, is that the proportion of Australian owner-occupied dwellings has remained in the range of 65% to 70% since 1961. Throughout this period the imputed rental income of home ownership has not been subject to income tax. Since 1983, unlike other forms of property including investor housing, owner-occupied dwellings have not been subject to capital gains tax (CGT). Why have these tax incentives been ineffective in realizing their supposed objective of making home ownership more accessible?

The probable answer to this question is that, broadly speaking, the *distribution* of income has not changed greatly. While real incomes have been rising they have done so across the income distribution. Real house prices (including the real value of residential land) have been increasing in a similar fashion. The thirty to thirty-five per cent of the population that includes potential home owners have experienced little easing in the task of making the transition from renter to owner. As the tax advantages of home ownership encourage greater expenditure on homes, than would be the case in their absence, they have the perverse effect of increasing the difficulty of becoming a home owner. Within the favoured home owning population the tax benefits are strongly biased towards the wealthiest. If the inequality of the distribution of *wealth* is increasing, as some observers claim, then the incidence of housing tax benefits in favour of the wealthy, and to the exclusion of the renting population, is an important reason for it becoming so. If a further inquiry into taxation should result from this inquiry then one of its terms of reference should be how best to tax the unearned increment of land values.

The advisability of making owner-occupied dwellings liable to CGT

It was noted above the DD is in favour of referring the income and capital gains tax benefits of home ownership to a wider, economy-wide review of these matters. With many of the issues raised before it this is indeed appropriate.

But there is a good case for one exception. The levying of capital gains tax on owner-occupation simply means the extension of the coverage of an existing tax structure.

The reasons, presumably, why the family home was excluded from the purview of the CGT at the time of its introduction were that, as the legislation was then conceived, the necessary record keeping task would have been very onerous, and it may well have also been judged politically too risky. The recent change to taxation of nominal capital gains greatly simplifies the record keeping task. The perceived political disadvantages are probably greatly exaggerated. About one-third of the population – renters and potential home owners - unambiguously stand to benefit. Within the home owning population the greatest benefits, and hence the greatest possible costs, accrue to the wealthiest section of the population. They, and self-interested members of the real estate market, financial markets, and the media, are the source of the greatest opposition. That other current owners are not greatly affected is apparent if one takes an objective look at what is actually involved in the widening of the capital gains net. The community as a whole undoubtedly benefits from it through the increase in the efficiency of the housing market and from a more equitable distribution of income and wealth.

As a CGT on owner-occupied dwellings would not be retrospective the capital value of the stock of dwellings at the time of its promulgation would not incur the tax. The principal initial effect would be a one-off reduction in that capital value (housing prices) as new purchasers discounted their future liability for the tax. As only realized capital gains are taxable, owners of the existing stock would not become liable to them until after the sale of their existing dwellings and moving to another owner-occupied dwelling. Its subsequent sale would be liable to the tax. Until then they would benefit in some degree from such growth in the yield of the CGT from owner-occupied dwellings as would be arising from the sales of new owner-occupiers or from the re-sales of other existing owners. If they remain in possession of their existing houses until their deaths their heirs would not be liable to a capital gains tax on those houses and would benefit from the increased revenue being raised. The eventual tax, if any, would only be part of a realised capital gain.

It follows that the yield of CGT from owner-occupied dwellings would take at least a year to emerge and would be slow to become substantial. As already noted its principal initial effect would be to lower the price level of the existing housing stock, which it is generally agreed is now over-priced, and in doing so would make housing more affordable for FHOs. As the administrative structure for capital gains taxation is already fully in place there would be low costs in widening its scope. By increasing the neutrality of the taxation of owner-occupied housing relative to investor housing it would increase the economic efficiency of the housing market and induce some reduction in the current over-investment in housing. It is difficult to see how it could have any *adverse* effect on the wider capital market. It eliminates an anomaly that adversely affects FHOs. It is the one single measure that would be of most immediate benefit to people on the margin of entry into home ownership. In the longer run it would make a real contribution to the equity of the tax system. The DD does not demonstrate why this particular proposal needs further detailed examination.

As noted above prevailing informed opinion holds that it is inappropriate for the Reserve Bank to intervene directly to limit the development of house price bubbles which are likely to recur at regular, though fairly lengthy, intervals. If that should remain accepted policy then alternative courses of action need to be developed to control this very inefficient and potentially damaging market behaviour. If both investor and owner-occupied housing were subject to the same capital gains tax regime then one such policy instrument could be to vary the rate of capital gains tax on dwellings in order to curb the developing house price bubbles with their inevitable adverse effects, amongst other things, on FHOs.

Conclusion

When fuller account is taken of the structural properties of the housing market it is apparent that the current difficulties faced by FHOs are largely the consequence of an excessive rise in housing prices which should have been addressed more directly by the monetary authorities. In due course, but at some cost the size of which remains to be seen, a more reasonable balance between FHOs real incomes and real house prices will be re-established. There is no strong case for increased direct assistance to FHOs. It is likely that their relative ease of entry into home ownership would be improved by the removal of the existing tax benefits on home ownership that, contrary to received opinion, are almost certainly perverse in their effects on the extent of home ownership. These tax benefits need thorough review but, for the most part, this should be done in the context of an industry-wide examination of the taxation of investment. The means of fostering personal saving and how best to tax the unearned increment in land values should be part of such an inquiry. Further review of the CGT regime, considered by itself, is unnecessary. Economic efficiency, tax payer equity and FHOs would all gain immediately from making occupied dwellings subject to CGT. Only the wealthy and the narrowly self-interested have grounds for objecting to this finding and even they experience some longer term gains from a sustained increase in the efficiency of the housing market..