Housing is not just another investment

A submission in response to
the Productivity Commission Discussion Draft on
First Home Ownership

by
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(January 23, 2004)

Summary

Further to Submission 68, Prosper Australia submits that:

- In terms of economic equity, housing affordability is more important than wage policy, welfare policy, or the superficial ‘‘fairness” of the tax system. The property market also exerts unique influences on employment and economic growth. These are ample grounds for believing that real estate should be taxed differently from other asset classes.
- Boom-bust cycles in asset markets are not inevitable, but can be prevented by taxing capital gains more heavily than income, preferably by means of holding taxes on the values (or changes in values) of assets. In the property market, land value taxation meets this requirement.
- The belief that every home owner is a direct beneficiary of rising home prices is a myth, whose perpetuation serves the interests of that minority of home owners who also own investment properties.
- Housing affordability *does* depend on whether infrastructure costs are defrayed up-front or over time, because up-front charges can only be transaction taxes, whereas payments spread over time can be holding taxes on non-replicable assets.
- The first home owners’ grant should be restricted to new homes, and perhaps also extended to new homes that are not ‘‘first” homes, in order to stimulate construction and contain prices and rents.
- If the tax arrangements for owner-occupied homes are to be brought into line with those for investment homes, there are more ways of doing this than meet the eye. In particular, an approximation to a land value tax on owner-occupiers can be implemented as a means test on welfare payments.
- The policies advocated by Prosper Australia at this time of high home prices are not merely *ad hoc*, but will continue to be appropriate after the market crashes and recession sets in.

Two small corrigenda to Submission 68 are included.

Introduction

Prosper Australia’s first submission (Sub.68) addresses the Terms of Reference and proposes a specific and coherent package of reforms. Expressed from the viewpoint of State governments, those reforms include:

- Abolition of up-front infrastructure levies, stamp duty on new homes, and payroll tax (and land tax as currently implemented);
- Introduction of a broad-based land value tax (LVT) with *no threshold*, but exempting owner-occupied principal residences, to replace the revenue from the abolished taxes;
- Amendment of Local Government Acts to require local councils to levy rates on land values alone (as already done in Queensland and NSW);
- (Optional) Subjecting welfare payments to an assets test based on the value of land under the principal residence, and refunding shares of the withheld payments to the respective State and local governments -- thereby effectively extending the land tax base to owner-occupied principal residences, albeit without sending bills to the owners.

In contrast, this second submission addresses a selection of points in the Discussion Draft, and in so doing floats ideas that are not necessarily compatible with each other or with the first submission. Each submission should be taken not as a statement of Prosper Australia’s preferred position, but as an attempt to advance the mission of Prosper Australia within given constraints.

Real estate is different

The Discussion Draft repeatedly argues that because negative gearing and capital gains tax affect all asset classes, any review of these arrangements should take place in the context of a general review of asset taxation and should not be restricted to housing (see e.g. pp. X, XXI-XXII, 59, 89). This attitude reflects an investor’s view of housing, not a tenant’s view or even an owner-occupier’s view. Seeing all assets exclusively through investors’ eyes leads to the presumption that all asset classes should be taxed alike.

We submit that there are at least four reasons why real estate should be treated differently from other asset classes:

(a) Housing is a necessity of life;

(b) Jobs cannot be created unless the workers can pay for housing within commuting distance of those jobs, out of wages that the employer can pay out of the proceeds of the business;

(c) Jobs cannot be created unless the employer can pay for the business premises out of the proceeds of the business;

(d) Because the land component of real estate does not have a cost of production, its market value is pure economic rent, whose private appropriation cannot be justified as an incentive to produce.

Concerning (a), a reduction in the recurrent cost of housing is a direct benefit to low income earners’ household budgets. The same cannot be said of safety-net wage increases, which are largely taken away (or sometimes more than taken away) by the stacking of income tax, income tests on welfare, and income-dependent child support payments. Neither can it be said of welfare increases or tax cuts for low income earners, both of which are largely competed away in the rental housing market. It follows that, as a social justice issue, *housing affordability is more important than ‘‘living wage” claims, the ‘‘adequacy” of welfare, or the ‘‘fairness” of the tax system!* In particular, the main redistributive effect of the tax system is to be found not in the statutory application of the various taxes, but in their ultimate influence on the cost of housing. As these facts are not acknowledged in the Discussion Draft (e.g. on p.2), we are led to wonder whether the Commission itself understands the full significance of its inquiry, especially as regards down-market rental housing.

Tax reforms affecting the cost of housing are too important to be subordinated to some abstract philosophy of asset taxation; rather, any such philosophy must be founded on the need for affordable housing. Besides, no one would seriously claim that the current favoured treatment of owner-occupied housing -- with which the Commission seems relaxed and comfortable -- has been adopted in the context of a general review of asset taxation. On the contrary, political considerations ensured that owner-occupied housing was excluded *a priori* from such reviews!

Cycles are *not* inevitable

When an asset market is cyclic, the cycle has a *speculative phase*, in which rising prices induce people to buy the assets in pursuit of capital gains, and the resulting demand accelerates the price rise, and so on. Thus prices are driven far above the present value of expected future earnings and are supported solely by the expectation of continuing, rapid capital gains. This expectation is self-fulfilling for a time. But eventually buyers or their financiers start losing their nerve and the price rise slows down. As soon as that happens, the justification for current prices is taken away, so the market dives -- until prices have clearly returned to levels justified by earnings. In the share market, in which billions of shares can be traded instantly by computers, the ‘‘dive” can take place literally overnight. In the property market, in which transactions are more cumbersome, the ‘‘dive” may take several months. But in both cases the speculative phase is essential.

The speculative phase of a cycle is driven by the pursuit of capital gains rather than income. It follows that *cycles can be prevented by tax reforms that make capital gains sufficiently unattractive relative to income*.

A conventional capital gains tax (CGT) is not the ideal instrument for this purpose, because it discourages the realization of capital gains and therefore impedes the resource reallocations that would occur in an efficient market. However, a *holding tax* on asset values (or changes in asset values) does not impede reallocation.

Even a holding tax may be inefficient in that it discourages the production of assets subject to the tax. But this argument does not apply to naturally occurring assets such as land. Neither does it apply to the unimproved land *value*, which is created by nearby developments and by demand from the surrounding community, and not by any activity of the owner/taxpayer. Moreover, because buildings depreciate, ‘‘capital gains” on real estate actually reflect increases in *land* values.

It follows that *property cycles can be prevented by a sufficiently heavy holding tax on land values or changes in land values*. Such a tax, if heavy enough, could replace the CGT on real estate, thereby reducing undesirable transaction costs including compliance costs. If heavier still, the holding tax could replace the income tax on income from the same asset class, thus maximizing the attractiveness of income relative to capital gains.

We therefore object to the defeatist view that ‘‘governments cannot prevent most of what happens to house [sic] prices and should not try” (Discussion Draft, p.XXVI), which seems to assume not only that prices are ‘‘inherently cyclic” (p.XI; cf. p.X), but also that nothing can be done about the cycles.

The same attitude finds expression when the Commission discusses periodic skill shortages in the construction industry (Discussion Draft, p.131) and concludes:

> It is unsurprising, in an industry as cyclical as housing construction, that shortages of labour, particularly skilled workers, occur from time to time. Such a situation does not necessarily require remedial action.

We submit that it requires remedial action to suppress the cycles, which cause the periodic labour shortages interspersed with periods of high unemployment.

We further submit that employers are never going to invest more in training as long as an employee trained at one firm’s expense can be snapped up by a rival firm under the guise of free competition. If bonded traineeships are ruled out, the market failure must be corrected either by allowing trainers to recover training costs from poachers (internalizing benefits) or by giving more generous subsidies or tax concessions for training (externalizing costs). The latter option seems cheaper to administer and enforce.

Although we have made a case for taxing real estate differently from other assets, the argument for taxing capital gains instead of income, by means of holding taxes rather than the usual transaction-based CGT, is valid for other asset classes. So, if the Commission insists on a uniform tax regime across all asset classes, that regime should be characterized by a holding tax on values or changes in values in lieu of any tax on earnings. But we cannot promise that this approach will not lead to technical difficulties when applied to asset classes other than real estate.

Winners, losers and dupes

One of the first statements in the Discussion Draft (p.XI) is the glib assertion that the 70 percent of Australian households who own homes are beneficiaries of the recent price rises. The catch is that the prices of alternative homes have also risen. On average, if the only property that you own is your home, what you gain by selling your old home is lost when you buy the new one (unless you trade down, which is not the preferred direction). Meanwhile, your children are losers because it is harder for them to enter the market -- unless each of them inherits a home, which cannot be guaranteed if you have more than one child. Rising home prices eventually lead to unaffordable wage demands, which tend to produce inflation and/or unemployment, either of which must somehow come back and bite the home owner.

The clear winners from the current high prices are investors who own two or more properties, so that they can sell without buying again. The clear losers are those who still aspire to enter the market. But it is not at all clear that ordinary home owners are winners.

The problem for property investors is that they do not of themselves make up a majority of the population. So, in order to gain majority support for policies that drive up home prices, investors must promulgate the message that ordinary owner-occupiers with mortgages are direct beneficiaries of rising prices. Unfortunately the message is quite believable. Mainstream political leaders, who presumably know better, make no effort to dispel the illusion, because one cannot win an election by telling the majority of voters that they are wrong. The Prime Minister, for example, disingenuously boasts that no home owner has ever complained to him about the rising value of his/her home. He can't compete with 1.3 million property investors engaged in ‘‘conversation” at barbecues, pubs and coffee shops; and if push came to shove, no political party could match the advertising budget of the property investment lobby. So ordinary home owners with mortgages continue to believe that their interests coincide with those of investors.

Up-front means transaction-based

The Discussion Draft (pp. 115,123,128) asserts that, in terms of affordability, it should not in principle make any difference whether infrastructure costs are recovered up front (e.g. through levies) or over time (e.g. through rates). We strongly disagree with this proposition inasmuch as it fails to distinguish between transaction taxes and holding taxes. An up-front infrastructure levy, being a condition of development, is effectively a *transaction tax* on development. As such it impedes development, reducing the supply of developed land and increasing its price. In contrast, a land tax or rate on the unimproved value of land is a *holding tax* on a non-replicable asset. As such it is capitalized in the price of the asset, so that on balance it does not reduce affordability of developed land for the purchaser; indeed, because such a tax reduces speculative demand for land, the reduction in price tends to outweigh the present value of the annual tax liability, so that affordability is improved.

Accordingly we welcome the conclusion (Discussion Draft, p.128) that up-front infrastructure levies should not be the norm, and that they should never be used for funding *social* infrastructure such as libraries. However, we note that the Commission sees ‘‘considerable merit” in up-front charges for *major* economic infrastructure, such as railways and trunk water supplies, if the costs can be accurately apportioned between subdivisions (a big ‘‘if”), so that developers receive appropriate price signals concerning the location and density of developments (p.125). We suggest that the merit is not so considerable when the real effect on affordability is taken into account. We further suggest that the best defence against ‘‘double dipping” -- i.e. taxing increases in land values caused by services that have already been paid for through up-front levies -- is to eliminate the up-front levies, not to complicate the land rating system in perpetuity to compensate for one-off levies (pp. 126,128). Funding infrastructure through taxes/rates on land values is consistent with the ‘‘beneficiary pays” principle, because infrastructure increases land values in the serviced areas.

Concerning the intergenerational question, the main causes of intergenerational inequity in housing are:

- Boom-bust cycles in the land market, which hurt those who enter the market at the top of the boom;

- Governments changing the rules, e.g. by charging up-front levies for new infrastructure while older infrastructure is still being paid off from general taxes, some of which are paid by the users of the new infrastructure.

The first of these can be prevented by a sufficiently heavy land value tax (LVT), which would replace, among other things, infrastructure levies.

First homes vs. *new* homes

If the first home owners' grant were means-tested (Discussion Draft, pp. XXVI, 150), its tendency to inflate prices would be reduced, but the total benefit to first-time buyers would still be limited to the actual disbursements. If, alternatively, the grant were restricted to new homes, it would encourage new construction rather than the purchase of established homes, thus increasing supply. Any upward pressure on prices would be restricted to new homes; the effect on established home prices would be downward, as would the effect on average prices across the market. First-time buyers choosing established homes would not get the grant but would still benefit from the resulting lower prices.

Because some of the people taking up a home buyers' grant would use it to form new households and consequently add to the numerical demand for housing (Discussion Draft, p.151), it is all the more necessary that the same people add to the supply. Restricting the grant to *new* homes meets this requirement.

The addition to supply would be greater, and the eligibility tests simpler, if the grant were available not only to intending owner-occupiers, but also to investors building new homes. From the viewpoint of investors, a fixed lump-sum grant would cover a greater fraction of the value of a cheaper dwelling, and would therefore tend to *encourage supply at the cheap end of the rental market*, which is tragically undersupplied at present. Because ‘‘first” homes and ‘‘new” homes historically account for similar shares of turnover in the housing market, switching the grant from one category to the other should not cause budgetary difficulties.

Any of these proposals would involve abandoning the pretense that the first home owners' grant is compensation for the GST. The grant is too small for that purpose, and in any case the effect of GST on prices has been greatly exceeded by the effect of speculation. Of all the pernicious influences on home prices, there is no reason why the GST should be the only one worthy of ‘‘compensation”.

The distinction between new homes and established homes is known to be administratively feasible, because it was implemented in respect of the Commonwealth Additional Grant (CAG), which supplemented the first home owners' grant from March 2001 to June 2002.

Income tax concessions available to property investors, including negative gearing and the discounting of capital gains, could also be restricted to new homes in order to stimulate supply. These reforms would of course increase administrative and compliance costs. But the same can be said of other proposed reforms that would fail to encourage construction, or even discourage it (Discussion Draft, pp. 86-7). Indeed, apart from the brief description of the CAG (p.56), the idea that new homes should be treated differently from established homes is entirely absent from the Discussion Draft, which consequently repeats the threadbare argument that if negative gearing were restricted, ‘‘reduced investment in rental housing would tend to force up rents” (p.88). In fact the supply of rental housing would increase if negative gearing were allowed on new homes only. We therefore submit that *if* there is any reform of negative gearing or CGT peculiar to housing, that reform should distinguish between new and established dwellings.

Addressing the Commission's apparent interest in the consistency of tax arrangements across asset classes, we note in passing that the distinction between new homes and established homes has an equivalent in the share market, namely the distinction between new capital raisings (including floats) and sales of existing shares.

Bringing owner-occupiers into line

All economists of repute agree that land value tax cannot be passed on in rents, provided that the tax does not exceed the rental value of the land and does not depend on the actual use (as opposed to legally permitted use) of the land. But if land used for a particular purpose is taxed more heavily, landlords will offer less land for that purpose, and tenants who want land for that purpose will pay more; that is, part of the additional tax *will* be passed on. In particular, if rental homes are subject to land tax while owner-occupied homes are not, there will be more homes sold to owner-occupiers and fewer to let, and some of the sales to owner-occupiers will represent new household formation rather than reduced rental demand. So the preferential treatment of owner-occupied housing hurts renters. This is more obviously true of income tax and its variants than of land tax, because it is quite normal for transaction taxes, including income taxes, to be partly passed on. Hence the interest of some participants in harmonizing the tax arrangements for owner-occupied and investment homes (Discussion Draft, pp. 82-3).

The Commission seems to assume that such harmonization would be achieved by extending current rules on investment housing to owner-occupied housing. But some changes could proceed in the opposite direction. For example, in recent years the rental income declared by property investors has been comparable to their claimed deductions. So if the rental income were tax-free (like imputed rent for owner-occupiers) and if the deductions were disallowed (as for owner-occupiers), the change would be approximately revenue-neutral. This of course would amount to disallowance of negative gearing. But it would also mean that the net income on positively-geared property would be tax-free. This would not only encourage investment in positively-geared property, but also dampen cycles by increasing the attractiveness of income relative to capital gains.

As explained above, capital gains tax can be subsumed by a sufficiently heavy LVT. This is quite practical for investment properties, which generate real rental income to cover the tax. The same cannot be said of owner-occupied homes. Moreover, if we maintain that ordinary home owners without investment properties do not gain from rising land values, it seems inconsistent to say that they should pay more tax because of those rising values. On the other hand, rising land values certainly improve the position of home owners *relative to non-owners*, who are the class most likely to depend on welfare. So, if rising land values do not justify higher tax bills for ordinary home owners, they surely justify greater withdrawals of welfare from those households that qualify for it. Because of the wide variety of benefits available to students, children, carers and the unemployed, the percentage of owner-occupier households receiving some form of welfare is considerable and likely to rise over time, especially if present unemployment benefits are extended as in-work benefits in order to remove disincentives to entering the workforce. So a means test based on the value of land under the principal residence could be a reasonable approximation to a land value tax for owner-occupiers, and the approximation can be expected to improve over time.

Although welfare is a Federal responsibility whereas land taxes and rates are State and local imposts, there is nothing to stop the Commonwealth from refunding the withheld portions of welfare payments in each local area to the responsible State and local governments. This would mean that many households would no longer receive bills for municipal rates.

At present, the income tests on welfare payments have taper rates that are generally much higher than marginal income tax rates. Yet these tests were introduced with far less controversy than comparatively trivial reforms of the tax system, showing that voters are far more tolerant of means tests than of the equivalent taxes. In the past, this attitude has been manifested mostly as a tolerance of bad policy. But it can also be exploited for the purpose of implementing good policy that would otherwise be bad politics. Land value taxation could be a case in point, whether the tax on owner-occupied land is merely a ‘‘*quid pro quo* for the removal of stamp duties” (Discussion Draft, p.83), or something more substantial.

Epilogue: Beyond the crash

Historical precedents indicate that the greater part of the Australian housing market must crash in 2004; indeed, some segments were clearly deflating in late 2003. However, the crash will not take the heat off the Federal Government and will not even solve the problem of affordability. At first, the sudden lack of interest in property will cause a catastrophic decline in the building industry. This together with the debt burden left behind by injudicious investments will plunge the economy into general recession by the end of 2005, if not earlier. And many things, including housing, are hard to afford when one has no job.

So there will be demands for stimulatory policies, especially from the building industry, and especially in matters pertaining to employment. Such policies include:

- removing transaction taxes from the housing supply chain, so that development and construction can proceed more easily;
- abolition of payroll taxes;
- a substantial holding tax on land, so that owners are compelled to use their land productively (or sell or let it to someone who will);
- taxing capital gains more severely than income (preferably by holding taxes) in order to discourage speculation and, by default, encourage more productive investments;
- Turning first home buyers’ concessions into *new home builders’* concessions, in order to encourage construction;
- replacing income tests on welfare by assets tests, so that employers can reward work more generously at less cost to themselves.

These of course are the kinds of policies that Prosper Australia has advocated in the context of housing affordability. That the same policies remain sound under different conditions supports our view that housing affordability is not a peripheral issue, but a fundamental measure of economic health and of the merits of any broad philosophy of economic policy.

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Corrigenda to Submission 68

We wish to make two (possibly obvious) corrections to the Conclusions of Submission 68.

First, in response to the Term of Reference

> (a) the identification, release and development of land and the provision of basic related infrastructure,

our Submission 68 says simply that LVT ‘‘pays for infrastructure”. But if ‘‘basic” infrastructure refers to infrastructure *within* the estate, then it is inevitable, for reasons related to engineering and project management, that at least some such infrastructure will be provided by developers, transferred to local authorities, and paid for in prices of developed lots (cf. Discussion Draft, p.123). If the efficiency of project management were compromised, home buyers would obviously bear the cost in some form. We should also acknowledge that user charges are theoretically efficient provided that they cover only the marginal costs of use, although in practice such charges may be too cumbersome to administer. However, we still maintain that the *fixed* costs of *other* infrastructure, including major and social infrastructure, are best funded by land value taxation.

Second, in response to the Term of Reference

> (f) the operation of the total housing market, with specific reference to the availability of a range of public and private housing types, the demand for housing, and the efficiency of use of the existing residential housing stock,

our Submission 68 says that LVT encourages the maintenance of high ‘‘occupancy” rates in the rental housing stock. Here the word *occupancy* would be better replaced by *availability*; the point is that LVT encourages landlords to seek tenants (and, by implication, keep their properties in habitable condition) in order to cover the tax liability. High *occupancy* rates by themselves would tend to produce high rents -- not the desired outcome.

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