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Improving Opportunities and Equity in Home Ownership through the Tax System

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Abstract

Housing affordability and equity within the housing sector is currently subject to a high level of media coverage and political debate. The controversy centres on difficulties for young households trying to purchase their first house at a time when the wealth of many home owners has grown dramatically with rising house prices. Despite the media attention, there is relatively little recent research into addressing the growing inequity in housing wealth. This paper seeks to redress this imbalance. Current taxation and tax expenditures on housing in Australia are succinctly reviewed, followed by discussion of the so-called 'crisis' in housing affordability and the various measures that have been proposed and/or implemented to date. The main parts of the paper present proposals for a taxation offset for first time home buyers and the application of capital gains tax to higher valued owner-occupied housing. Initial estimates of the overall net tax revenue implications of the combined proposals are presented, and show that after five years the overall package is about revenue neutral. This compares well with the current high transparent and hidden subsidies to all sectors of the Australian housing market. The main challenges in implementation are considered, followed by some concluding comments and suggestions for further analysis.

I INTRODUCTION

Tax policy research is fraught with difficulties, not least because of the political nature of any proposed reforms. The introduction of the Australian Goods and Services Tax in July 2000 came after over a decade of intense academic, business, political and media debate as to its merits and how best it should be designed and implemented. Some tax and related reform policies come unexpectedly, as with the abolition of the Superannuation Surcharge Tax¹ in 2005 and the tax-free status of

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¹ The study by Pope, J., Fernandez, P. and Le, V. (2003), *The Hidden Costs of the Superannuation Surcharge Tax*, Australian Tax Research Foundation, Sydney, advocated its abolition around two years before the Government announced its decision in May 2005 as part of the 2005–06 Federal Budget, to apply from 1 July 2005.

superannuation pensions for retirees aged 60 years and over from July 2007. On the other hand, strong pressure by business, academic researchers and others in the community for Personal Income Tax reform² particularly from 2004 to 2007 led to very little change.

There have been other areas of reform research and debate over the past decade, such as that arising from *A New Tax System*,³ the Ralph Review,⁴ and in the fields of small business and international taxation. However, little research attention has been given to tax reform to improve housing affordability, particularly for first home buyers, and the distortions to investment encouraged by the large tax free capital gains arising from home ownership, particularly at the upper end of the market. Housing affordability has severely declined in Australia in recent years and this receives a high level of political and media coverage. Several measures to alleviate this problem, other than tax reforms, have been proposed and a few have been implemented. This paper explores, as a further measure, partial relief from tax for mortgage interest payments by first home buyers and the potential to fund this tax expense, either partially or, in the longer-term, fully, by taxation of capital gains on principal residences over and above the price range of most home owners.

This paper is organised as follows. Following an overview of the current taxation and tax expenditures on housing in Australia (Section II), the paper outlines what is often described as a ‘crisis’ in housing affordability and the various measures that have been proposed and/or implemented in Section III. Section IV discusses a proposal for a taxation offset for first time home buyers. Section V then considers the merits and difficulties of applying capital gains tax to higher valued owner-occupied housing. Initial estimates of the overall net tax revenue implications of the combined proposals are presented in Section VI. Section VII explores the main challenges in implementation. The final Section VIII presents some concluding comments.

II THE TAXATION OF HOUSING IN AUSTRALIA

Any proposals to change the taxation of the benefits of home owner-occupation must be related to the methods and scale of current subsidies and taxation on housing in Australia. In aiming towards sufficient housing stock of an acceptable standard, Governments around the world provide direct subsidies and tax concessions for rental and owner-occupied housing. However, real estate, including homes and residential land, often incurs various taxes because it is ‘an easy, immobile target’.⁵ The principal Australian subsidies (and other tax expenses) and taxation are outlined below,

² For a useful review and reference sources refer *Australian Tax Forum* (2007), Vol 22 Nos 2 and 3 comprising papers presented at the ATAX Personal Income Tax Reform Symposium, and especially Pope, J. ‘Personal income tax reform: consensus, outliers, specifics and some sensitive issues’ in No 3 at 3-29.

³ *A New Tax System (ANTS) (1998): Tax Reform: Not A New Tax, A New Tax System*, White Paper (Canberra: Commonwealth of Australia).

⁴ Review of Business Taxation (1999) chaired by Mr John Ralph *A Tax System Re-Designed* Final Report (Canberra: Commonwealth of Australia).

⁵ Abelson, P. (2008), *Public Economics*, 2nd Edition, McGraw-Hill, Sydney, at 506.

together with some indications from other studies of the aggregate costs of and revenues from these measures.⁶

There are rental subsidies to low income tenants of private housing and most public tenants pay rents that are below market levels. The only direct subsidy to home owners is the First Home Owners Grant (FHOG), paid as a lump sum on the first purchase by an Australian resident of a home for occupation.

Tax deductions can be claimed for interest payments on loans taken out by private landlords to earn rental income, even if the property earns less than the tax deductions (i.e. negative gearing). Owner-occupiers cannot claim a tax deduction for loan interest payments. However, it can be argued that home owners receive a tax concession in that they do not pay tax on the imputed rent for their house (whereas landlords must declare rent as assessable income).⁷ There is no Capital Gains Tax (CGT) on the increase in value of principal residences (but private landlords pay tax on the capital gain on the resale of rental properties, with allowance for the same discount of the gain as for other assets).

Goods and Services Tax (GST) is not charged on the purchase of existing residential properties but is paid on new dwellings and renovations; it is not charged on residential rents. Other taxes on housing include State taxes on properties other than owner-occupied residences (Land Tax), user-pays charges for local services (water and local government rates) and stamp duties on property transfers. Charges on land and housing developers, mainly for infrastructure, are generally seen as user fees but are often regarded by developers as taxes.

Key details of the significant tax expenditures on and revenues from housing are provided so that the estimated costs and revenue of the proposals in this paper for owner-occupiers can be set in context. In 2004, it is estimated that subsidies (tax expenditures) on owner-occupied housing, excluding the CGT exemption, cost \$16.5 billion.⁸ For comparison the private rental housing subsidies are \$6.0 billion. Aside from the FHOG with a cost of \$1.2 billion, the owner-occupied subsidies comprise notional losses of \$15.3 billion because imputed rents of owners are not taxed and are exempt from GST. Individuals claimed \$13.8 billion in rental interest deductions in 2005-06 (up from \$12.1 billion the previous year) and in aggregate the 1,562,000 individuals declaring rental income claimed a net rental loss of \$5.1 billion in 2005-06 (up from \$4.1 billion the previous year).⁹

In aggregate, taxes on owner-occupied housing have been estimated for 2004 to be \$17.8 billion, representing 24.3 per cent of 'gross annual rental value' of owner-occupied housing.¹⁰ In comparison, private rental housing paid \$5.6 billion in taxes, around 21.5 per cent of annual housing value. The taxes on owner-occupiers comprise

⁶ Abelson P. and Joyeux, R. (2007), 'Price and efficiency impacts of taxes and subsidies for Australian housing', *Economic Papers*, Vol. 26 No. 2, 147-169; the subsidies and taxes are summarised in Table 1 at 148 and their aggregate values for private housing are summarised in Table 3 at 154.

⁷ Australian Institute of Health and Welfare (2004), *Measuring the distributional impact of direct and indirect housing assistance*, AIHW Cat. No. HOU 108, Canberra, at 45.

⁸ Abelson and Joyeux, above note 6, in Table 3 at 154.

⁹ *Taxation Statistics 2005-06* (2008), Australian Taxation Office, Canberra, at 12.

¹⁰ Abelson and Joyeux, above note 6, in Table 3 at 154.

about \$6.0 billion in local government rates, \$7.0 billion of stamp duties on transfers and \$4.8 billion of GST on new homes, sites and renovations.

Overall CGT raised \$11.4 billion in 2005-06 with \$5.1 billion from some 1,012,000 taxable individuals and the remainder from 19,000 taxable companies and 90,000 taxable funds.¹¹ The source of capital gains of taxable individuals reveals that real estate accounted for 35 per cent in (income years) 2003-04 and 2005-06 and 39 per cent in 2004-05. Some 138,000 taxable individuals earned \$10.7 billion in real estate capital gains in 2005-06 with respective figures of 129,000 and \$9.3 billion in 2004-05.¹² These are gains from investment and second properties, such as holiday homes. The CGT concession for owner-occupied housing, the focus of the latter part of this paper, was estimated to be worth around \$7.2 billion in 2004, representing 9.9 per cent of annual housing value.¹³ An earlier and far higher estimate of the tax expense of this CGT exemption for owner-occupiers in 2001 was \$13 billion,¹⁴ although this was during a boom in house prices in the larger States. This clearly illustrates the difficulties of estimating CGT revenue and revenue foregone.

The net position of subsidies minus taxes is illuminating: owner-occupied housing costs the government some \$5.9 billion (which is estimated to be 8.1 per cent of annual housing value) compared with private rental housing being close to being in balance, at \$0.4 billion (estimated to be 1.6 per cent of annual housing value).

The link between tax and housing burdens has been recently emphasised by Smith,¹⁵ who argues that “Australia’s housing policies are not working well”. A distinction is made between people who are long-term owners and those who do not own or have more recently purchased a home.¹⁶ Smith notes that improvements in equity through government tax, transfer and expenditure policies are being undermined by a growing unfairness in what he terms the “housing burden”. Essentially the range of policies that affect home ownership, including taxation, are working in opposite directions.

The overall effect of combined government policies and housing market forces is “to redistribute income and wealth from new and lower income households to the older, generally higher income, property-owning generations”.¹⁷ Arguably, the tax burden of the former is relatively higher than the latter, and now unfairly so. This specific issue of housing affordability can also be set in a wider inter-generational context.¹⁸ Thus the primary purpose of this paper is to explore, insofar as the available data allows,

¹¹ *Taxation Statistics*, above note 9, at 75.

¹² *Ibid.*, at 77.

¹³ Abelson and Joyeux, above note 6, in Table 3 at 154.

¹⁴ AIHW, above note 7, in Table 3.1 at 47.

¹⁵ Smith, G. (2007), *Australia’s Aggregate Tax Burden*, Australian Tax Research Foundation, Sydney, at 30-33.

¹⁶ The term home, house or housing is generally used in this paper to cover a house, apartment or unit. The housing industry normally distinguishes and classifies its data on the latter basis.

¹⁷ Smith, above note 15, at 33.

¹⁸ Refer Budget Paper No. 5 (2002-03), Intergenerational Report 2002-03, Treasury, Canberra (May 2002) and the second Intergenerational Report 2007 (at www.treasury.gov.au) for an understanding of the broader issues involved, particularly in terms of the Australian Government’s ‘fiscal outlook over the long term and the sustainability of economic growth in light of Australia’s ageing population and other factors’. Refer also AIHW, above note 7, which shows how the tax benefits of owner-occupied housing were skewed in 1999 towards those in the two higher income quintiles and the older age brackets, in Table A3.2 at 96 and Table A3.6 at 103 respectively.

taxation expenditure (subsidy) and taxation policy options that may redress this balance, if only marginally.

The end of 2007 probably marks a watershed in a range of Commonwealth government policies arising from the change from a Coalition Government under Prime Minister John Howard to a Labor Government led by Prime Minister Kevin Rudd. Generally there is optimism among many that the incoming government can make inroads into some hitherto strongly embedded trends in Australian society. As Smith notes, “the complex interaction between the distribution of the housing burden and the intergenerational and social distribution of housing burdens will likely require a wide-ranging policy response if it is to be addressed effectively”.¹⁹ The changing political climate in Australia strengthens the timeliness of the following research that may be controversial and unfavourably received in some quarters.

In a broader socio-economic context, the distribution of wealth in Australia is important, particularly as it is more inequitably distributed than income. Housing accounts for around half of all wealth,²⁰ with a further 20 per cent being held in superannuation funds. In 2003-04 the wealthiest 20 per cent of Australian households owned 59 per cent of all household wealth at an average net worth of \$1.4 million. But wealth is positively correlated with age as much as income. The relationship between income and wealth is that the richest 20 per cent of households in terms of “equivalised” household income held 37 per cent of household wealth compared with the poorest household income quintile holdings of 15 per cent.²¹

III HOUSING AFFORDABILITY IN AUSTRALIA

Governments at Federal and State level have been under considerable pressure to make housing more affordable in Australian cities. The principal concern is that young couples, who have traditionally been the largest group of first home buyers, are finding it increasingly difficult to find sufficient deposit for the purchase of a home and to meet the repayments on the loan required to complete the purchase.

Although Australia has a very large land area, especially given its small population of around 22 million persons, residential land and housing is now among the most expensive in the world. This has taken many by surprise, having largely occurred over the past seven or so years. Housing affordability, as measured by the ratio of median house prices to median incomes, is now becoming an important Australian policy issue. In many Australian cities this ratio has increased from around four to seven in recent years.²² It is also largely a national problem, with Queensland and particularly Western Australia having experienced significant housing price increases over the past three to four years, largely due to the resources boom and increased immigration,

¹⁹ Smith, above note 15, at 33.

²⁰ *Australian Bureau of Statistics* (2007) “Household Wealth and Wealth Distribution in Australia” Cat No 6554.0 (AGPS, Canberra), at 18. Average household wealth in 2005-06 was reported to be \$563,000, with the average value of owner-occupied dwellings \$286,000 (51 per cent) and an average loan on owner-occupied dwellings of \$50,000.

²¹ Abelson, above note 5, at 515-516, citing data from *Australian Bureau of Statistics* (2005) ‘Household Income and Income Distribution in Australia’, Cat No 6523.0 (AGPS, Canberra).

²² Smith, above note 15, at 31.

so as to rival their New South Wales and Victorian counterparts in terms of housing affordability difficulties.

Housing affordability is an emotive and politically sensitive topic. If housing markets are active at stable or rising prices, it is clear that some buyers can afford houses but there are two concerns. First, the buyers may be committing so much of their capital and future earnings to the purchase that this creates social and economic stress for the household. Secondly, it may be that the housing is affordable at current prices for groups such as investors and recent immigrants but that some potential first home buyers must remain as tenants.

Housing affordability for owner-occupiers is determined by four main factors: the price of the residence, the earnings of the potential buyer, the deposit (or equity) of the buyer and the loan terms (mainly the availability and interest rate). Residential prices in Australian cities have grown much faster than average earnings since 1986.²³ The relationship between median house prices and median earnings was used to carry out a recent international survey that described all Australian capital cities and most urban areas of over 50,000 people as “severely unaffordable”.²⁴ One widely quoted index of affordability, based on median first home prices, loan payments and average household income, indicated in its September 2007 quarter that, for first home buyers, housing affordability was at its worst since the survey started in 1984.²⁵

Loan interest rates declined from typical rates of about 17 per cent per annum at the start of 1990 to under 10 per cent per annum by 1994, dropping to six to seven per cent per annum by 1997. They remained at this level until 2006 and had moved up to over nine per cent per annum by May 2008.²⁶ Recent rises in interest rates have and will cause difficulties for those seeking loans and existing borrowers. These rises have exacerbated but not caused the lack of housing affordability.

A number of remedies to improve affordability have been introduced or suggested in recent years. The First Home Owners Grant (FHOG) was introduced partly to compensate for the effects of GST on building costs from 2000. The criticism of this as a means of improving housing affordability has been that it probably pushed up house prices, negating its purpose.²⁷ Similar measures by some State governments to lower rates of Stamp Duty for first home buyers (or exempt them from Stamp Duty) may do the same. They increase the amount of the buyers’ savings that can be used as a deposit, potentially flowing through to the vendor as a higher price.

Many of those involved in supplying land and houses believe that there would be major improvements if land supply could be brought forward by speeding up the subdivision and rezoning processes and if the current methods of recovering the costs

²³ NATSEM (2008) ‘Wherever I lay my debt, that's my home’, National Centre for Social and Economic Modelling Pty Ltd, Issue 19, published by AMP, at <http://www.amp.com.au/ampnatsemreports> (7 April 2008), at 7.

²⁴ Cox, W. and Pavletich, H. (2008), 4th Annual Demographia International Housing Affordability Survey, at <http://www.demographia.com/dhi.pdf> (8 April 2008), at 9.

²⁵ HIA/Commonwealth Bank (2008) Quarterly Review of Housing Affordability, Housing Industry Association, at http://economics.hia.com.au/media/affordability_index.pdf (4 April 2008).

²⁶ RBA (2008) “Indicator Lending Rates” *Reserve Bank of Australia Bulletin*, May, at Table F.05.

²⁷ Guest, R. S. (2005), ‘A Life Cycle Analysis of Housing Affordability Options for First Home Owner-Occupiers in Australia’, *Economic Record*, Vol 81 No 254, 237-248.

of servicing residential land from developers (and hence the buyers) were changed. In February 2008, the Federal government announced funding to improve the approvals process. Changing the recovery methods for servicing land would presumably require State governments to absorb some of the off-site costs of infrastructure from general revenue. Some commentators and developers have also advocated lower standards of land subdivision to lower the costs of servicing.

The importance of land supply and the role of Commonwealth, State and local governments, the interplay of government policies and housing market forces, immigration into Australia and inter-state migration, and other factors, need to be emphasised. Smith neatly sums up the situation: "...while one tier of government [Commonwealth] has pushed demand and provided tax subsidies, the others [State and local] have restricted supply and imposed higher taxes and costs".²⁸ Abelson too stresses the critical role of supply: "With limited supply response, a housing subsidy simply increases housing prices with little effect on housing consumption".²⁹ It has been estimated that a 10 per cent subsidy to homeowners without any subsidy to renters would increase housing prices by 5.8 per cent.³⁰

The major recommendation of the Federal government's Task Force on Home Ownership³¹ was to encourage "shared equity" financing, by which financial institutions would be encouraged to become part owners of homes, entitled to part of the capital gain rather than full loan payments. Such schemes are only now becoming available and there appears to be some reluctance by buyers (the sharing of risks in the event of house price declines is a troublesome issue). Western Australia was the first State to introduce such a public sector scheme to enable low income earners to become owner-occupiers.³² It is too early to judge how the buyers will respond when these schemes are better understood.³³

Others have suggested that buyers should be encouraged by special savings accounts attracting subsidised interest or tax-free interest, with the balance to be used specifically as a deposit on a first home. A few advocate that first home buyers should be allowed to use part of their superannuation balance as a deposit on a home (a form of this operates in Singapore).

To improve affordability, there must be significant changes to one or more of the residential prices, household earnings or the loan terms. Few of these policies would result directly in lower prices for established housing although ultimately cheaper land would flow through to established house prices. There would be concerns that declining house prices would have a drastic effect on existing borrowers and their

²⁸ Smith, above note 15, at 32.

²⁹ Abelson, above note 5, at 551.

³⁰ Abelson and Joyeux, above note 6, at 158.

³¹ Joye, C. and Caplin, A. (2003), Summary of the Findings for the Prime Ministerial Task Force on Home Ownership, The Menzies Research Centre.

³² Government of Western Australia (2007) First Start Shared Equity Home Loan Scheme at <http://www.keystart.com.au/key/SharedEqBrochure.pdf> (6 April 2008). First home buyers are ineligible if their income exceeds \$80,000 for families, \$70,000 for couples and \$50,000 for singles. The maximum property price allowed is \$375,000. State government equity would vary, with up to 40 per cent for families.

³³ Whitehead, C. and Yates, J. (2007), 'Increasing Affordability Problems', *Housing Finance International*, Vol 25 No 5, 16-20.

willingness to keep making loan payments, particularly when interest rates have risen. Macro-economic policies to contain consumer price inflation are designed to contain wage growth. It is therefore unlikely that wages will suddenly improve to make homes more affordable, although, in the very long term, this would lower the ratio of house prices to average wage levels.

More immediate help must relate to changes to loan payments. Given that interest rates are currently the main mechanism for the control of inflation, interest rate policy is determined by signals of consumer spending, inflation and business investment. Government and Reserve Bank policies may have strongly adverse, but incidental, consequences for groups such as potential first home buyers. One way to counter this would be to offer some tax relief on loan payments to first home buyers.

IV A TAX OFFSET FOR FIRST TIME RESIDENTIAL HOME OWNERS

One policy option to alleviate the difficulties of housing affordability for first time (residential) home buyers (FHB) would be to introduce a tax offset or tax deduction for the interest paid on home loans. Tax relief on mortgage interest for home owners is or has been available in other countries. The UK had non-targeted mortgage interest relief tax expenditure from 1983 until April 2000, but this was left to decline in real terms and eventually was abolished.³⁴ Non-targeted mortgage interest tax relief is also available in other European countries, including the Netherlands, Sweden, Finland, Italy and Greece,³⁵ and housing tax benefits are also available in the USA.³⁶ However, it is worth noting that the main UK policy to assist certain FHB, mainly those who cannot afford conventional financing, now appears to be shared equity approaches.³⁷

³⁴ Much can be learnt from the UK's experience with its (non-targeted) Mortgage Interest Relief At Source (MIRAS) policy. Up until 1988 up to 30,000 pounds for a single person and 60,000 pounds for a couple could be claimed – high limits at the time relative to property prices. In 1990-91 it cost the Treasury 7.7 billion pounds, but with the rate of tax relief and the real value of the limit of borrowing reduced the cost fell to 3.5 billion pounds by 1994-95 (Devereux, M. and Lanot, G. (2003), 'Measuring Tax Incidence: An Application to UK Mortgage Interest Tax Relief', *Journal of Public Economics*, Vol 87 No 7-8, 1747-1778). Difficulties with the scheme included not only its cost but the high growth in endowment (insurance-linked) mortgages (to avoid tax) and the real or perceived benefits to the better-off. In 1999-2000 around a third of all beneficiaries earned household income greater than 25,000 pounds per annum. After mortgage interest relief was withdrawn from 6 April 2000, the average increase in tax was around 14 pounds per month for the 7.1 million borrowers (66 per cent of the 10.8 million total borrowers) that had a mortgage of 30,000 pounds or more, at a (then) typical mortgage interest rate of 5.5 per cent pa (HM Treasury, 'Explanatory Note Clause 35 and Schedule 4: Withdrawal of relief for interest on loans to buy land etc.: Summary', at <http://archive.treasury.gov.uk/financebill/1999/c35.html>; 2 May 2008).

³⁵ See, for example, Matsaganis, M. and Flevotomou, M. (2007), 'The Impact of Mortgage Interest Tax Relief in The Netherlands, Sweden, Finland, Italy and Greece', EUROMOD, Institute for Social and Economic Research, Paper No em2/07 (at <http://ideas.respec.org>; 2.5.08) and Ellis, L. (2006), 'Housing and Housing Finance: The View from Australia and Beyond', Reserve Bank of Australia, Research Discussion Paper 2006-12 in Table 3 at 11.

³⁶ There is a rich economic literature on the effect of housing tax expenditures, not considered further here. Note that this paper's proposal for Australia is targeted and time-limited for FHB and that this should preclude many of the difficulties, particularly regarding higher income groups benefiting disproportionately, experienced in some other countries.

³⁷ These policies started on a small-scale in 1999. From October 2006 England has introduced a more significant shared equity mortgage scheme called Open Market HomeBuy ('Thousands more families to be helped on to the housing ladder – New homebuy mortgage launched', published 2.10.06 at www.communities.gov.uk). This is similar to the WA scheme outlined above in note 32.

In order to properly consider mortgage tax relief, the primary issues are (i) the limits on the amount; (ii) whether it is available as a tax deduction or tax offset; (iii) the criteria for qualifying for such relief; (iv) the length of time it would be available; (v) the need for a phasing-out period of such relief; (vi) the cost (revenue loss or tax expenditure) of such a scheme, (vii) its administrative and compliance costs (i.e. operating costs) and (viii) some preliminary consideration of the effects upon the housing market.

The proposal is for a tax benefit that is designed to help those FHB who would find it difficult to meet loan payments on the purchase of a typical first home. The average size of home loan to FHB in Australia in March 2008 was \$230,000.³⁸ Loan payments on a 25 year monthly amortising loan of \$230,000 would be \$23,162 at an interest rate of nine per cent per annum, with interest in the first year of \$20,596. It is therefore suggested that the tax benefit should be limited to \$20,000 per annum of interest (although this would need to be adjusted in future years). However, a sensitivity analysis using maximums of \$10,000 pa and \$30,000 pa is presented below.

This tax benefit could take the form of a tax deduction, whereby say up to \$20,000 per annum could be tax deductible for FHB at whatever their marginal rate. This would obviously favour upper income earners who may claim 41.5 per cent or even 46.5 per cent whilst lower income taxpayers would claim relatively less. The amount claimable could be possibly capped at the 31.5 per cent rate. The authors' preferred alternative is a tax offset, which has commonly been favoured in Australia as it helps lower income FHB more than those on higher incomes. The proposed tax offset would be calculated at 31.5 per cent³⁹ of interest paid on a mortgage to FHB⁴⁰ up to the maximum amount of loan interest. The proposal is that every dollar of loan interest up to \$20,000 per annum for eligible FHB would give a tax offset of 31.5 cents, at current tax rates.

The eligibility rules for the proposed FHB scheme are potentially contentious and involve economic, political and legal judgment. One of the major drivers of residential prices increases in Australia in recent years is probably the high level of immigration in order to increase labour supply during a period of high economic growth. The effect on house prices is difficult to estimate but logically immigration, biased towards skill levels and hence higher income earners, has increased demand for owner-occupied houses at a time of severe supply limitations. Thus it would seem self-defeating to allow newly arrived immigrants to access any FHB scheme immediately. A time-period qualification rule could be implemented. This may take the form of 'having been an Australian taxpayer for a certain number of years', having been a Permanent Resident for a certain number of years or being an Australian citizen. The authors favour either a minimum residence period in Australia, perhaps three years out of the last five years or limiting the benefit to Australian citizens.

No restrictions on the value or location of the properties, or of the age or family composition of the recipient, are proposed. No annual indexation of the benefit is recommended but obviously occasional reviews of the maximum benefit would be

³⁸ *Australian Bureau of Statistics* (2008), Cat. No. 5609.0, Table 9 (AGPS, Canberra); the average for the 12 months to March 2008 was slightly higher at \$236,500.

³⁹ 30 per cent tax rate for taxpayers earning between \$34,000 and \$80,000 with effect from 1 July 2008, plus the Medicare Levy of 1.5 per cent.

⁴⁰ This approach also lends greater certainty to estimating the costs of this proposal.

required. The length of time such a FHB tax offset would be available is critical.⁴¹ If the period is too short, say three years, then FHB may in their fourth year face a much lower overall disposable income (due to higher mortgage interest repayments without any offset) and may be forced to sell their much cherished home.⁴² On the other hand it would be extremely costly to have no time limit or even a lengthy period such as ten years. It is proposed that this tax offset would be portable, enabling FHB who wished to move to claim the offset on their second and subsequent properties for however many years the offset is available.⁴³

The principal factor which should decide the time limit for the offset is the increase in disposable incomes over the years and the point at which FHB can be “expected to stand on their own two feet”. To illustrate by way of an example, FBH with loans of the recent average of \$230,000 at an interest rate of nine per cent (costing \$23,162 pa in loan repayments over 25 years) would be eligible for a tax offset based on the maximum claim of \$20,000 pa, giving them a subsidy of \$6,300 per annum (or around \$121 per week). Using a gross income for households of \$75,000 per annum,⁴⁴ the loan repayment would reflect 31 per cent of the gross income without a FHB offset but 22.5 per cent with the repayment reduced by \$6,300 per annum. There are several measures of “mortgage stress”⁴⁵ but loan payments of more than 25 per cent of gross income is adopted here to illustrate the effect of the offset and for how long it is available. Table 1 shows how growing gross income would make the offset significantly less important to FHB after five years. This table assumes that the loan interest rate remains unchanged and gross income grows at five per cent per annum in nominal terms. Although the average FHB will be required to pay more of their gross incomes in Year 6 (without the offset) than in Year 1 (with the offset), the percentage of gross income would have declined to loan payments of less than 25 per cent (i.e. below the mortgage stress level). Thus, depending on the assumptions made, it is reasonable to argue that at least a five year period is needed.

Table 1: Average FHB Loan Payments as a Percentage of Gross Income

Year	Gross Income (GI)	% of GI with FHB offset	% of GI without FHB offset
1	\$74,816	22.5	31.0
2	\$78,556	21.5	29.5
3	\$82,484	20.4	28.1
4	\$86,608	19.5	26.7
5	\$90,939	18.5	25.5

⁴¹ Any restriction of relief to the initial and specific property purchased by the FHB is likely to severely impact upon housing market activity and is not considered a viable option.

⁴² This could have similar consequences to the so-called ‘sub-prime mortgage crisis’ in the USA, where relatively low ‘honeymoon’ rates came to an end forcing many homeowners on low incomes and with poor credit ratings, to sell.

⁴³ The percentage of FHB likely to exercise this right is considered to be low. In economic terms such a policy is akin to the ‘infant industry’ argument justifying government subsidies to private enterprises in their early formative years. The difficulty of course lies in weaning the receiving enterprise off of government support to stand on its own two feet in a competitive market. A similar difficulty is likely to arise with this proposed FHB tax policy.

⁴⁴ This is based on the mean gross income for Australian households in 2005-06 of \$1,305 per week, increased at five per cent per annum for two years to estimate the mean gross income for 2008.

⁴⁵ NATSEM, above note 23 at 30.

6	\$95,486	17.7	24.3
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Note: The assumptions on which this table is based are explained in the text but include a constant interest rate, the current average FHB loan and growing average income.

The size of the FHB offset and the number of years for which it is available partly determine whether a phase-out period is needed and if so for how long. Essentially, the larger the FHB offset (and therefore the more help it is to FHB to enter the housing market) and the shorter the period for which it is available, the more likely a phase out period would be required. For example, such a phase out period could be over a one year period (i.e. 50 per cent of full concession in Year 6 if it is available for five years) or over three years (i.e. 75 per cent in Year 6, 50 per cent in Year 7 and 25 per cent in Year 8). The critical calculation is to ensure that a high percentage of FHB beneficiaries do not return to a position of mortgage stress because the offset has run out, either with or without a phase-out period.

The estimated costs of a FHB mortgage interest tax offset depends on a range of assumptions including the maximum offset, the numbers of years for which it is available and prevailing mortgage interest rates. A preliminary estimate of the tax expense for a five year tax offset (with no phase out period) for up to \$20,000 per annum of loan interest, in 2008 dollars, but after the scheme has been running for five years, is \$3.17 billion per annum, as shown in Table 2. The estimates are based on a constant number of 120,000 FHB loan per annum.⁴⁶ This assumes that the average claim would be 83.8 per cent of the maximum of \$6,300 at a nine per cent per annum interest rates.⁴⁷

The sensitivity of the costs of the FHB offset to different maximum eligible interest payments and different interest rates is shown in Table 2. Apart from these two variables, the other assumptions are as explained above. The figures suggest that, even if a \$30,000 mortgage interest deduction was allowed and interest rates were a relatively high 11 per cent, the cost of this tax expenditure would be around \$4.2 billion – far less than the arguably conservatively estimated subsidies on owner-occupied housing, excluding the CGT exemption, of \$16.5 billion and \$6.0 billion for private rental housing (2004 figures).⁴⁸

⁴⁶ The number of new FHB per annum is based on the 113,529 average per annum over the 10 years to June 2007, with a low in 2003-04 of 88,400 and a high in 2001-02 of 143,885; there were 134,524 new FHB in the year to March 2008 (*Australian Bureau of Statistics* Cat. No. 5609, Table 9), above note 38. In NATSEM, see above note 23, in Table 4 at 15, the estimate of 316,000 FHB who were in the first three years of their mortgages in 2005-06 is used. These variations (and those in note 53 below) give some idea of the difficulties of estimating the likely cost of the proposal. In Section VI below, which estimates the costs of the phase-in of this tax offset, it is assumed that an additional 10,000 FHB per annum claim the offset in each subsequent year.

⁴⁷ \$3.17 billion is calculated as 120,000 FHB x 5 years x \$6,300 x 83.8%. The use of 83.8% of the maximum claim is justified as follows. The lower the maximum interest payments on which the offset is calculated, the higher will be the average claim as a percentage of the maximum offset. It is assumed that if the maximum interest payments are \$10,000 per annum, the average claim will be 100 per cent. As the ceiling on the offset increases, the average claim will drop to less than 100 per cent of the maximum permitted. Without knowledge of the distribution of the amount of FHB loans, a plausible (but unsubstantiated) reduction in the percentage of the maximum claim has been applied based on the formula: (Maximum interest for offset - \$10,000) / (3 x Average FHB loan interest). Interest in the first year of the current average FHB loan of \$230,000 at a 9% interest rate would be \$20,596.

⁴⁸ Abelson and Joyeux, above note 6.

Table 2: Aggregate Annual Estimated Costs of Five Years Mortgage Interest Relief for First Home Buyers in \$Billion (in current prices, after fully established)

Maximum eligible interest pa	Average % of maximum offset at 9% interest	Loan interest rates		
		7%	9%	11%
\$10,000	100.0%	\$1.89	\$1.89	\$1.89
\$15,000	91.9%	\$2.54	\$2.61	\$2.65
<i>\$20,000</i>	83.8%	\$2.99	\$3.17	\$3.29
\$25,000	75.7%	\$3.25	\$3.58	\$3.79
\$30,000	67.6%	\$3.31	\$3.83	\$4.17

Note: Subject to various assumptions as discussed in the text. The authors' core proposal is italicised.

The impact of this proposal on housing markets should be thoroughly debated and modelled; the following are only preliminary comments. Some measures to improve housing affordability for FHB are likely to push up prices for what are typically first homes by most of the initial benefit. It has been suggested that the FHOG and reductions in stamp duty for FHB have done this. This effect is likely to be because of the immediate saving to the buyer and the inelasticity of housing supply in the short term. The availability of a FHB tax offset may bring more buyers into the market but it does not immediately increase their deposit. It would however increase their buying power, provided that most lenders continue to calculate borrowing capacity based upon a maximum portion of disposable income. The effect would be similar to a drop in interest rates but restricted to the targeted group of buyers. Therefore, one would expect there to be some upward pressure on house prices, unless there are also measures to increase the supply of first homes or sites for first homes. It must be emphasised, therefore, that the FHB tax offset should be considered as part of a package of measures to improve affordability to avoid much of the benefit being swallowed up by higher house prices.

V CAPITAL GAINS TAX APPLIED TO HIGH VALUED OWNER-OCCUPIED HOUSING

Capital Gains Tax (CGT) was introduced in Australia in September 1985, with the owner's principal private residence exempted.⁴⁹ The capital gain, being resale proceeds less the cost base, is added to other assessable income in the year of sale. In December 1999 a 50 per cent discount on the gains of personal taxpayers was introduced for assets that had been held for a year or more.⁵⁰ The proposal discussed here is to levy CGT on the gain in value of the principal residence above a specified high-value cost base or threshold.

As well as raising additional tax revenue from the realisation of hitherto exempt owner-occupied housing assets from those most able to pay, this proposal would help to reduce what many believe to be an over-investment in non-productive owner-occupied housing assets, particularly so-called luxury houses. The reason for twinning this proposal with a FHB tax offset is that their combined effect would be to

⁴⁹ Section 160 ZZQ(12) of the *ITAA 1936*. It is now dealt with under Division 118 of the *1997 Act*.

⁵⁰ *New Business Tax System (Integrity and Other Measures) Act 1999*; the earlier inflation adjustment of the cost base remains as an alternative but with no further adjustment after 1999.

reduce the increasing gap between the older wealth owning generation and younger working generation that have comparatively little wealth.⁵¹ Therefore, the main justification for these proposals is their improvement to inter-generational wealth distribution.

The great political sensitivity of levying CGT on the family home, even if it is limited to the highest price brackets, is recognised. Nonetheless, there is a great deal of current political and media coverage⁵² concerning housing affordability without any real debate as to the corollary that, in some way, those with the greatest wealth in housing assets would be expected to contribute the most to helping those who aspire to own their own house. This paper seeks to address this imbalance by analysing one housing policy taxation option, whilst continuing to stress the importance of greater supply of new housing into the market through a range of other policies that are outside the scope of this paper.

This CGT proposal, although simple in its intention, has several complex issues in its implementation, particularly any transitional arrangements. The following suggested criteria are proposed for debate and are used for preliminary estimates of the potential tax revenue.

The proposal is for owner-occupiers to pay CGT on half of the positive difference (the gain) between the resale proceeds (price, less selling costs) and the cost base, being the greater of:

- (i) \$1 million; or
- (ii) the purchase price, plus buying costs; or
- (iii) an independent valuation of the property at the date of introduction.

This would not permit any “grandfathering” rights for those who purchased their homes prior to the introduction of this tax. However, the objective is to avoid any taxation of gains in value prior to the introduction (or perhaps the announcement) of the legislation; the need for independent valuations is a compliance cost that is necessary to avoid any retrospective taxation. Valuations would only be required for those properties that were purchased before the date of introduction for less than \$1 million and are sold for more than \$1 million. The threshold figure of \$1 million is roughly double that of the typical median house price of around \$500,000 in various parts of Australia.⁵³

It is proposed that the threshold should relate to the cost base, rather than the resale price. One reason for this is the difficulty of devising a method of phasing in CGT above a resale price that is simple to understand and yet avoids any possibility of the

⁵¹ *Australian Bureau of Statistics* (2007) “Wealth in homes of owner-occupier households”, Cat. No. 4102.0 (AGPS, Canberra) at 2.

⁵² For example, *The Australian* (2008), Megalogenis, G. “Facing up to hard home truths”, *Inquirer* at 26, 15 March. The sub-heading was “Making housing more affordable will test the cleverness of the Government, but it can be done”.

⁵³ *Australian Bureau of Statistics* (2008) “House Price Indexes: Eight Capital Cities”, Cat. No. 6416.0 (AGPS, Canberra) indicates “stratified” median prices of established houses of \$513,000, \$369,000, \$388,000 and \$465,000 in Sydney, Melbourne, Brisbane and Perth respectively in September 2007 in Table 7 at 10. Growth in prices between then and March 2008 is provisionally estimated for each city at 0.6%, 11.7%, 8.3% and 0.8% respectively in Table 1 at 4. Median house prices are published by several institutions which often report somewhat different prices and growth rates.

perverse effect of more tax on lower prices. An alternative is to adopt the US approach where there is a threshold gain and tax is paid on gains greater than the threshold.⁵⁴ If tax is levied on the gain above a tax-free threshold, either it ignores the number of years over which the gain has been earned or it would need a threshold that varies with the ownership period, the latter being a further complexity that might be susceptible to tax minimisation strategies. If the amount of the tax-free gain ignores the holding period, it might encourage trading before the gain reaches the threshold. Although few taxpayers would be affected, the treatment of capital losses arising from the sale of residence bought for more than \$1 million must also be defined in the legislation.⁵⁵

This proposal would initially affect about five per cent of owner-occupiers, based upon the portion of sales for more than \$1 million in 2007. This ignores the variations in the composition of housing sales as a sample of all homes.⁵⁶ The number and percentage of sales in different price brackets in recent years is set out in Table 3, indicating the growing number and portion of sales for more than \$1 million.⁵⁷ Table 4 provides a more detailed breakdown of the number and portion of sales in price brackets starting at \$200,000. Most of the sales for less than \$200,000 are likely to be sales to related parties and other sales which are not at arm's length and they have therefore been excluded.

Table 3: Australian House and Unit Sales from 2000-01 to 2006-07 and calendar year 2007 at prices of \$1 million or more

Year	Number of sales =>\$1million	Number of sales => \$200,000	% of sales =>\$1million
2000/01	5,091	195,554	2.6
2001/02	8,117	296,494	2.7
2002/03	10,176	337,622	3.0
2003/04	12,574	362,658	3.5
2004/05	12,119	344,131	3.5

⁵⁴ US law permits up to \$500,000 of tax free capital gain for the principal residence of a couple and gain above this amount is taxed at 15 per cent; Keown, A.J. (2004) *Personal Finance*, 3rd Edition, Prentice Hall, New Jersey, at 97 and 125 respectively.

⁵⁵ The three main alternatives would be to allow capital losses on high value principal residences to be carried forward to offset against future gains on the sale of principal residences, to allow capital losses to be offset against any taxable capital gains or not to allow the taxpayer to offset or carry forward any capital losses on high value principal residences.

⁵⁶ The changing composition of the type of house selling in each period, particularly when location is limited to one city and the period is less than annually, is widely recognised to limit the reliability of house price indices based on median sale prices; Prasad, N. & Richards, A. (2006) *Measuring Housing Price Growth - Using Stratification to Improve Median-based Measures*, Research Discussion Paper RDP 2006-04, Reserve Bank of Australia at 7; *Australian Bureau of Statistics* (2006) *A Guide to House Price Indices*, Cat. No. 6464.0 at 5. With aggregate national annual data, the change in composition may still be influenced by economic conditions but will be less significant than for local, quarterly data.

⁵⁷ This data has been supplied by RP Data Information Services. The sales include houses and units but exclude sales of vacant blocks, on which dwellings are subsequently built. Sales data is not available in the same format for Tasmania and sales in Tasmania are therefore excluded. This exclusion slightly understates the total number of sales over \$1 million in Australia but because average residential prices are lower than in Tasmania than in all other States and Territories the portion of total sales over \$1 million is slightly overstated.

2005/06	14,836	387,206	3.8
2006/07	20,214	423,089	4.8
2007	21,455	417,420	5.1

Source: RP Data

Table 4: Australian House and Unit Sales 2000-01, 2003-04, 2006-07 and calendar year 2007 by Range of Value

Price range	Year			
	2000/01	2003/04	2006/07	2007
\$200k to \$499k	166,532 (85.2%)	288,333 (79.5%)	318,260 (75.2%)	305,248 (73.1%)
\$500k to \$999k	23,931 (12.2%)	61,751 (17.0%)	84,615 (20.0%)	90,717 (21.7%)
\$1m to \$1.49m	2,804 (1.4%)	7,334 (2.0%)	11,444 (2.7%)	12,133 (2.9%)
\$1.5m to \$1.99m	1,050 (0.5%)	2,580 (0.7%)	4,196 (1.0%)	4,483 (1.1%)
\$2m to \$2.49m	441 (0.2%)	1,022 (0.3%)	1,776 (0.4%)	1,802 (0.4%)
\$2.5m to \$2.99m	245 (0.1%)	534 (0.1%)	997 (0.2%)	1,027 (0.2%)
\$3m or more	551 (0.3%)	1,104 (0.3%)	1,801 (0.4%)	2,010 (0.5%)
Total	195,554 (100%)	362,658 (100%)	423,089 (100%)	417,420 (100%)

Source: RP Data

This data has been used to estimate the tax revenues from the proposed CGT on high value, principal residences. No estimate of revenue from CGT in the future is possible without several assumptions. The most significant and problematic is the projected growth in house values. In this case, it has been assumed that house and unit values grow at a *nominal* eight per cent per annum, after allowance for transfer costs. This is consistent with the increase in the ABS Established House Price Index between December 1997 and 2007 of 9.8 per cent per annum before transfer costs.⁵⁸ There is some evidence that higher priced properties in Australia grow at a faster rate than others⁵⁹ but this has been ignored in the modelling.

Tables 3 and 4 show how CGT “bracket creep” would have occurred in the past, as the percentage of sales in all the brackets over \$1 million has increased each year since 2000-01. There was an average 24.8 per cent per annum increase in the number of sales per annum at prices of \$1 million or more between 2000-01 and 2007.⁶⁰ For a conservative assessment of revenue growth, a 10 per cent per annum increase in the volume of sales in each of the price brackets over \$1 million has been adopted. In the first year, the volume of sales in the taxable brackets is assumed to be half a full year’s volume.

⁵⁸ Australian Bureau of Statistics (2008) “House Price Indexes: Eight Capital Cities”, Cat. No. 6416.0 in Table 1, above note 53; after allowing for 4% buying costs and 4% resale costs, the average growth drops to 8.9 per cent per annum. Data series including the early to mid 1990s show somewhat lower growth; for example, the 8.1 per cent per annum for the 13 years to December 2007 before transfer costs.

⁵⁹ In Perth, median prices in the top quartile of suburbs (by price) grew at 10.5 per cent per annum between 1981 and 2006, whereas median prices in the bottom quartile of suburbs grew at 7.9 per cent per annum over the same period; Rowland, P.J. (2007) “Real Estate in the Family Investment Portfolio”, paper presented at the European Real Estate Society Conference, available at www.eres2007.org; Table 7 at 10.

⁶⁰ The increase in the portion of the sales at prices of \$1 million or more was 11.0% per annum. The increase in the number of sales at prices of \$1 million or more also reflects growing sales volume across all prices during this period.

Another key assumption is that 70 per cent of all sales are to owner-occupiers, rather than to investors,⁶¹ and this is treated as constant across the price brackets and over time. Because this tax will only apply to high value homes, it is assumed that all the discounted CGT will be paid at the maximum marginal tax rate of 46.5 per cent. The average CGT has been calculated on values and prices at the mid-point in each price bracket (and on a value or price of \$4 million in the bracket for sales at \$3 million or more) and using the midpoint of the year (for example, the third year's gain is based on 2.5 years of growth at eight per cent per annum). The revenue for the first five years after introduction is modelled in Table 5, assuming that the tax was introduced on 1 July 2008 and that all taxpayers have held their properties for one year or more (and hence are entitled to discount the gain by half before adding it to other taxable income). The tax revenues in Table 5 are in nominal terms.

Table 5: Estimated Revenue from the First Five Years of applying Capital Gains Tax to Owner-Occupied Homes above a Threshold of \$1 million (in nominal prices)

Price bracket	\$1m to \$1.49m	\$1.5m to \$1.99m	\$2m to \$2.49m	\$2.5m to \$2.99m	\$3m+
Year 1					
Average sale	\$1,299,038	\$1,818,653	\$2,338,269	\$2,857,884	\$4,156,922
Tax on ½ gain	\$11,401	\$15,962	\$20,522	\$25,083	\$36,484
No of sales	4,671	1,726	694	395	774
Revenue (billions)	\$0.053	\$0.028	\$0.014	\$0.010	\$0.028
Year 1 revenue					\$0.133bill
Year 2					
Average sale	\$1,402,961	\$1,964,146	\$2,525,330	\$3,086,515	\$4,489,476
Tax on ½ gain	\$35,563	\$49,789	\$64,014	\$78,240	\$113,803
No of sales	10,277	3,797	1,526	870	1,702
Revenue (billions)	\$0.365	\$0.189	\$0.098	\$0.068	\$0.194
Year 2 revenue					\$0.914bill
Year 3					
Average sale	\$1,515,198	\$2,121,277	\$2,727,356	\$3,333,436	\$4,848,634
Tax on ½ gain	\$61,659	\$86,322	\$110,985	\$135,649	\$197,307
No of sales	11,304	4,177	1,679	957	1,873
Revenue (billions)	\$0.697	\$0.361	\$0.186	\$0.130	\$0.370
Year 3 revenue					\$1.743bill
Year 4					
Average sale	\$1,636,414	\$2,290,979	\$2,945,545	\$3,600,111	\$5,236,524
Tax on ½ gain	\$89,841	\$125,778	\$161,714	\$197,651	\$287,492
No of sales	12,435	4,594	1,847	1,053	2,060

⁶¹ Australian Bureau of Statistics (2007) "Household Wealth and Wealth Distribution", Cat. No. 6554.0, above note 20, at 19: Of all households in 2005-06, 34.3 per cent were owners with mortgages and 35.0 per cent were owners without mortgages; private landlords provide housing for a further 23.1 per cent of households, with the remainder mainly occupying government owned properties. Owner-occupiers comprised about 69 per cent of households or about 75 per cent of private housing (being 69.3/(69.3+23.1) per cent). Anecdotal evidence would suggest that private landlords may hold properties for somewhat shorter periods than owner occupiers but one would expect that landlords own a lower percentage of the high value properties. To estimate revenue conservatively, it is assumed here that about 70 per cent of the sales for \$1,000,000 or more are by owner-occupiers currently exempt from CGT.

Revenue (billions)	\$1.117	\$0.578	\$0.299	\$0.208	\$0.592
Year 4 revenue					\$2.794bill
Year 5					
Average sale	\$1,767,327	\$2,474,258	\$3,181,189	\$3,888,119	\$5,655,446
Tax on ½ gain	\$120,279	\$168,390	\$216,501	\$264,613	\$384,891
No of sales	13,678	5,054	2,031	1,158	2,266
Revenue (billions)	\$1.645	\$0.851	\$0.440	\$0.306	\$0.872
Year 5 revenue					\$4.115bill

Note: Subject to various assumptions as explained in the text.

The following example explains the calculations in Table 5. In the second year (2009-10), the selling price of a property bought for \$1,250,000 on 1 July 2008 is estimated to be \$1,402,961, being eight per cent per annum compound growth for 1.5 years. This gain of \$152,961 would be halved (the 50 per cent discount for personal taxpayers CGT) and taxed at 46.5 per cent per annum, resulting in tax of \$35,563. It is estimated that there would be 10,277 sales of properties that were in the \$1 to \$1.5 million price bracket, based upon 70 per cent to owner-occupiers of the 12,133 sales in the bracket in 2007 (see Table 4), increased by 10 per cent per annum for two years⁶². These 10,277 sales paying average CGT of \$35,563 would generate revenue of \$0.365 billion. The total revenue for all the price brackets for each of the first five years is shown in Table 5. As many owners hold their properties for more than five years, the revenue would continue to increase in later years.

These estimates are based on permitted “bracket creep” and, at some stage, the threshold of \$1 million would need to be increased unless there is a decision in the future to make the incidence of CGT on principal residences more widespread. It is not proposed that there should be indexation of the threshold but that “bracket creep” would be used to make the tax more widespread in a politically acceptable manner. A decision for the future would be how widespread the tax is allowed to become. For example, the trigger for reviews of the threshold might be when more than 10 per cent of sales are over the threshold or when median house prices are two-thirds of the threshold.

The administrative costs, compliance costs, start-up costs and deadweight losses are recognised but ignored in these calculations. If the CGT threshold⁶³ is set at \$1 million purchase price for an owner-occupied home then around five per cent of principal residences would be subject to CGT, as shown in Table 3. This would have affected a little over 15,000 owner-occupied homes in 2007 based on 70 per cent of the 21,455 sales. The revenue per assessment is relatively high, making the tax reasonably cheap to levy.

No allowance has been made for any lowering in the growth in values of properties worth more than \$1 million caused by the introduction of the CGT (although a slowing to half of the volume of sales in the first year has been factored in). The effect

⁶² This modelling of the number of sales is slightly inaccurate for the bottom taxable price bracket as properties bought for less than \$1 million prior to introduction will not move into the taxable category in later years. This overstates sales numbers slightly in the bottom taxable price bracket but this would be more than compensated for by properties moving into the higher price brackets.

⁶³ This would be similar in principle to the operation of the Payroll Tax which coincidentally has a threshold of around \$1 million in some States.

of the tax on higher priced residences could only be estimated if there was evidence of how much purchasers of higher priced homes are influenced by the current tax free gain.

Whilst the threshold might appear to be an arbitrary figure, it has been set at a level that might be politically acceptable in a climate in which the difficulties of FHB are widely recognised and the costs of assisting them could be largely met from this additional CGT revenue. Setting the CGT threshold lower at around the median house price of \$0.5 million would increase the number of owner-occupied housing liable for CGT to about half the owners, or even including all houses in any CGT, would incur high administrative and compliance costs and would create huge political difficulties. Around 95 per cent of owner-occupied housing would be exempt under this proposal, although this percentage would slowly decline over time until a review of the threshold.

Based on the assumptions above, it is estimated that CGT from owner-occupied housing would be around \$4.1 billion per annum in nominal terms after five years, as shown in Table 5 (or \$3.5 billion in current dollars; see below). However, into the longer term, maintaining the threshold at \$1 million would lead to a considerable year on year increase in revenue.

VI NET TAX IMPLICATIONS OF THESE PROPOSALS

It is worth re-iterating that estimated tax expenditure and revenue from these proposals is based on many assumptions, some of them problematical. For an initial, indicative analysis such rough estimates are acceptable as long as the limitations are fully recognised. That said, it is now appropriate to make some comparison of the likely costs of the proposed FHB mortgage interest deduction and the revenue that would be raised from applying CGT to higher valued residential housing.

To better reflect the implications of the phase in of both taxes, the aggregate costs and revenues from Tables 2 and 5 respectively have been adjusted as follows. The aggregate cost that was based on an additional 120,000 FHB loans per annum to eligible borrowers in the first year has been adjusted to allow for an extra 10,000 FHB loans in each subsequent year. The expense has been calculated in current dollars. To make the CGT revenues consistent with the FHB expense, the revenue for the first five years has been deflated to current dollars (using inflation rates of four per cent for the first two years and three per cent for subsequent years). The annual cost and revenue estimates are displayed in Table 6.

Table 6: A Comparison of the Estimated Costs of the FHB Tax Offset and Revenue from CGT on Higher Value Owner-Occupied Homes in \$Billion (in current prices)

	FBH Tax Expense	CGTax revenue	Net effect
Year 1	\$0.63	\$0.13	-\$0.51
Year 2	\$1.32	\$0.85	-\$0.48
Year 3	\$2.01	\$1.56	-\$0.44
Year 4	\$2.69	\$2.43	-\$0.26

Year 5	\$3.38	\$3.48	\$0.10
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Note: Subject to various assumptions as discussed in the text.

Table 6 is calculated as follows. For the FHB Tax Expense, the estimated expense in the first year of operation at a nine per cent per annum interest rate with \$20,000 maximum eligible interest payments and an assumed average claim of 83.8 per cent of the maximum (as explained in Section IV) is \$0.63 billion, being 120,000 buyers multiplied by 83.8 per cent of \$6,300. In the second year, a further 130,000 FHB are assumed to claim the same amount (in current prices), making a total of 250,000 FHB claiming 83.8 per cent of \$6,300, totalling \$1.32 billion. For the third, fourth and fifth years, the number of FHB claiming is estimated to increase to 380,000, 510,000 and 640,000 respectively. For the CGT Tax Revenue, the Year 1 to 5 totals from Table 5 are deflated to current prices. For example, the Year 2 revenue of \$0.914 billion is deflated by $(1.04)^2$ to estimate the revenue in current prices of \$0.85 billion; the Year 3 revenue of \$1.743 billion is deflated by $(1.04)^2$ and then by 1.03 to estimate the revenue in current prices of \$1.56 billion.

In current dollars, our analysis suggests that after five years the costs of the FHB tax offsets reach their highest because this is the first year in which there will be five years of FHB claiming the offset. By this year, the CGT revenue will be stabilising but it is anticipated that it would still increase slowly in subsequent years. By Year 5, the combined proposals would be approximately revenue neutral. As shown in Table 6, the preliminary estimates suggest that the net cost in current dollars over the first five years would be around \$1.58 billion and thereafter the revenue should more than match the expense, subject to adjustments to the thresholds for each proposal.

The net costs of these proposals may be compared with other tax expenditures. By comparison to other housing tax expenditures and indeed tax expenditures and income tax deductions overall, the net figure of around \$0.5 billion per annum in the early years is a modest sum. Even allowing for changes in economic conditions, behavioural changes and so on, it is unlikely that such factors would change this conclusion. A figure of \$0.5 billion per annum is relatively low compared with recent owner-occupied housing subsidies (including imputed costs and the CGT exemption for owner-occupiers) \$5.9 billion, and represents a nine per cent increase.⁶⁴ Such a policy would further exacerbate government support for owner-occupied housing compared with rental housing, *ceteris paribus*. Comparing each proposal separately suggests that taxation of owner-occupied housing, after five years but in current dollars, would increase to around \$21.3 billion and subsidies to around \$27.1 billion, from \$17.8 billion and \$23.7 billion respectively.⁶⁵

For further comparisons, other capital tax expenditures worth noting include funded superannuation, at \$17.9 billion and the 50 per cent CGT concession at \$5.0 billion (both 2005-06 figures); other capital tax expenditures are less than \$1 billion pa.⁶⁶

⁶⁴ See Section II for an explanation of these costs; these costs were mainly 2005-06 estimates from other studies, whereas the current proposals are estimated in 2008 dollars, making direct comparisons slightly inaccurate. Nevertheless, the modest scale of the proposed costs and net effects of the current proposals is evident.

⁶⁵ Abelson P. and Joyeux, R. (2007), above note 6 in Table 3 at 154.

⁶⁶ Freebairn, J. (2007), 'A package of less special deductions and exemptions and low tax rates', *Australian Tax Forum*, 22 (2), Table 3 (drawn from the Tax Expenditure Statement 2006, Treasury,

The income tax deduction for work-related expenses, a major factor in the debate on personal income tax reform, costs around \$13 billion pa (in 2005-06 figures).⁶⁷ Over a longer time horizon, with both proposals continued unamended, the FHB tax expenditure and CGT housing revenue would be in balance and then move into a net surplus for the government.

This paper should be seen as initial, exploratory research. If these proposals or similar ones were to be considered further by policy makers then full econometric modelling of the economic and social effects would need to be undertaken over the long-term. This would include distributional effects of both income and wealth between family income groups, owner-occupiers and those in private rented accommodation and different generations (age groups).

VII CHALLENGES IN IMPLEMENTATION

The major challenges to implementing these proposals are political and fiscal, rather than economic. The FHB tax offset would be a significant cost to the federal government. Owner-occupied housing in Australia has traditionally been CGT-free, a policy adopted in many countries. By twinning these proposals, it is believed that many objections will be muted. To lessen the tax expense of the FHB offset, CGT revenues can be used. To obtain community approval to change the CGT-free status of owner-occupied homes may be possible if this is explained as an inter-generational shift of wealth: the proposals enable more young couples to become home owners, at the expense of a small portion of the population who have been able to benefit from tax-free investment returns. Although each of the proposals has merit in their own right, tax reform generally works best as an overall package, and that approach has been adopted in this paper.

The economic arguments against either of these two proposals lie in their further distortion of an already distorted market. As earlier figures have shown, the government currently effectively subsidises owner-occupied housing around \$6 billion per annum. The effect of the FHB proposal could be increased house prices particularly below the median unless there is a commensurate increase in land supply, a key factor emphasised earlier in this paper. However, given greater land supply, the effect of the FHB proposal is likely to be far greater opportunities to purchase a house for younger, lower income households. The eligibility rules become critical in this regard.

Major difficulties of the proposed FHB mortgage subsidy concern the length of time any individual or family would be eligible and whether any phase-out period would be needed. The shorter is the former, then the greater the likely need for the latter. The issue essentially depends on economic growth and rising real incomes such that mortgage interest repayments may be comfortably made by the 'typical' FHB after a

Canberra) at 73. It is worth noting that "imputed rent" and "capital gains" for owner-occupied housing does not have a Treasury Tax Expenditure Code i.e. they have not been estimated. The economic reasoning for this is that investment and saving in owner-occupied housing "essentially is given a pre-paid consumption base tax treatment"; in other words, the cost of a home and mortgage payments come from after-tax income (Freebairn, *ibid.*, at 73). Freebairn notes that the annual cost to tax revenue of both is large.

⁶⁷ *Taxation Statistics 2005-06* (2008), Australian Taxation Office, Canberra, at 14.

number of years. It has been suggested earlier in this paper that at least a five year period is needed and possibly longer. If the tax offset is available for more than five years, a phase-out system would probably not be necessary, thereby minimising administrative and compliance costs.

Turning to the upper end of the scale, subjecting owner-occupied houses over \$1 million to CGT may or may not affect sales depending on hard-to-predict behavioural responses in terms of holding periods for such houses. One likely behavioural response would be tax avoidance. This may take the form of high income and wealth families placing their principal residence in the names of family-owned companies, company structures or trusts although this is not obviously advantageous, given the 50 per cent CGT discount for personal taxpayers.

To ensure that only changes in value from the date of introduction are taxed, there will be occasions when property valuations at the date of introduction will be necessary, as outlined in Section V. Property valuations are relatively costly and, particularly for high value residential properties, valuations may contain a subjective element, exposing the valuers to pressures to lean towards the higher end of the range of possible values. There seems to be no alternative to such uncertainty and compliance costs if the CGT is to be introduced without retrospective tax.

The timing of a phase-in between Parliamentary legislation and implementation is another potentially contentious and challenging area. If the difference is too short then would-be sellers would feel disadvantaged and there would be pressure on valuers and the valuation process. If too long, then it increases the likelihood of tax avoidance and/or greater distortion of the market through the bringing forward of sales to the CGT-free period.⁶⁸ It also increases the risk of greater political lobbying.

VIII CONCLUDING COMMENTS

This paper has explored two, possibly linked, tax policy options - a subsidy for FHB and the application of CGT to owner-occupied houses with a value greater than \$1 million - that would arguably improve equity in Australian housing markets. Although presented here in the context of overall housing policy, either policy could be introduced in its own right without the other, but this may increase the political or fiscal difficulties to an unacceptable level.

In analysing these policies, the paper has spelt out the simplifying assumptions and data limitations in estimating their revenue and costs, as well as the difficulties and challenges in implementing either policy, particularly the political difficulties. The application of CGT to owner-occupied housing is likely to be vigorously resisted in some quarters, especially by those likely to be affected and the housing industry itself, who would probably stress practical valuation difficulties and possible market distortions. The FHB tax offset would not be without controversy. Of particular importance here would be any eligibility rules, the time-period of such subsidies and the further extension of the favourable treatment of house purchase vis-à-vis housing rental.

⁶⁸ The introduction of the Goods and Services Tax on 1 July 2000 and ensuing market distortions in new housing purchases prior and after that date provide an analogy.

Suffice it to say that for meaningful change to occur then possibly controversial proposals need to be presented and debated from time to time. These proposals are believed to be worthy of further policy consideration and econometric modelling. Neither of these proposals should be seen as precluding or replacing other measures to alleviate the growing problems of housing affordability for first home buyers and the widening gap in Australia between the housing (and other) wealth of “baby-boomers” and those aspiring to own a home.