REIA RESPONSE TO THE TAX DISCUSSION PAPER
RE: THINK

MAY 2015

PREPARED BY

Real Estate Institute of Australia (REIA)
PO Box 234
Deakin West ACT 2600
Amanda Lynch
Chief Executive Officer
amanda.lynch@reia.com.au
Ph: 02 6282 4277
@REIANational
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The Real Estate Institute of Australia (REIA) is the peak national association for the real estate profession in Australia.

The REIA's members are the State and Territory Real Estate Institutes, through which around 75 per cent of real estate agencies are collectively represented. The 2011 Census records the Rental, Hiring and Real Estate Services Industry employment sitting at a total of 117,880. By occupation the key data recorded by ABS Census were 64,699 business brokers, property managers, principals, real estate agents and representatives.

The REIA represents an important element of the broader property and construction sector which together makes a significant contribution to Australia's social climate and economic development. Property contributes $300 billion annually in economic activity.

Importantly, REIA represents an integral element of the small business sector. Some 99 per cent of real estate agencies are small businesses and 11 per cent of all small businesses in Australia are involved in real estate. Only 0.6 per cent of businesses employ 50 or more persons.

REIA is committed to providing and assisting research and well-informed advice to the Federal Government, Opposition, professional members of the real estate sector, media and the public on a range of issues affecting the property market.

The REIA welcomes the opportunity to provide a response to the Tax Discussion Paper *Re:think*.

Introduction

The Discussion Paper provides a summary of the current tax system, Commonwealth and state, and asks a number of questions with the aim of facilitating a debate on tax reform. The need for substantive and strategic tax reform is an issue of increasing importance. The current situation is simply not sustainable.

Importantly *Re:think* includes an examination of one of the states' larger revenue components, GST. About 23 per cent of revenues for all states come from the GST. By comparison state-levied taxes – which are generally considered inefficient compared to the GST - generate about 31 per cent of total state revenue. It is important that such state taxes also be considered as part of the discussion on tax reform as they impede economic growth. Further unless they are considered as part of an overall package of reform could see states taking unilateral action on taxes such as stamp duty which could lead to a sub-optimal outcome.

This submission focusses on the area of property taxes - one is state based stamp duties and the other is the treatment by Commonwealth taxation of property investment namely negative gearing and the Capital Gains Tax (CGT) concession. The submission advocates that stamp duties be abolished with the revenue forgone being replaced by a restructured Goods and Services Tax (GST) and that negative gearing and CGT remain unchanged.

Stamp Duty

State taxation, especially those taxes that impact upon the conduct of business, and the broader issue of Federal and State government finances, are key areas where there are significant problems in current arrangements. Further, jurisdictional differences in how the States apply the same tax divide Australia into sub-scale markets, reducing efficiency and competitiveness.

Significant change was achieved with the introduction of the Goods and Services Tax (GST). At the time in exchange for obtaining all of the GST revenue raised by the Australian Government, the States under an Intergovernmental Agreement (IGA) agreed to eliminate ten inefficient State taxes. However, the agreement did not include a specific timeline for the abolition of the agreed State taxes. As a result, States have obtained a guaranteed revenue source that has often exceeded the revenue from the taxes they had agreed to abolish. Some 15 years have elapsed and the States have still not yet abolished all of the taxes included in the agreement. A number a number of smaller taxes - accommodation tax, financial institution duty, quoted marketable securities duty, and debits tax – were abolished by July 2005.

Both *Re-think* and the Henry Review, note that stamp duties are some of the most inefficient taxes levied in Australia. *Re-think* goes on to say whilst stamp duties on the transfer of property are the second-largest source of state tax revenue (generating 24 per cent of state tax revenue) they are a highly volatile tax, with revenue fluctuating by over 50 per cent in previous years. Stamp duties also impact on consumers by increasing the cost of buying and selling houses. As house prices increase over time, unadjusted progressive tax rates also increase the tax burden associated with stamp duty. This adds to transaction costs and contributes to the high costs of moving which discourage mobility, impedes economic growth and leads to an underutilisation of the housing stock as older residents are reluctant to downsize.

Stamp duty is also inequitable for those who move more frequently, for work related reasons for example, than those that do not as they face higher costs even if their circumstances are otherwise similar. Choices between renting and buying, and between moving house and renovating are also distorted by stamp duties.

According to the Henry Review “stamp duties on conveyances are inconsistent with the needs of a modern tax system …..and should be replaced with a more efficient means of raising revenue”.

State governments cannot eliminate inefficient taxes without going into deficit or having to reduce expenditure substantially. Hence cooperation between the Australian Government and the States is needed to undertake reform of inefficient state taxes.

Economic analysis shows that economic activity in Australia can be lifted by just shifting the composition of taxes from high economic cost State taxes to lower cost Australia-wide taxes, without changing the overall level of tax revenues. The Centre of International Economics in its report, *State Busines Tax Reform in 2009* showed that the abolition of stamp duties on residential and non-residential property, removal of insurance duties and reform of land taxes and payroll taxes is projected to increase long run GDP by 1.7 per cent per year and investment by 4.4 per cent per year.

The Federal Government needs to show leadership on the matter and seek the states and territories agreement to do this in a co-ordinated way. The current Federal Review of tax is the appropriate vehicle for achieving this.

REIA recommends that conveyance stamp duties be abolished and replaced by an efficient source of revenue for states and territories.

REIA recommends that the Australian Government take a leadership role in abolishing stamp duties and seek to have an agreed timing across all states and territories.

Replacement Revenue Source

Both an adjusted (level and/or rate) GST and a land tax have been suggested as possible replacement sources for the revenue forgone by states and territories if stamp duty was abolished. Both are efficient taxes, unlike stamp duty, and overcome the volatility of stamp duty revenues which add a complexity to the planning and budgetary processes of state governments.

Re-think indicates that Australia's GST rate is one of the lowest among developed countries and is roughly half of the average rate among OECD countries. Of the 33 countries in the OECD that operate taxes like the GST only Canada, Japan and Switzerland have lower rates. However, some Canadian provinces have higher tax rates than Australia when sub-central government VATs and sales taxes are taken into account.

One such country is New Zealand where GST was introduced in 1986 at 10% and increased for the first time in 1989 to 12.5% and again in 2010 to 15% in October, 2010. The increase in GST enabled New Zealand to abolish stamp duty in 1999.

The Centre of International Economics in its report, *State Busines Tax Reform in 2009* showed that the required increase in the GST rate under the reform of abolition of stamp duties on residential and non-residential property, removal of insurance duties and reform of land taxes and payroll taxes would be 0.45 percentage points. That is, the Australian Government could fund State tax reform by raising the GST rate from 10 per cent to around 10.45 per cent. This calculation takes into consideration the positive flow-on impacts on the economy that would result in higher revenue collection from other revenue sources as well as the GST through increased consumption.

Another approach to replacing the forgone revenue is that a broad based land tax is implemented.

Re think indicates that Australia's reliance on taxes on land, as a percentage of total taxation is higher than the OECD average, but around half the proportion raised in the US, UK and Canada.

The proponents of land tax in advocating for them seem to assume that one is starting with a blank canvas for the tax landscape. If this was the case then land taxes could be considered as an alternative to adjusting GST. But the reality is that this is not the case and one cannot assume a smooth replacement of one approach with another as if there is no history of home owners having paid stamp duty. The reality is that all existing home owners have already paid stamp duty - some recently others longer ago. It is not until they purchase another property that they pay for only one tax.

Whilst REIA fully supports the need to abolish stamp duties it advocates against replacing the revenue forgone with land tax because in shifting the burden of tax from purchasers to all owners a number of consequences arise which have a deleterious impact on sections of the community.

REIA recommends that the replacement revenues associated with the abolition of stamp duty come from an adjusted GST.

The problems associated with land taxes and the experience in the ACT in implementing a land tax over a transitional period is discussed below.

Case Against a Land Tax

Drop in Property Prices

One of the consequences of introducing a land tax after a history of stamp duty is that property values fall as the value of future taxes are factored into home prices. The Henry Review amongst others have identified that all current home owners are 'losers' from a move to land tax.

More recently *Re-think* points out that "an ideally designed land tax would result in a once-off reduction in the value of the land …. in an ideal land tax, land owners would bear the full cost of the tax."

Modelling by AHURI on a progressive rate of land tax in Melbourne shows that home owners will see a drop in land values on average of 5% and up to 12%. AHURI found that the average plot with a land value of $335,000 (at 2006 prices) will decline by $24,000, or approximately 5%. However, the expected decline in land value will be greatest in those suburbs in and around the CBD (at around 12%). In suburbs further away from the CBD, the percentage decline in mean land value will be lower - within the 60-70km ring, the percentage decline in mean land value is 3%. AHURI points out that these estimates are conservative.

Elderly and Low Income Earners

The AHURI study estimated that existing home owners would have the impost of an annual land tax on their property of on average $1458 in 2006 prices.

This amount will be a major burden for low income earners particularly elderly home owners whose retirement incomes would be insufficient to meet land tax payments. This would be particularly so for those that have not moved for a long period of time and have relatively high land values but modest incomes. They may be forced to release housing equity, through reverse mortgages for example, to fund land tax payments.

Rents in Affordable Market Segments

Currently in most states investment properties with a land value below a certain level are exempt from land tax. These properties are generally seen as being in the affordable market segment. If a land tax was introduced for these properties, rents would invariably rise as a result.

Reduced Profitability for Agriculture

Similarly, currently agricultural land in is generally exempt from land tax. If a land tax was introduced for these properties margins for agricultural producers will be squeezed.

Equity Considerations

Advocates of a land value tax emphasize its efficiency, but efficiency should not be the only consideration. Equity considerations are also important. A tenet of tax policy is that similarly positioned individuals should pay similar taxes. A land tax fails this test.

Land tax discriminates against those that have chosen to invest in real estate rather than other asset classes such as shares or bonds. Land tax amounts to a surcharge for holding one's savings in real estate whereas other asset classes have no such charges for merely holding onto them.

Any exemptions if allowed, such as lower valued properties or agricultural land, would be inequitable to other property owners.

Land tax can be seen as a tax for past capital appreciation of one's home when there is no CGT on one's own home nor is it likely. *RE-think* states that it is not appropriate to have a CGT, nor a tax on imputed rent, for owner occupied housing.

Another equity consideration is that between owners of commercial property and owner occupiers of residential property. If a uniform land tax was introduced it would see a reduction in the total amount paid by owners of commercial property with the consequences of this being that the state would recoup the extra revenue from owner occupiers and commercial property owners would increase their profits.

Discourages Supply of Housing

Re- think suggests that levying land tax at progressive rates on total landholdings leads to higher taxes on large landholdings, compared to smaller landholdings. The OECD argues that this introduces a bias against large investments in residential property and discourages institutional investors from investing in private rental housing. Other analysts of land tax have come to similar conclusions.

Any further constraints on supply should be avoided when it is universally acknowledged that supply is the major factor affecting affordability.

Transitional Arrangements are Problematic for State Government

To try to minimise the impact of double taxing existing home buyers –stamp duty for the purchase and land tax – transitional arrangements are considered to ease the impost on existing home owners. Ideally these arrangements would be such that no property owner must meet an additional tax. Unless this is the case there will be losers.

The problem of the gradual transition arrangements for state governments is the shortfall in their revenue stream through the transition period. The more gradual the transition to a broad based land tax, the greater the shortfall in tax revenue to a state government in the interim. Given the importance of stamp duty as a source of revenue for state governments, it would be unlikely to expect them to simply forego such revenue. Unless current owner occupiers are taxed twice then any state government acting unilaterally would need to either increase land taxes on those that are currently paying land taxes until no exemptions exist and/or increase other charges. Both are unlikely.

REIA recommends that the introduction of land tax on owner occupied housing should not be considered by the Commonwealth and/or states.

The ACT Experience

The ACT Government in 2012 announced that it will abolish conveyance duty over a 20 year period with an initial 5 Year Plan. The rates of stamp duty would fall progressively over the years with the first cut in stamp duty applying to properties up to $500k – homes of $300k had proportionally the largest savings of $950 and properties of $500k had a saving of $2,450. Under this plan all homebuyers will pay less conveyance duty on properties valued up to $1.2 million by 2016) and over 20 years the Government will continue to reduce conveyance duty rates until they reach zero. At the same time general rates were increased for all property with a land value above $200,000, including by a greater proportion for higher valued properties and will progressively take this approach over 20 years. Not unexpectedly this has caused much consternation in the electorate.

The reform involved significant transitional costs, including to governments (with short-term falls in revenue as stamp duties decline), home buyers in particular recent buyers (with equity concerns about people who have recently purchased a house facing double taxation) and low-income home owners (who have financial difficulty making regular land tax payments under the guise of increased rates).

In an examination of the ACT approach to land tax J. McLaren from the University of Wollongong concludes that "the ACT initiative to abolish stamp duty and replace it with a land tax in the form of an increase in the general rates may not achieve its objective within a twenty year period" and that "it is understandable if State governments are reluctant to adopt similar tax reforms to the ACT as the burden of tax is shifted from purchasers of real property to all owners of property in the ACT and an increased burden for the owner-occupier".

Negative Gearing and Capital Gains Tax Concession

To enable REIA to make a valuable and considered input to the Government's consideration of taxation as it relates to property investment the REIA together with the Property Council of Australia have engaged ACIL Allen Consulting to prepare an independent analysis which: investigates the myths surrounding the impacts that the negative gearing and CGT 50 per cent discount have on the property market, on different social groups and on the economy at large using available data and information; identifies the economic and social benefits of negative gearing and the CGT 50 per cent discount; and assesses the potential impacts of reforms to the existing negative gearing and CGT arrangements.

A copy of the Report will be made available to the Tax White Paper Task Force within Treasury when it is finalised.

The main findings of the research are:

- Negative gearing is a tax deduction for investments in a variety of assets, including property investments, share investments and business ventures.
- The ability of investors to gear and use debt is a crucial part of investing and fostering economic growth. It is a fundamental principle that taxpayers should be able to deduct the associated costs incurred in earning income from investments, including the cost of borrowing. The ability to deduct the cost of

debt and losses against income is necessary to ensure that investments are not taxed punitively.

- The rationale for the 50 per cent discount on capital gains is to ensure that only real capital gains are taxed (not nominal capital gains). This approach replaced the previous indexation of capital gains in 1999.
- The current booming residential property market in Sydney and Melbourne has put the spotlight onto negative gearing and the 50 per cent discount on capital gains for residential property investment with commentators blaming a number of the adverse consequences of the current property boom on the tax treatment
- Negative gearing is not a special concession for property — it is a legitimate deduction of expenses in the course of earning income from investments in all asset classes until the investment generates a positive income stream in the future.
- Negative gearing benefits a range of Australian households by providing all individuals with an opportunity to invest in property, not just those in higher income brackets. Seven out of ten property investors who benefit from negative gearing earn a taxable income of less than $80,001 a year. Furthermore, while individuals with incomes higher than $80,001 claim around 40 per cent of losses on investment property, those earning less than $80,001 a year claim the majority of rental losses (above 60 per cent of all losses).The data also shows that the majority of investors own only one property and this has not significantly changed over time.
- Property is not the investment class that benefits the most from the CGT discount. The majority (around 60 per cent) of the capital gains are sourced from shares, while capital gains from real estate investments (which include residential and other types of property) represent approximately 26 per cent of the total capital gains of taxable individuals. Individuals across all income ranges benefit from the CGT discount. However, the highest proportion of taxable net capital gains income tends to be received by individuals at the higher end of the income distribution and hence these individuals receive a larger share of the benefits from the CGT discount.
- Negative gearing contributes to the provision of new housing — total dwelling commencements have been on a growth trend since the 1950s. A significant proportion of these new dwellings have been financed by investors. Around a third of all new dwellings construction is financed by investors every year and the absolute amount of investor loans committed to new housing has increased by more than seven-fold since 1986.
- Many factors other than negative gearing and CGT discounts influence house prices — the cost of housing is shaped by a range of factors influencing demand and supply and hence it is hard to analyse the housing market in isolation from other markets and without considering the local, national and international interconnections. Quantifying the effects of negative gearing on

housing prices is a difficult task that would require modelling of complex investors' capital movements and secondary behavioural impacts and their effects on the macro economy. The idea that financing arrangements such as negative gearing can singlehandedly change the fundamentals of housing demand and supply is not supported.

- Negative gearing does not pose a huge cost on taxpayers – the existence of negative gearing does cost taxpayers to some extent in terms of foregone tax revenues. However, this cost is not large. In fact, it is not significant when compared to other housing concessions/exemptions that cost the Budget far more.
- Housing is not an unproductive asset. It serves a valuable purpose of providing shelter to people. It also serves two important functions for households - it acts as a savings and wealth building vehicle for owner occupiers and investors and it produces a flow of housing services that households consume.
- Australia is not the only country with negative gearing. The ability to deduct expenses is a common feature of tax systems in other developed countries in the world, and is not unique to Australia.
- Negative Gearing fosters the efficiency of the Australian taxation system by ensuring deductibility of expenses in the course of earning income. Access to negative gearing also ensures that all taxpayers (including individual PAYG taxpayers) can access the deduction, thereby promoting the horizontal equity of the taxation system.
- The 50 per cent discount on capital gains ensures that nominal gains are not taxed and in doing so, promotes the incentive for individuals to save and invest. This is consistent with promoting the efficiency of the taxation system. In addition, the ability of all taxpayers to access the discount (where an asset is held beyond 12 months) fosters equity of the system while the simple design of the discount (relative to indexation) fosters simplicity of the tax system.
- The provision of negative gearing promotes the equity of the Australian taxation system and has provided many ordinary Australians with the opportunity to invest in property which they otherwise would not have had. This is because negative gearing reduces the amount of accumulated losses in the initial years of investment and by doing so, reduces the cost of investing. This benefit is particularly advantageous for 'ordinary' taxpayers (as opposed to the higher income taxpayers) who have less resources and capacity to carry real cash losses for several early years of investment.
- This increased opportunity for ordinary Australians to invest in property also broadens the investment options for these individuals. By doing so, this increased investment opportunity enables individuals to augment their savings.

- The provision of negative gearing in conjunction with the CGT discount promotes investment in rental properties and increases supply of new housing.
- An increase in rental supply means higher rental vacancies and lower rents than would otherwise be the case. The benefit to renters from improved rental affordability was directly recognised by the Henry Tax Review (2010) which noted that 'the current tax advantages available to highly geared investment can operate as a subsidy to renters by placing downward pressure on rents.'
- Investors should be able to deduct expenses such as interest payments in calculating their taxable income. An efficient taxation system should ensure that taxes are based on net income (as opposed to gross receipts). As such, the costs of earning income must be subtracted to arrive at a proper measure of income. If interest payment deductions are denied then it is revenue, not income that is being taxed.
- A policy of denying deductions associated with property would, additionally, distort investment decisions away from property and towards other asset classes for reasons of tax benefit.
- Quarantining of expense deductions against corresponding income would primarily only affect the timing of tax payments, so would not result in large tax collection increase for the Government.
- Limiting negative gearing to a maximum number of properties per taxpayer would be highly distortionary, notwithstanding the practicality of determining an acceptable upper limit.
- If nominal capital gains are taxed without discount then investors will be taxed on a gain they have not made (in real terms, which is what matters).
- A policy of removing negative gearing and the 50 per cent discount on CGT for investment in existing residential property would probably increase investor demand for new dwellings, displace owner occupier buyers and induce capital flight from investment in established dwellings.
- Adoption of the Henry Tax Review policy changes, especially the changes in the taxation of net rental losses and higher CGT payments, is likely to result in a marginal increase in taxes collected by government and penalise the pursuit of capital gains. Furthermore, as noted by Henry, changes to residential negative gearing should only be implemented after housing supply constraints are resolved.
- Eliminating or limiting negative gearing and capital gain tax concessions is likely to have direct impacts on asset prices and rents, returns on investment and the level of investment in the assets affected by the changes.

REIA recommends the retention of current taxation arrangements for investment in residential property.

Recommendations

REIA makes the following recommendations:

- ***That conveyance stamp duties be abolished and replaced by an efficient source of revenue for states and territories***
- ***The Australian Government take a leadership role in abolishing stamp duties and seek to have an agreed timing across all states and territories***
- ***That the replacement revenues associated with the abolition of stamp duty come from an adjusted GST***
- ***The introduction of land tax on owner occupied housing should not be considered by the Commonwealth and/or states***
- ***The retention of current taxation arrangements for investment in residential property.***