Submission to the Federal Tax Discussion Paper

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UDIA in Brief

The Urban Development Institute of Australia (UDIA) is the peak body representing the interests of the development industry around Australia, acting on behalf over two thousand members across the country from a wide variety of fields.

UDIA aims to secure the economic prosperity and future of the development industry in Australia, recognising that national prosperity is dependent on our success in housing our communities and building and rebuilding cities for future generations.

The property development industry is a major contributor to the Australian economy.

- It is the fourth largest industry in Australia in terms of its contribution to GDP. It directly accounts for 7.3% of GDP and, taking into account indirect impacts on the rest of the economy, delivers an additional 6.2% of national output.

- Almost one in ten Australian workers are employed in property development, with the industry directly accounting for over 975,700 jobs (9.1% of the workforce). In comparison, the mining industry employs less than 2% of the workforce. Property development employs a further 749,600 people through its indirect impact on the rest of the economy.

- As a conservative estimate, the property development industry, both directly and through associated industries, generates in excess of $29.7 billion in State and Federal taxes annually.

Introduction

The Australian tax system is one of the fundamental determinants of the success and sustainability of the Australian economy, and all levels of Australian Government. It provides the framework by which individuals, households and businesses conduct their economic affairs, and generates the revenue necessary for governments to operate.

The world in which Australia's tax system operates has changed dramatically in recent decades, and tax policies which may have worked well or been appropriate in the past are now outdated. In order to support the Australian economy and community in the future, significant changes will have to be made to Australia's tax system.

This is particularly the case in relation to Australia's property industry, which as the discussion paper notes, is one of the largest contributors to taxation, comprising around 9% of tax revenue. Many property taxes, such as stamp duties and developer charges are inefficient and inequitable, holding back new housing supply and contributing to poor housing affordability and dwelling shortages across the country.

Poor affordability and housing shortages impact negatively on workforce participation rates, which will become increasingly important as Australia's population ages. High housing costs also necessitate higher wages, which flow through to the cost of goods and services, and damage Australia's international competitiveness.

The current combination of state and federal taxes has significantly contributed to poor housing affordability, and it is essential that the impact of taxation on housing, and the flow through impact to economic performance is addressed.

This submission provides the views of the urban development industry on key aspects of Australia's tax system, specifically:

- The base and rate of the GST
- Double taxation within the GST
- Negative Gearing and Capital Gains Tax
- Stamp Duty on property
- Developer Charges
- Land Tax

By addressing these key areas of Australia's tax system, the Government can help unlock the full potential of the development and construction industries, creating new jobs, economic growth, and making homes more accessible and affordable for all Australians.

UDIA and the urban development industry welcome the opportunity to provide this submission to the Government's Tax White Paper discussion paper, and we encourage the Government to consider the recommendations it puts forward.

Recommendations

UDIA makes the following key recommendations in relation to Australia's tax system.

1. ***RECOMMENDATION – Broaden the base of the GST to improve tax system efficiency, with the additional revenue used to replace inefficient taxes.***

2. ***RECOMMENDATION – The rate of GST should not be increased, as a higher GST rate would have a major negative impact on housing affordability.***

3. ***RECOMMENDATION – Exclude state and local government taxes and charges from GST calculations on land development, to reduce double taxation and improve tax system integrity.***

4. ***RECOMMENDATION – Existing tax arrangements in relation to negative gearing and the capital gains tax should not be changed, to maintain tax consistency and support investment in the property industry.***

5. ***RECOMMENDATION – Stamp duty on property purchases should be phased out, and replaced with more efficient taxes.***

6. ***RECOMMENDATION – Governments should avoid revenue raising through the application of up front developer charges, and should seek to fund infrastructure through recurring charges directly related to specific infrastructure investment, over extended time frames.***

7. ***RECOMMENDATION – Governments should commit to broadening the base and reducing the rate of land tax regimes, as an efficient way to raise revenue and reduce reliance on up front developer charges.***

8. ***RECOMMENDATION – Governments should ensure land taxes apply per land holding, not on an aggregate basis, in order to promote large scale land development.***

GST

The GST is one of the most efficient taxes available to government, by virtue of its relatively broad base and simplicity of administration. It is also typically the largest single tax applied to new housing, and thus has a considerable impact on housing affordability and the level of housing construction in Australia.

GST Base

Consumption taxes such as the GST are less costly to the economy by virtue of their broad bases, which limit economic distortions relative to narrow and more easily avoided taxes. However a number of exemptions to the GST's base mean it is only paid on 47% of all goods and services consumed, which distorts economic activity.

In addition to creating economic distortions, exemptions to the GST also create additional compliance costs for business, with this burden falling disproportionately on small businesses. By broadening the base of the GST, its economic costs can be reduced, and additional revenue can be raised efficiently for governments.

Proposals for a broadened GST are often criticised as having a proportionally larger impact on lower income households, however the additional revenue from a broadened GST could be used to compensate lower income households for increases in the cost of essential goods and services, whilst still delivering a net benefit to efficiency and revenue raised. Modelling by the Grattan Institute shows that broadening the base of the GST could deliver an additional $13 billion a year to governments, including the cost of compensation to lower income households[1].

A broadened GST would also provide revenue that could be used to assist with the phase out of inefficient state taxes such as stamp duties.

RECOMMENDATION – Broaden the base of the GST to improve tax system efficiency, with the additional revenue used to replace inefficient taxes, such as stamp duty.

GST Rate

Proposals to raise the rate of the GST must take into account the impacts such a change would have on the price and supply of new housing, and housing affordability.

At the current GST rate of 10%, a new home sold at Australia's median dwelling price of $571,500[2] includes a GST component of $51,955. Were the GST doubled to around the OECD average VAT rate of 20%, the GST burden on a median new home would double to over $100,000. This would undoubtedly increase the price of new housing, and also lead to a considerable reduction in new

[1] John Daley, The Grattan Institute, *Balancing budgets – tough choices we need,* November 2013
[2] ABS 6416

housing supply, which would be a highly undesirable outcome given Australia's poor housing affordability and dwelling undersupply.

UDIA believes that should changes to the GST rate be considered, it is essential that there is no net increase in the taxation burden on new home buyers as they are a critical component of the new housing supply equation. Any change to the GST rate should only be considered where there is formal commitment by all states government to conduct concurrent tax reform that reduces taxation on new housing.

RECOMMENDATION – The rate of GST on should not be increased.

Application of GST on State and Local Government Taxes and Charges

As a principle, the tax system should seek to avoid instances of double taxation, whereby a tax is levied on top of an existing tax.

The GST exhibits characteristics of double taxation in the case of land development. When developed land is sold by a developer, GST is incurred on top of stamp duty paid on the initial purchase of the undeveloped land, as well as other state and local government taxes and charges levied on development. This creates a higher tax burden on development than necessary, and amplifies the distorting effects of inefficient state based taxes such as stamp duty.

Removing this instance of double taxation would have the triple benefit of improving the integrity and efficiency of the tax system, easing affordability pressures by reducing the tax component of new housing, and supporting housing supply, economic growth, and jobs in the construction and development industries.

RECOMMENDATION – Exclude state and local government taxes and charges from GST calculations on land development, to reduce double taxation and improve tax system integrity.

Capital Gains Tax and Negative Gearing

In recent years, the practice of negatively gearing residential property has generated some controversy, with growing concerns around the impact it has on housing affordability. There have been a number of calls to limit or otherwise modify the tax concessions available to negatively geared property investors.

An asset is said to be negatively geared when the interest payments on borrowings used to finance the asset exceed the income it generates net of other expenses, resulting in a loss. Such an investment strategy relies on future capital gains to offset ongoing losses and generate a net profit. Negatively geared investors may deduct losses against other forms of income such as wages, and receive a 50% discount on capital gains if the asset is held for more than one year.

An often overlooked aspect of negative gearing is that it is a tax concession that applies to a broad range of investments, not just investment property. Therefore, any changes to negative gearing or capital gains tax as it pertains to property investment would result in inconsistent tax treatment of different asset types. This would add complexity to the tax system, and distort individual investment decisions. It would also likely disadvantage investors who have invested under the current arrangements in good faith.

Additionally, the existing negative gearing and capital gains tax arrangements have been long established in Australia's property market, and any modifications would likely reduce certainty and cause a reduction in the level of investment in residential property. This would result in a decline in the supply of new dwellings, activity in the development and construction industries, and lower government revenue from housing related taxes.

Given the importance of new housing development and construction to the Australian economy, particularly in the current context of slowing mining investment, lower levels of new housing investment would be a highly undesirable outcome.

UDIA believes that the existing tax arrangements in relation to negative gearing and capital gains tax should not be modified, as doing so would create inconsistencies in the tax treatment of different asset types, additional tax system complexity, and would likely result in a decrease in new housing investment to the detriment of the broader Australian economy.

The fundamental cause of poor housing affordability in Australia is insufficient new housing supply, and as such, efforts by the Government aimed at improving affordability are better placed in addressing supply side constraints.

RECOMMENDATION – Existing tax arrangements in relation to negative gearing and the capital gains tax should not be changed, to maintain tax consistency and support investment in the property industry.

State and Local Government Taxes and Charges

Stamp Duty

Stamp duties are a highly economically inefficient tax that contributes considerably to the cost of new homes. In 2010, the Henry Tax Review stated that "there is no place for stamp duty in a modern Australian Tax system", and recommended the Commonwealth Government facilitate the transition to less costly and more equitable taxes. More recently, both Tax and Transfer Policy Institute and the Australian Treasury have identified stamp duties as among the least efficient taxes available to governments[3].

When levied on property, stamp duties distort the efficient allocation of housing and land by penalising owners for moving to properties that best suit their needs. This has the effect of damaging economic productivity by constraining labour mobility, which negatively impacts on the efficiency of labour markets. This propensity to lock people into certain locations also has the potential to increase transport congestion and costs, as individuals are forced to commute rather than move to areas closer to employment.

Stamp duties distort investment in both existing and new housing. With Australia's population rapidly aging, they act as a disincentive for retirees to relocate to housing that may better suit their needs, and prevent larger sized housing stock from being released to the market for new families. This leads to significantly more large dwellings being constructed than would occur in a system that actively supported mobility of the population into housing that is fit-for-purpose.

Additionally, by increasing incentives to renovate rather than relocate, stamp duties divert investment towards making existing housing larger, rather than into more affordable and newer housing. The burden of stamp duty also falls disproportionately heavily on those who hold property for a short time, such as developers, which further discourages investment in new housing.

As a source of revenue for state government, stamp duties are highly unreliable, as they rely on the volume of property transactions, which are highly variable. Whilst providing a boost in heated property markets, in slow markets with fewer transactions, lower stamp duty receipts hit state government budgets. A more reliable source of revenue is needed.

RECOMMENDATION – Stamp duty on property purchases should be phased out, and replaced with more efficient taxes, such as a broadening of the GST.

[3] ANU Crawford School of Public Policy, *A Stocktake of the Tax System and Directions for Reform,* February 2015

Developer Charges

Developer charges are upfront charges levied on developers for the provision of new or upgraded infrastructure by both state and local governments. Not all states (e.g. South Australia) have set developer charges, but instead rely on negotiation between stakeholders for charges reflective of the cost of infrastructure provided.

The implementation of developer charges is justified based on the belief that those who directly benefit from infrastructure should cover the costs of its construction. Unfortunately in many cases developer charges do not reflect the cost of the infrastructure being provided, and have subsequently taken on the characteristics of a tax rather than an end user charge.

Developer charges are often opaquely applied, with no clear connection between the cost of the infrastructure provided and the charge, to the extent that the charges may be well in excess of the cost of the infrastructure it is supposed to pay for. In many cases developer charges are used to pay for infrastructure that benefits the wider community (for example trunk roads and utilities infrastructure upgrades), replacement of previously ill-maintained community assets, or other government expenses. In this case, developers and ultimately new home buyers are being forced to subsidise the rest of the community.

A further problem with developer charges is that where the developer is required to build and bear the upfront cost of public infrastructure, local governments and councils have a strong incentive to set unnecessarily high engineering and construction standards in order to minimise their ongoing maintenance and replacement costs. Where these reduced costs aren't reflected in lower council rates, new home buyers effectively end up paying for their infrastructure twice, once through a higher up front house price, and again through recurring rates.

Fundamentally, the use of developer charges as a revenue raising tool for governments rather than as a pure user charge is inequitable to new home buyers, and unnecessarily increases the cost of new housing. This acts to prevent investment in new housing that would have otherwise occurred. UDIA believes that Governments should favour other forms of revenue raising over developer charges.

RECOMMENDATION – Governments should avoid revenue raising through the application of up front developer charges, and should seek to fund infrastructure through recurring charges directly related to specific infrastructure investment, over extended time frames.

Land Taxes

Land taxes have the potential to be highly efficient and stable source of revenue for governments, owing to the immobility of land, and the relative simplicity with which they can be administered. In particular, where land taxes are applied to a broad base and to the unimproved value of land, they have very low economic costs. Australia has existing land taxes in the form of state land tax and local government rates, however the way in which they are currently levied is inconsistent, and has the potential to distort land use:

- Most states that levy land tax currently calculate the liability on the basis of aggregate land holdings, rather than per land holdings, with the rate increasing with the size of holdings. This leads to higher taxes on large landholders, which unnecessarily discourages large scale investment in land.

- Some state and local governments levy tax on the market value of land or total property value, rather than the unimproved land value. Where buildings and improvements are taxed, the economic efficiency of the tax is reduced, by creating a disincentive to undertake investment in improvements.

- The land tax base is narrowed by exemptions and tax free thresholds, creating the potential for distortion, and increasing the administrative complexity.

Any changes to the rate and base of state and local government taxes on land should be supported by well-considered transitional arrangements, recognising that households and businesses will need a significant period to adjust.

RECOMMENDATION – Governments should commit to broadening the base and reducing the rate of land tax regimes over a number of years, as an efficient way to raise revenue and reduce reliance on up front developer charges.

RECOMMENDATION – Governments should ensure land taxes apply per land holding, not on an aggregate basis, to in order promote large scale land development.

Conclusion

UDIA thanks the Government for the opportunity to provide this submission in response to the Tax Discussion Paper. The Federal Tax White Paper process is a critical step in undertaking the necessary tax reforms for Australia to prosper in the future.

UDIA would welcome the opportunity to discuss any aspect of this submission in greater detail. For further information, please contact UDIA National on 02 6230 0255 or at udia@udia.com.au.