

Effects of taxes and transfers on housing affordability

The 2nd Annual Housing Affordability Congress, organized by Informa Australia, was held at Melbourne's Vibe Savoy Hotel on 10th and 11th December. The big-shots in attendance included Federal Housing Minister Tanya Plibersek, her State counterparts from NSW and South Australia, NAB Chief Economist Alan Oster, Master Builders CEO Wilhelm Harnisch, and academic lawyer Prof. Julian Disney. Our Communications Officer, **Gavin Putland**, was one of the presenters. Here's his abridged paper.

1 CONCEPTS

1.1 Affordability as competition

Affordability of housing is a function not only of its **rent or price** (lower is better, all else being equal), but also of the **amenity** (utility) of the housing available for that rent or price (greater amenity is better, all else being equal), and of the **spending power** of the prospective renters and buyers (more is better, all else being equal). But the variables are not independent (that is, not all else is equal). Rents and prices increase with amenity and/or spending power, and some aspects of amenity are manifested as spending power; for example, better public transport reduces travel costs, especially car-related costs, leaving greater capacity to spend on housing. Thus one cannot separately assess rent or price, amenity, and spending power and *then* weigh them against each other. Rather, one must look for another variable that determines the balance. That variable is competition: **affordability** of housing is the **competitive advantage of renters and buyers** relative to lessors and sellers. More competition on the supply side, and/or less on the demand side, makes it easier for renters and buyers to afford housing — all other variables considered.

1.2 Avoiding zero-sum games

Property owners *as such* want **higher rents and prices**, which could be achieved through

- (i) greater amenity (e.g. by provision of infrastructure),
- (ii) more spending power for renters and buyers, *or*
- (iii) a weaker competitive position for renters and

buyers due to, e.g., a worsening shortage of housing.

Of these, only (iii) is contrary to the interests of renters and buyers. On the other side, renters and buyers *as such* want a **competitive advantage**, which might be

- (i) a means to greater amenity,
- (ii) a result of more spending power, *or*
- (iii) a means to lower prices or rents.

Of these, only (iii) is contrary to the interests of owners.

The words "*as such*" are needed because ordinary home owners — those who do not own second homes or investment properties — have a foot in each camp: they are their own landlords and their own tenants, and if they need to sell or let their present homes, they will need to buy or rent alternative accommodation. The interests of **owners as such** are therefore *not* the interests of owner-occupants, but the interests of **investors**.

Restricting the supply of housing is at best a zero-sum game in which owners win and non-owners lose. Subsidies for renters and buyers, being funded by taxpayers, are at best also zero-sum games. In contrast, investment in infrastructure is a **positive-sum game**: it increases the net wealth and

income of the community, making it possible for both owners and non-owners to share in the gains.

1.3 Site values: where all the money goes

A **site** is a piece of ground or space, whose value includes the value of any *attached rights*, such as the right to build on that ground or into that space, but *excludes* the value of any actual building(s). Individuals and corporations cannot create or eliminate sites. By increasing permitted building heights or rezoning land for more intensive uses, *governments* can effectively create sites; but private entities cannot.

From the viewpoint of private entities, then, *the supply of residential sites is fixed*. This is true not only of the *overall* supply, but also of the supply within acceptable distance of any particular services, infrastructure, or job opportunities. For those who have the means to develop new estates, the supply of residential sites is limited by the willingness of governments to rezone land for residential use or for higher-density use. For those who have the means to build dwellings (or to have them built), but not to develop new estates, the effective supply is further limited by the willingness of big developers to develop and re-sell their "land banks". For those who lack even the means to build dwellings, the supply of sites is effectively determined by the supply of dwellings. But for all consumers of residential sites, the supply is limited. Yet access to suitably located residential sites is essential to life and livelihood. Therefore *rents and prices of residential sites are competed upward until they absorb the people's capacity to pay*.



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1.4 Affordability as equity

The propensity of site values to absorb all available household income has profound implications for the distribution of wealth. If wages and salaries rise due to a "strong economy", so does the cost of housing. If childcare or petrol or food gets cheaper, the cost of housing eats up the savings. In short, there is an equilibrium at which everything gained in the rest of the economy is competed away in the housing market. But the intensity of the competition determines the point of equilibrium.

Therefore, for renters and home-buyers as a class, the only gains that are *not* competed away in the housing market are those that are delivered *through* the housing market by enhancing the competitive advantage of renters and buyers — that is, by enhancing *affordability* as defined above. Any

other method of redistributing wealth may help some renters or buyers at the expense of other renters or buyers, but cannot help renters and buyers as a class. One must conclude that *housing affordability is the fundamental problem of economic justice.*

1.5 Affordability as efficiency

There can be no job creation, and no associated wealth creation, *unless*:

- the employer can pay the rent or mortgage on the business premises out of the proceeds of the business; *and*
- the workers can pay the rents or mortgages on housing within commuting distance of the premises, out of wages that the employer can pay out of the proceeds of the business.

So affordable access to sites, including residential sites, is a prerequisite for wealth creation. Combining this with the decisive influence of housing affordability on equity, we see that housing affordability is not a peripheral economic issue. Neither does it merely deserve a seat at the main table. *Affordable access to sites, including residential sites, is the fundamental economic problem.*

2 GUIDELINES FOR TAXES AND TRANSFERS

2.1 Tax sites, not buildings

All taxes on buildings deter construction, making dwellings more scarce and therefore less affordable for both buyers and renters. But because the supply of sites is fixed, *taxes on sites cannot reduce the overall supply of sites* (although, as explained later, some such taxes can impede turnover of sites and thereby reduce the supply available for particular purposes). Therefore, if we must have taxes, it is better to tax sites than buildings.

Municipal rates comply with this principle if levied on the site value alone. Conveyancing stamp duty violates this principle because it is levied on combined values of land *and buildings*. Income tax on rental income violates this principle in so far as it applies to rent attributable to buildings.

2.2 Subsidize construction, not sites or existing buildings

Just as the supply of buildings can be reduced by taxes while the overall supply of sites cannot, so the supply of buildings can be *increased* by subsidies while the overall supply of sites cannot. Therefore any subsidies or tax concessions offered in the name of housing affordability should be directed at buildings, not sites. Furthermore, because the supply of buildings is increased by *construction*, and not by the mere acquisition of existing buildings, any subsidies or concessions for buildings should be limited to new buildings.

The "negative gearing" deduction, the 50% discount for capital gains, and the first \$14,000 of the First Home Owners' Grant violate this principle because they are not contingent on building anything.

2.3 Tax holdings, not transactions

A **transaction tax** is one for which the tax liability is attached to an avoidable economic exchange — the "transaction". A pure **holding tax** is a periodic tax payable by the owner of an asset regardless of any transactions (e.g. rent payments) that occur during the period of ownership. In this paper, a **transfer tax** is one which is payable at the time of transfer (sale or purchase) of an asset, but which may or may not be apportioned to the transfer price; in *form* it

resembles a transaction tax, but in *substance* it may be a transaction tax or a holding tax, depending on how it is calculated.

A pure holding tax on a site cannot reduce the supply of sites or the availability of sites for housing, but can only encourage a site owner to use the site productively in order to cover the tax (or sell the site to someone who will). But a

transaction tax, by deterring the targeted transaction, may inhibit the supply of housing *even if the transaction concerns a site.*

For example, a tax on the *rent actually paid* for sites is a transaction tax; it will make the owners less inclined to offer sites for rent, and will therefore raise rents. But a periodic tax on the *values* of sites is a pure holding tax and will have the opposite effect; site owners cannot avoid such a tax by withholding sites from the market, but must cover the tax by finding tenants, or avoid it by selling the sites. A tax of the latter kind makes sites more affordable not only for renters, but also for buyers, because the tax deters purely speculative buyers (so that the remaining buyers face less competition) and because the tax is compensated by a lower price: in effect, the "tax" is the rent paid for a portion of the site value that is still owned by the people through the government, while the purchase price covers the privatized portion [cf. the submission by the Land Values Research Group at <http://taxreview.treasury.gov.au/content/submission.aspx?round=1>].

A transfer tax on the sale or purchase of a site, if apportioned to the transfer price, is a transaction tax (the taxable "transaction" being the sale or purchase). By impeding the many transactions needed to bring sites onto the housing market, such a tax makes housing less affordable for both renters and buyers. One such tax is the present stamp duty on conveyances.

If the site-transfer tax were instead apportioned to the **unearned increment**, i.e. the *real increase* in the site value since the last transfer, it would have the substance of a *holding tax*, because the tax liability would accumulate during the period of ownership and would only be *realized* by the sale. If, in addition, the tax were payable by the vendor, it could not render an otherwise profitable resale unprofitable, but would merely reduce the profit margin; and in the event of a loss-making resale it would not worsen the vendor's loss. Thus the tendency to impede sales of sites would be much reduced, and sites would more readily come onto the housing market. Moreover, by reducing the attractiveness of capital gains relative to current income, the tax would encourage site owners to seek income from their sites and would thereby enhance the bargaining positions of prospective tenants.

2.4 Finance infrastructure from uplifts in site values

The benefit of an infrastructure project is measured by the total price that people are willing to pay *for the benefit*. Part of that price is paid in **user charges** (fees, fares, tolls, etc.), and the rest is paid in rents and prices of *locations* that benefit from the project — in other words, property values. And the locational component of the value of a property is the *site value* — not the values of any buildings, because the value of a building is limited by the cost of constructing an alternative building, whereas a site has a location, and therefore a locational value, even if no building yet occupies it.

One must conclude that housing affordability is the fundamental problem of economic justice

Therefore, if the benefit of an infrastructure project exceeds the cost, whatever part of the cost is not covered by user charges can be covered by taking back a sufficient fraction of the **uplift** in site values. A holding tax on site values is suitable for this purpose, as is a transfer tax on the real increase in the site value since the last transfer. Property owners who campaign against such taxes are harming their own interests by cutting off the funding of infrastructure that would raise their property values.

Conversely, if a government, through the tax system, receives a fraction of all increases in site values, it has a fiscal incentive to invest in infrastructure that increases site values. This is clearly in the interests of the site owners, who retain the rest of the uplifts.

The uplift in site values due to infrastructure does *not* damage affordability, because it reflects greater amenity, not higher rents or prices for sites of *given* amenity.

3 INFLUENCES ON THE BUILD/BUY DECISION

Property investors do not “provide” housing unless they *build new homes* or cause them to be built. Those who buy established homes do not add to the overall supply, but merely turn homes for sale into homes to let. This does not address the overall shortage of homes. It does not even address the shortage of *rental* homes, because the reduction in the supply of homes for sale throws potential owner-occupants onto the rental market.

Therefore every so-called incentive to “provide” housing must be assessed on the extent to which it encourages *new construction*.



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3.1 First Home Owners' Grant (FHOG)

For most of its history, the First Home Owners' Grant (**FHOG**) was a \$7000 grant available to first-time owner-occupants regardless of whether they bought new homes or established homes. Thus it did nothing to encourage recipients to add to the supply of housing, rather than merely bid up the prices of existing homes for the benefit of incumbent owners. In 2003, this writer suggested that the grant be limited to new homes [Letter in *Daily Telegraph*, Sep.30, 2003].

Some first home owners who build homes with the aid of the FHOG find themselves unable to take up residence as planned. Hence we must periodically endure media beat-ups and political grandstanding about “*rorts*”. The appropriate

remedy for the “*rorts*” is to legalize them: the grant, having been limited to *new* homes, should be extended to *all* buyers of new homes, including investors and repeat buyers. The incentive for investors would increase the supply of rental accommodation. Better still, because the grant is a fixed sum per dwelling, an investor with a limited budget would choose to build a larger number of cheaper dwellings rather than smaller number of more expensive dwellings. The increase in supply would therefore be concentrated at the affordable end of the market.

3.2 Negative gearing; discounting of capital gains

Contrary to the claims of the property lobby, neither the “negative gearing” deduction nor the 50% discount for capital gains is an incentive to provide housing, because neither is contingent on building a new home; both are available for purchases of established homes as well as new homes.

In 2008, the Senate Select Committee on Housing Affordability cited two submissions suggesting that “negative gearing” be limited to new homes, and one submission suggesting that the discount for capital gains be similarly restricted. The present writer made both suggestions nearly five years earlier [Letter in *Sun-Herald*, Jul.20, 2003].

While the full deductibility of current expenses related to an investment property is contingent on making the property available for rent, it is *not* contingent on actually having a tenant, and therefore does not discourage owners from demanding ambitious rents. If deductibility were contingent on having a tenant, it would force owners to moderate their rent demands in order to secure tenants.

4 EFFECTS OF PRESENT TAXES; SUGGESTED REFORMS

4.1 Conveyancing stamp duty

As already noted, the present stamp duty on conveyances penalizes construction and impedes the flow of sites onto the housing market for both renters and buyers; but its effect could be alleviated by making it *payable by the vendor* and *proportional to the real increase in the site value* since acquisition.

Contrary to superficial appearances, the suggested reform would *not* shift the burden of the tax from the buyer to the seller. If a transfer tax is nominally payable by the seller, the seller will try to add it to the price. If it is nominally payable by the buyer, the buyer will try to subtract it from the price. In the end, the burden of the tax will be shared between the buyer and the seller in inverse proportion to their bargaining power, regardless of who actually “pays” it. In the present context, the reason for making it payable by the seller is that the seller already knows (or should know) what the site value was at the time of acquisition, and is therefore better able to anticipate the tax liability.

To avoid any suggestion of retrospectivity, a taxpayer disposing of a property acquired before the tax change could be given the *option* of paying tax as if the property had been sold and bought back (at market price) on the day before the change. Under this option, any vendor who pays more tax than would have been payable under a continuation of the old system does so solely because the site has increased in value *since* the change.

4.2 Lump-sum developmental levies for infrastructure

Property developers complain about lump-sum infrastructure levies imposed on them by State and local governments, claiming that the levies are “passed on” in

prices of new housing lots. These complaints conveniently fail to acknowledge that:

- the mere *permission* to develop land raises its market value; and
- public provision of infrastructure for a new estate raises the market values of the serviced lots, whether the developer contributes to the cost of the infrastructure or not.

That said, if the infrastructure levies are so high that they render development unviable, they will delay development until land prices rise sufficiently to enable recovery of the levies. This outcome would be prevented if the levy on each lot were

- payable on resale of the developed lot, and
- proportional to the uplift in the value of the lot since acquisition, net of the development cost notionally attributable to that lot.

4.3 Municipal rates

Where local government rates are levied on site values alone, they do not penalize construction and therefore do not damage housing affordability. Where rates are levied on combined values of sites and buildings, they penalize construction, restricting the supply of housing and making it less affordable.

To obtain the full affordability benefit of site-value rating, one must avoid not only *explicit* taxes on buildings but also *implicit* ones, including "service charges" of so much per year per dwelling, or per some other unit related to a dwelling. Because Council services add value to every site to which they are provided, it is logical and convenient to finance them from a general rate on the site value.

By allowing thresholds or surcharges that vary from site to site, one can avoid winners and losers in the transition to a site-value system while retaining its advantages for affordability. A companion paper explains how Victorian Councils could do this [Google on "Why Site-Value rating is better, and how to implement it with no losers"]. The same paper includes an overview of the published empirical evidence confirming what should be obvious: that site-value rating is more conducive to construction than rating systems that include buildings in the tax base. That paper and a related letter include comprehensive rebuttals of numerous arguments used against site-value rating in political campaigns [Google on "Don't let land speculators do to Monash what they did to the rest of Victoria"].

4.4 Land tax (and the Big Lie)

Land tax is a pure holding tax on site values, and therefore tends to reduce rents and prices of sites by pressuring site owners to seek tenants (to generate income to cover the tax) or sell their sites. The burden cannot be passed on to tenants in higher rents, because the tax is not a cost of *letting* the land, but rather a cost of *owning* it.

A comparison may help. The burden of a *sales tax* can be passed on to the buyer because the tax is a cost of selling. The seller holds out until someone offers a sufficient price to cover the tax, and is *able* to hold out because the tax is not payable until the item is sold. If, on the contrary, the tax were payable whether the item were sold or not, then the seller would need to sell something in order to pay the tax, and the selling pressure would tend to *reduce* the price. Land tax works in the latter manner; it is payable whether the land is let or not, and therefore creates pressure to let, which tends to reduce the rent.

So property investors cannot pass on land tax in higher rents. So they resent it. So they campaign against it — by

falsely claiming that they *can* pass it on! They never cite any reputable economists in support of this claim, because there are none.

Occasionally a reputable economist will support a more qualified claim, namely that because land tax exempts owner-occupied residential land, it induces sales of rental homes to owner-occupants and therefore reduces the supply of homes to let, raising their rents. This claim, if true, means that rents are higher than they would be if land tax were extended to owner-occupants; it does *not* mean that rents are higher than they would be if there were no land tax at all. Indeed, if there were no land tax at all, there would be *less* pressure to let and *less* pressure to sell to owner-occupants (or anyone else), so that both rents and prices would rise.

These facts do not stop the property lobby from demanding land tax concessions or exemptions, ostensibly for the purpose of reducing rents. In truth, the only kind of land-tax concession that would reduce rents would be one that is conditional on having a tenant in place, so that owners would try harder to attract tenants — by moderating their rent demands. But those who seek land-tax concessions never ask for any such condition to be attached.

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4.5 Payroll tax

Payroll tax deters construction and inflates its cost. The most complete solution is to abolish payroll tax and replace the revenue by a holding tax on site values. One possible candidate is the vendor stamp duty suggested above, set at a sufficient rate (roughly 37% in Victoria) to replace both the old stamp duty and the old payroll tax.

5 CONCLUSION

Australia's tax-transfer system almost seems to have been designed to create a shortage of housing by punishing construction and frustrating the provision of associated infrastructure. All levels of government could easily improve their systems without sacrificing revenue.

Local governments could apply rates to site values only, and eliminate any implicit taxes on buildings. The State parliaments should mandate this or at least remove legislative impediments to it.

State governments could make conveyancing stamp duty payable by the vendor and proportional to the real increase in the site value since acquisition, and could set the rate high enough to allow the abolition of payroll tax. Land tax should *not* be abolished or reduced, and any exemptions or concessions for residential sites should be contingent on having tenants in place.

Lump-sum infrastructure levies, whether payable to State or local authorities, could be reformed in the same way as stamp duties, with a further deduction for development expenses.

At the Federal level, the entire First Home Owners' Grant could be restricted to *new* homes but extended to *all* buyers of new homes, while the "negative gearing" deduction and the capital-gains discount could be allowed for *new* homes but not for future purchases of established homes.

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