Prosper Australia's Submission

to the

House of Representatives
Standing Committee on Economics
Inquiry into Home Ownership

by David Collyer
Policy Director
Prosper Australia

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LSX 285 Lennox Street Richmond Vicc 3121

About Prosper:

Prosper Australia is a non government organisation inspired by economic justice. When wealth produced from land – the earth, minerals and natural monopolies – is the funding base for government, equality of opportunity becomes possible for all.

We reach out to all citizen taxpayers on lower costs and greater efficiencies through the removal of deadweight taxes; to conservatives on universal land ownership, self-reliance and security; and to progressives on urban density, self funding public infrastructure and resource conservation.

www.prosper.org.au

“Land tax logically applies to a measured service which the individual receives from the community. It is equitably distributed according to the quantum of advantage which the possession of land gives the taxpayer. Best of all, against the present environment so open to evasion, land tax cannot be evaded."

"Around the world the demand for land rights becomes ever more strident. The possibility of eventual confrontation between the `haves' and the `have nots' on the land question awaits only an awakening by the landless masses to the enormity of the crime involved in the denial of what must surely be the most basic of human rights to share equitably in the bounty of the earth."

Sir Allen Fairhall MHR 1909-2006

Minister for Interior and Minister for Works (1956-58), Minister for Supply (1961-66) and Minister for Defence (1966-69) in the Menzies, Holt and Gorton governments.

Housing Supply[i]

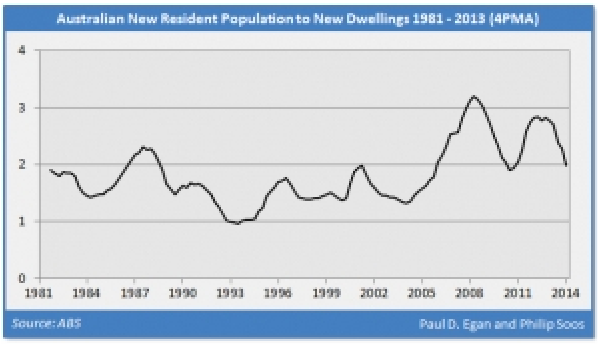
For over a decade, the common refrain is a shortage of dwellings has driven up housing prices. It is a mantra repeated endlessly by government, industry and academia.

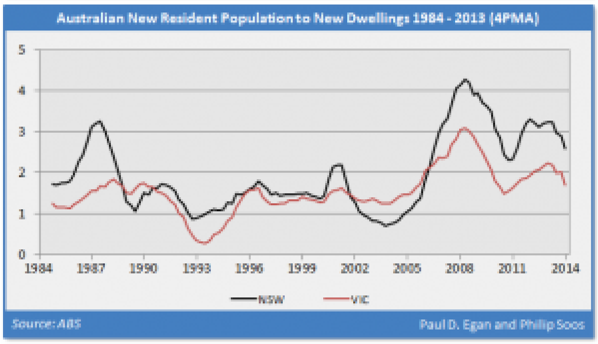
Observers see demand exceeding supply and equalising by boiling off into land price inflation. Some even cite this as evidence of progress, rather than constipation and harm. While it is easy for vested interests to claim a shortage exists, the data paints a different story.

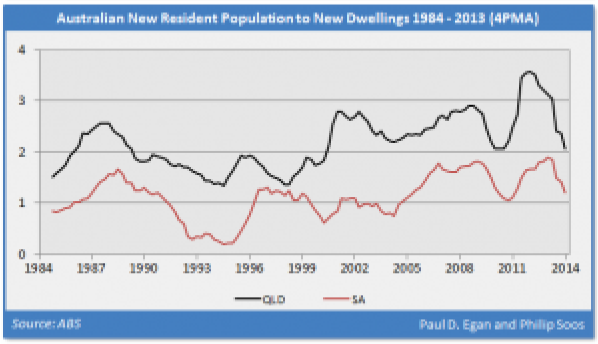
A good way to examine whether an adequate supply of housing exists is to compare the flow of new dwellings to new net population. Many analyses simply look at the relative or absolute change in dwelling stock, which is pointless without first considering changes in population. Also, comparing the flow of new dwellings to existing population says little as new supply matters most to the net flow of new people, rather than the majority of the population who are already housed. It is important to note there are factors that are not captured in the ratio that require additional consideration:

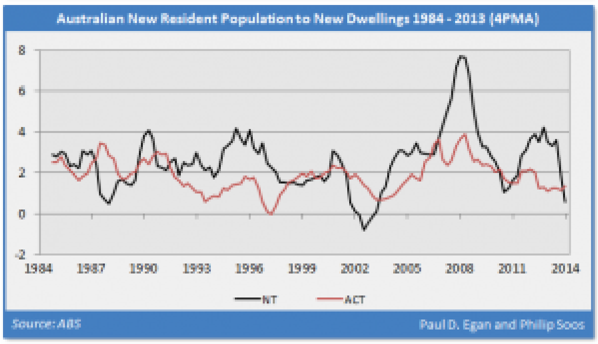
- The total population measure is used, although only adults should be considered, for children don't purchase homes, make mortgage payments or pay rent.
- An increase in the natural population through births doesn't automatically necessitate new dwellings be built, though it may result in families upgrading to larger dwellings.
- Renovations and extensions of existing dwellings are overlooked, but generate additional housing capacity.
- Many immigrants arrive in groups, initially requiring only one dwelling per family/shared household.
- Building completions do not take into consideration dwellings that are demolished, condemned or held off the market.
- The slow rise in sole occupant households, divorce and/or childless couples (demographic change) may drive a long-run trend toward lower occupancy rates in general.

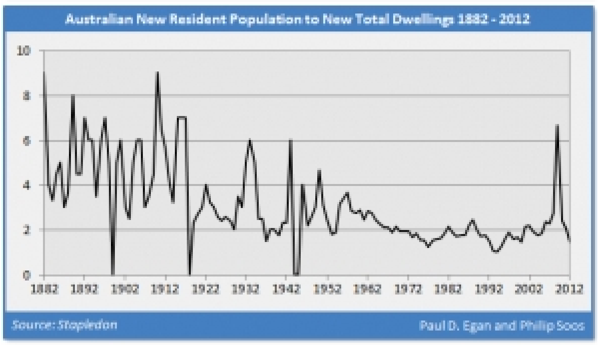
A total housing stock series adjusted for demolitions would be better than using housing completions, but there are no long-term housing stock series available for the states and territories on a quarterly basis. The series for building completions, however, provides a reasonable measure to illustrate general trends. Overall, the factors above probably have the net effect of understating supply. Due to the volatility of these data series, a 4-period moving average (4PMA) trend line is used to clarify the trends.


Australian New Resident Population to New Dwellings 1981 - 2013 (4PMA)
Source: ABS
Paul D. Egan and Philip Soos


Australian New Resident Population to New Dwellings 1984 - 2013 (4PMA)
NSW
VIC
Source: ABS
Paul D. Egan and Philip Soos


Australian New Resident Population to New Dwellings 1984 - 2013 (4PMA)
QLD
SA
Source: ABS
Paul D. Egan and Philip Soos


Australian New Resident Population to New Dwellings 1984 - 2013 (4PMA)
NT
ACT
Source: ABS
Paul D. Egan and Philip Soos


Australian New Resident Population to New Total Dwellings 1882 - 2012
Source: Stapledon
Paul D. Egan and Philip Soos

Between 1996, when real housing prices began to boom, and 2006, just before the onset of the GFC, Australia built, on average, one new dwelling for every 1.5 new net persons. The ratio then surged during the GFC as uncertainty, debt deleveraging, fraud and insolvencies swamped property developers, leading to a reduction in the rate of building completions. The rising ratio was boosted by the government's foolishly high population growth policies as they sought to lift the weakening economy via immigration .

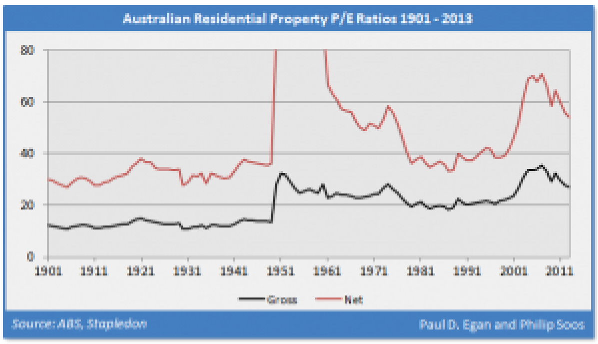
This appeared to create a genuine housing shortage between 2007 and 2010, as both the nominal rent to inflation and rent to income ratios strongly increased, and the ratio of new people per new dwelling exceeded the overall occupancy rate (2.7) for the first time in over four decades.

After 2010, nominal rents tracked the rate of inflation, and are now falling steeply in Perth and Canberra, with Brisbane likely to follow on the end of the mining investment boom. This indicates the GFC-induced shortage has abated, and supply has resumed its trend, even in the face of higher population growth.

It should be noted that most demand for housing comes from buyers, not tenants. Thus, a rise in imputed rents on owner-occupied housing, not actual rents on the investment property stock, signals a shortage in the housing market. Unfortunately, data series of quality-adjusted imputed rents are not available, and would still technically require the 'user cost of capital' method to properly assess the trend in imputed rents.

Nevertheless, the long-term residential price to rent ratio, which combines total imputed and actual rents, experienced a steep surge beginning in 1996. Economist Dean Baker, who identified the US bubble back in 2002 and predicted the GFC, noted:

"No one can produce an explanation as to how fundamental factors can lead to a run-up in home sale prices, but not rents."

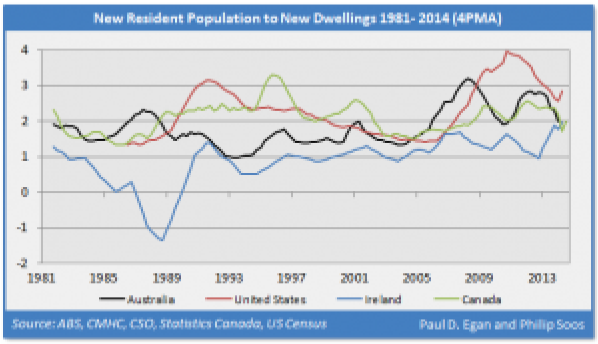


From the trends identified in the graphs, it is clear the supply of housing has been more than sufficient to meet new net population growth. In some years, there has been more than one dwelling built per person, while at other times, there has been a continual growth of housing supply while population growth turned negative. Over the course of the housing price boom beginning in 1996, Australia has built, on average, one new dwelling for every 2.0 new net persons. This is in line with the post-WW2 average of 2.0 between 1946 and 2012.

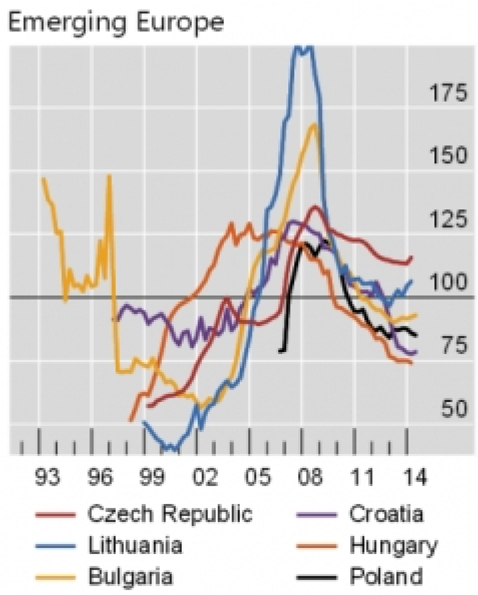
The inadequacy of the housing shortage argument is apparent for the trend in the NSW ratio. Sydney, which dominates the state's housing market, experienced a massive price boom between 1996 and 2004, yet over this period, one new dwelling was built for every 1.4 new people. At the peak in 2004, the ratio decreased to an insane 0.2 (the trend line removes some of the visible precision in the ratio). In other states and territories, the ratio turned negative, indicating negative population growth in the face of positive dwelling construction, even while prices remained steady or even rising.

The housing booms in both the US and Ireland was blamed on shortages, but the real cause of high prices were speculative bubbles. The graph below shows that between the mid-1990s (when prices began to rise) and the GFC, Australia's supply was superior to that of the US, but below that of Ireland. The latter country had an epic building boom, with a ratio of 1.1 between 1995 and 2007, the trough and peak of real housing prices.

Canada probably has the world's largest current housing bubble, but with a ratio of 2.1 between 1996 and 2014 (similar to Australia's), it is highly unlikely this country has a housing shortage. Canada's ratio closely tracked that of the US pre-GFC, and continued post-GFC while the US housing market crumbled.



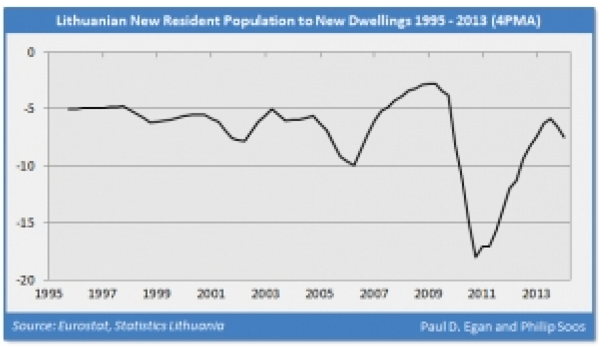
No country better illustrates the utter absurdity of the housing shortage argument than Lithuania. This country experienced an irrational housing bubble in recent times, with the real (seasonally adjusted) housing price index increasing from 25 in 2001 to 200 in 2007; a boom of 700 per cent! This is an average annual increase of 117 per cent between 2001 and 2007. The Lithuanian housing bubble dwarfs even the massive Irish bubble, approximately double the size in real terms from trough to peak.



While data from Statistics Lithuania are clearly not as reliable as the ABS or the statistical offices of other developed nations, it is sufficient to show the trends in housing and population during the boom and bust. Its population has been in constant decline since independence (Modern Lithuania).

Lithuania has a housing stock of around 1.3 million, which hasn't grown. Unsurprisingly, between 2004 and 2013 (where data are available), the total housing stock declined by 0.2 per cent or by almost 2,000 dwellings. Population fell by 12.6 per cent or a net -427,000 persons over this period. Although both dwellings and population have fallen, this translates into an effective decrease of 214 people per net demolished dwelling!

Even though the housing stock declined slightly, there was a constant flow of building completions of a couple thousand per quarter, likely replacing old dwellings in prime locations. Comparing the ratio of net population change to building completions yields a persistently negative ratio, given the extreme net emigration. In 2007, the Lithuanian population fell by 40,000 while the housing stock increased by 6,000 dwellings – as prices boomed to its peak.

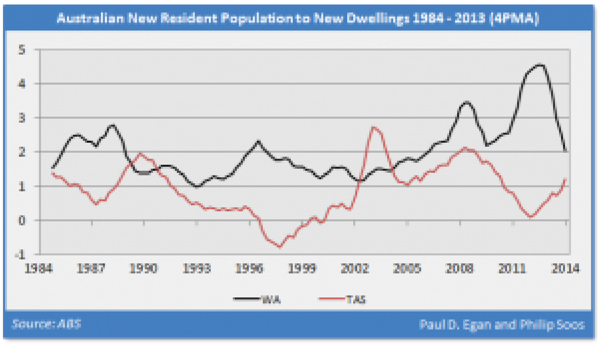


It is clear dwelling shortages were never the cause of the international housing booms, but Australian commentators continue to blithely make this assertion. The most authoritative body on this issue, the (now abolished) National Housing Supply Council (NHSC), made these claims in numerous reports.

Take the US as a case study. Leading institutions such as the Federal Reserve, National Association of Realtors, California Building Industry Association and Harvard University's Joint Center for Housing Studies produced sophisticated studies to show that the $8 trillion housing boom was caused, in part, by dwelling shortages. These studies were authored by professors, PhDs, and businesspeople, all with extensive knowledge and experience but with conflicts of interest that could fill a small book. Yet, their expertise was as illusory as the shortage when the housing market crashed. The same again occurred in Ireland and Spain to the point where these three countries are now bulldozing entire neighborhoods to reduce some of the massive oversupply.

The housing shortage argument is also used to claim Australia needs more investment into the residential property market, whether domestic or foreign, to increase supply. Strangely, the housing market functioned relatively well during the 1960s, 1970s and 1980s with a household debt to GDP ratio of around 10 to 20 per cent and a low proportion of property investors relative to owner-occupiers.

The ratio has risen close to 100 per cent in recent years, the result of debt-financed speculation – a primary cause of bubble-inflated prices. More of the same is not the solution, but this helps explain why the government refuses to take action to constrain accelerating debt. Despite the certain hardship and risk in allowing the trend to continue, the contribution to short-term GDP growth provides the illusion of prosperity and competent economic management.



The RBA refuses to implement macroprudential regulations, the FIRB is unwilling to enforce foreign investment rules, APRA allows the Big Four banks to use generous, opaque and manipulated internal ratings based models to determine wafer-thin capital buffers, ASIC declines to investigate serious and credible allegations of subprime fraud, unfettered self-managed super fund property investment is booming, and government will not consider re-casting regulation of the banking and financial sector or reduce leverage-inducing tax expenditures.

As noted in Paul Egan and Philip Soos' forensic investigation of the banking and real estate markets – *Bubble Economics: Australian Land Speculation 1830-2013* – the Australian economics profession has never managed to identify any growing asset bubble or predict the subsequent economic fallout. There is no evidence economists warned about or even noticed the real estate bubbles in the 1830s, 1880s, 1920s, mid-

1970s and the late 1980s, or the stock market bubbles of the 1920s, 1987 and the Dot-Com.

Not only does the mainstream economics profession have a 100 per cent failure rate in forecasting, but economists across the board expend significant effort into denying bubbles exist, as was the case with the Dot-Com bubble, and the numerous housing bubbles in international jurisdictions. If elite Harvard/MIT/Chicago economists not only missed the largest housing bubble in US history, but also denied there was one, what hope do Australian economists have?

As history patently reveals, the answer is ‘exactly none’. Ignorance and/or denial are standard fare, and we should not expect anything different. Treasurer Hockey may wish to review his position, for the easy and lazy analytical path is actually being trodden by those economists and policymakers claiming that high housing prices are caused by a mythical shortage.

Confronting the real causes would require our compromised legislature to proactively respond, instead of rigging government and market outcomes to benefit the growing power, profit and authority of the horde of private monopolists, usurers, speculators, rent seekers, free riders, financial robber barons, control fraudsters, inheritors and the indolent rich.

Australia would be much better served if investor attention was refocussed onto genuine investment that added to our national capacity and strength rather than idle ticket-clipping.

There is an obvious incentive to oppose any analysis and/or policy that could potentially reduce the mountain of unearned wealth and income flowing from surging land prices (economic rents). The conservatively estimated $300 million in real estate owned by federal parliamentarians means this bias is widely shared by all in parliament.

In conclusion, there is no housing shortage as is commonly claimed, though a temporary shortage did emerge during the GFC. Australia is a mirror of other countries where high housing prices were also blamed on a shortage, always revealed, in hindsight, to be a chimera.

Tax Policy

If Australia is to endure the upset and cost of tax reform, we have an obligation to discard the most damaging tax bases and migrate to those economists can demonstrate have the following features:

- Nil deadweight losses
- Cannot be avoided or passed on
- Are equitable
- Reflect capacity to pay
- Can be universally applied

The worst tax on property is conveyancing stamp duty collected by state and ACT governments.

Stamp duty deters property transactions and thus deters change and innovation. It inhibits the transfer of property to higher value uses, resulting in an inefficient allocation of resources. This transaction tax falls on both land and buildings, whereas land tax falls solely on the underlying land. Thus, stamp duty lifts the cost of and constrains construction and construction employment.

Most studies of stamp duty focus on the residential impacts. The economic consequences for business are very similar, inhibiting moving closer to their customers, expanding and contracting efficiently, making a key capital asset less liquid and imposing avoidable costs, such as longer travel times for employees and customers with city-wide congestion impacts.

All these factors compound to reduce overall economic activity.

Land tax is a small but insistent reminder to owners of their obligation to put land to its best and highest use. Removing stamp duty on property transactions and neutralising the financial impact on government by revising the state land tax schedule will drive this demand harder.

KPMG Econtech[ii] estimates the marginal excess burden of conveyancing stamp duties at 34 per cent, and regards this as a serious underestimate as it does not consider the cost to households displaced to renting and the welfare losses in the mismatch of housing and families. Collecting that $12,841 million nationally therefore imposes a civic burden of at least $17,206 million, of which $4,365 million is cast on the ground in deadweight losses each and every year.

Further, recent economic modelling by federal Treasury calculates land tax actually has a negative marginal excess burden as land tax paid by foreign and domestic landowners is spent solely on domestic households[iii]. A boost to demand of this scale would be welcomed by business and citizens alike.

This reform is low-hanging fruit indeed.

Who pays?

The *statutory incidence* of Stamp Duty falls on buyers, as they must physically pay the tax. However, the *economic incidence* falls entirely on vendors. This assertion can be tested by considering what the sale price of a property would be without Stamp Duty.

However, ending stamp duty would be funded by the removal of the principal place of residence exemption from state land tax, transforming a property transaction tax into a land holding charge – one already levied on investors and second-home owners.

The complexion of the property tax base changes considerably with this reform. Prof. Gavin Wood *et al* at Australian Housing and Urban Research Institute modelled the impacts of a broad-based land tax in line with the Henry Review recommendations on Melbourne.[iv] They found landowners in Boroondara, Stonnington, Bayside, Port Philip, Melbourne and Yarra LGAs – the most valuable land per square metre in

Melbourne - would pay considerably more while landowners elsewhere would enjoy overall property tax reductions.

Prosper regards this reform outcome as entirely appropriate and defensible on economic efficiency and social justice grounds. These parts of Melbourne are transport rich, liberally provided with quality, fully-amortised community facilities, durably superior government schools, low crime rates, high quality and rising housing stock, excellent parklands, and other permanent locational and geographic advantages that are enjoyed by owners and capitalised into land costs and (imputed) rents.

Current tax settings confer considerable advantages upon wealthy landowners – self-defined by their demonstrated capacity to buy and occupy the most valuable sites. The exchange of stamp duty for a universal land tax levels many of these economic distortions, though there will be loud and specious arguments it introduces them.

Stamp duty inhibits transactions. If removed, we would see:

- More and better construction
- Lower rents
- Better matching of households to housing stock
- A greater propensity to buy (on ease of exit)
- Less traffic congestion
- A deeper, more active land market

Whether the exchange of stamp duty for land tax would raise or lower property prices depends entirely on the tax schedule government adopts. Does it zero-rate low value land? To what level? How progressive is the tax scale on higher values? Does it aggregate land holdings for calculation or adopt the recommendation of the Henry Review and rate on a per square meter basis? On commercial property, does it simply perform a revenue-neutral exchange of stamp duty for a slightly higher land tax, bearing in mind the holding period for commercial property is generally much longer than for residential?

Prosper commends the Henry Review recommendation to tax on a per square meter basis, rather than aggregating holdings. The flatter the rate schedule, the less significance this question holds.

Government will be tempted to a progressive rate schedule to advantage lower income earners. Given the cost of transactions without stamp duty would be very low, over time, those choosing to hold high value land which incur larger land tax bills can be confidently deemed to do so voluntarily.

Citizens consciously and voluntarily paying tax – on a base proven to have a negative marginal excess burden – is a civic transformation of great significance.

The proposed property tax should fall solely and utterly on the underlying land. Taxing structures discourages construction; land cannot be discouraged, it simply is.

State revenue volatility

A key government concern is the volatility of its revenues and the difficulty this imposes on planning future spending.

The best revenue bases are not those that deliver a rock steady income stream to government, whatever the circumstances of its citizens. Instead, the ultimate aim should be to use wherever possible revenue bases with the economic virtue of being *automatic stabilisers*.

The federal income tax, in combination with unemployment benefits and the general social security system exhibits this feature, adding friction when incomes rise and joblessness falls, and supporting activity in recession without policy change.

Few state taxes have such economically useful and dynamic properties, except State Land Tax, which rises and retreats with land price changes. This rare and valuable quality is masked by biennial land valuations.

Prosper recommends government revalue all land annually, by interpolation. This is quite straightforward with computer-assisted mass appraisal. The economic benefit of this automatic stabiliser function is profound in eras of rapidly rising or falling land prices.

If Australia was to endure a land price slump like that observed in the USA, Ireland, Spain and others – typically a revert to the long term mean, perhaps with an overshoot on weak confidence, negative equity and credit rationing - a sound economic case can be made for even quarterly revaluations to market to enhance the stabilizer function of land tax.

Australia is very richly endowed with land. This is a key national economic advantage over almost all competitor countries. Government has an unceasing obligation to nurture advantage in this by siding with the future (buyers) over the past (vendors).

Universal access to inexpensive land is a core economic and cultural Australian value.

Over the last 30 years, land prices have boomed – propelled by speculation, easy credit, restrictive planning and rising real incomes. On one hand, many have made their fortunes, on the other, first home buyers now find it nearly impossible to buy a house to start a family and enter the independence, privacy and security of property ownership except on extremely onerous terms.

An inefficient taxation system, comprised of high work taxes and low land taxes, allows landowners to expropriate ‘geo-rent’ (economic rent derived from land) by capturing the uplift in land values generated by taxpayer-funded infrastructure and rising economic productivity derived from labour and entrepreneurial activity. As property valuer Bryan Kavanagh notes: “...land price is actually the private capitalisation of imputed site rent remaining on a site, developed or undeveloped, after the deduction of government charges.”

Because government has preferred to tax wages and enterprises ahead of land, the capital sum people are willing to pay for this asset is elevated by its privileged status. Counter-intuitively, reducing wage and business taxation and increasing land tax would not necessarily lower land prices, given the offset of increased final wages, profits, and real and imputed rents. This macro reform – urged on government by every independent tax review in living memory – would solidly correct the price/income and price/rent ratios.

If Australia wishes to escape or ameliorate the profound financial destruction of a bubble burst, the solution lies in this equation. Further, there are major economic benefits available in reducing deadweight costs and our very large tax expenditures by shrinking tax bases we know distort behavior and shedding the tax relief extended to preferred groups.

The generous scope of tax expenditures relating to the housing market has increased land costs. Tax expenditures are defined as a deviation from the commonly accepted tax structure, whether it is a tax exemption, concession, deduction, preferential rate, allowance, rebate, offset, credit or deferral. Australia has the highest rate of tax expenditures among our OECD peers, at more than 8 per cent of GDP.

Tax expenditures are vulnerable to lobbying, and compromise the fairness and efficiency of the tax system. Lavish tax expenditures for both owner-occupied and residential investment property has significantly worsened housing affordability. They allow landowners to capture greater amounts of land rent and prioritise unearned wealth and income over what is earned. Existing home owners capture the greatest benefit, ahead of first home buyers, investors and tenants.

The profound influence on human behavior of where and how governments choose to tax is amply demonstrated by the emergence of a very large cohort of negatively geared property investors – the overwhelming majority middle income earners seeking to escape the PAYE tax system, although the biggest income losses are made by high income negative gearers.

These tax expenditures, reinforced by already low property taxes, provide strong incentives to speculate on housing prices. Investors perceive rental income as secondary to expected rises in capital prices, while first home buyers over-leverage themselves to enter a bubble-inflated market.

In Australia, a perverse culture of homeowner entitlement is compounded by a degenerate taxation system that penalises hard work and innovation, while rewarding speculation.

A New Federalism

The ideal tool to moderate land bubbles and properly fund infrastructure already exists in the hands of state and territory governments: State Land Tax. Unfortunately, this tax has been so riddled with exemptions and concessional treatments it must be considered dormant. The states show no interest in, for example, removing conveyancing Stamp Duty or Payroll Tax – both very damaging tax bases - and funding this by also removing exemptions from SLT. They say they fear the political consequences.

We recommend the Abbott government introduce a nation-wide one per cent Federal Land Tax - fully rebatable on State Land Tax paid - to oblige the states and territories to migrate their revenue bases away from genuine economic injury. State governments could adjust their tax rules and keep every dollar the Federal Land Tax raises, to the great benefit of all Australians. The Commonwealth would be entitled to argue this intervention is for sound economic reasons and dissipate the political fallout.

Transitional arrangements would need to be considered. A logical solution is to credit all landowners with the amount of stamp duty paid and then deduct the hypothetical land tax they would have paid since the date of purchase. This would address much of the fairness question.

Placing state and territory finances on sound bases would vastly improve the federal system mandated by Australia's Constitution. It would also introduce a new dynamism into all levels of government and overall economic activity.

Conclusion

The Abbott government is confronted by hard choices that will determine Australia's future economic character and direction. Investor activity is currently deflected to speculation in residential property, notably in Sydney and Melbourne, by the sum of the economic incentives available here and in investment alternatives. If government chose the tax reforms we suggest, univeral prosperity and the pre-conditions for an economic Golden Age would emerge, elevating both rich and poor.

[i] This section is largely derived from *Housing shortage chimera rises* by Paul Egan and Philip Soos www.macrobusiness.com.au/2014/09/housing-shortage-chimera-rises/

[ii] www.taxreview.treasury.gov.au/content/html/commissioned_work/downloads/KPMG_Econtech_Efficiency%20of%20Taxes_Final_Report.pdf

[iii] www.prosper.org.au/2015/03/30/treasury-unearths-a-beautiful-tax/

[iv] www.ahuri.edu.au/downloads/publications/EvRevReports/AHURI_Final_Report_No182_The_spatial_and_distributional_impacts_of_the_Henry_Review_recommendations_on_stamp_duty_and_land_tax.pdf