

Final Report

A distributional analysis of the impact of indirect housing assistance

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EXECUTIVE SUMMARY

Home ownership in Australia is amongst the highest in the Western world. One factor that has contributed to this has been generous direct and indirect assistance provided by the Commonwealth government. When home ownership is the dominant tenure, the extent and impact of these fiscal subsidies needs to be reconsidered regularly and assessed against the housing assistance provided to other tenures. This paper contributes to such an assessment by providing estimates of the extent and distribution of the direct and indirect assistance provided to owner-occupiers. It has been motivated by a significant growth in real dwelling values and changes to the tax system since the mid 1980s that have resulted in increased tax concessions to owner-occupiers. The results presented provide a partial update of an earlier study by Flood and Yates (1987). The update will be finalised with the publication at the end of 2003 of work on direct assistance currently being undertaken by the Australian Institute of Health and Welfare. The AIHW have worked collaboratively with AHURI on this project to complete the assessment of both indirect and direct assistance to households across all tenures.

Chapter 1 provides an overview of the fiscal subsidies to home ownership currently provided by the Commonwealth government. Direct assistance has been re-introduced with the First Home Owner's Grant introduced to compensate for changes to the tax system. Indirect assistance provided through the tax system has been affected by changes in the tax system arising from the introduction of the GST, changes in the treatment of capital gains and from associated changes in income tax rates. Chapter 1 summarises the time series estimates provided in the Positioning Paper of the gross and net values of the stock owner-occupied housing in Australia over the past decade.

For 2001, these estimates indicate

- a gross value of owner-occupied housing wealth of just over \$1,000 billion
- a net value of owner-occupied housing wealth of just under \$800 billion
- a growth in real gross housing wealth of just under 4 per cent per annum from 1990 to 2001
- a growth in the real value of outstanding mortgage debt of just over 8 per cent per annum from 1990 to 2001
- a decrease in net equity in owner-occupied housing from 87 per cent in 1990 to 76 per cent in 2001
- a gross rental value of the owner-occupied housing stock of \$54 billion
- a net rental value (after operating costs) of \$42 billion with net rent less interest costs of \$25 billion.

The capital gains associated with the growth in the value of owner-occupied dwellings and the services provided by these dwellings (reflected in their rental value) provide the basis of the indirect assistance provided through the tax system. This assistance is measured against a tenure neutral benchmark that compares the tax treatment of owner-occupied housing with the tax treatment of rental housing in the income tax system. Exemptions from tax give rise to tax expenditures. These have the capacity to be both inefficient and inequitable.

In general, tax expenditures arise as a result of exemptions, deductions, rebates, imposition of a lower rate of tax or deferred liabilities. Under tenure neutrality, the tax expenditures for owner-occupied housing are derived by comparing the tax treatment of owner-occupied housing with the tax treatment of non owner-occupied housing (that is, rental housing). This means that, unlike the tax expenditure estimates provided in Treasury's annual tax expenditures statement, the concessional treatment of income from capital gains accorded to individual tax payers is not assessed as a tax expenditure because it applies both to owners of rental and owner-occupied housing.

In Australia, the primary source of indirect assistance to owner-occupiers arises from the income tax system through the non-taxation of capital gains and the non-taxation of imputed

rent (that is, the estimated rental value of their dwelling). This latter benefit, however, is offset by their inability to deduct their housing expenses. There are no non-tenure neutral tax expenditures associated with the GST. Section 2.1 of the paper provides an overview of these measures of indirect assistance to housing.

Section 2.2 summarises the aggregate estimates of tax expenditures for 1990 to 2001 presented in the Positioning Paper and based on the methodology outlined in that paper. For 2001, the level of indirect assistance provided to owner-occupied housing is estimated to equal \$21 billion.¹ This consists of

- \$13 billion arising from the non-taxation of capital gains under the post 1999 approach to taxing capital gains
- \$8 billion arising from the non-taxation of imputed rent, consisting of a \$13 billion benefit from the non-taxation of net imputed rent and a \$5 billion cost from the non-deductibility of mortgage interest costs.

On a per household basis, the total tax expenditures for owner-occupied housing in 2001 amounted to

- \$4,200 per household arising from \$2,600 from the capital gains tax exemption and
- \$1,600 per household arising from the net effect of the non-taxation of imputed rent.

In real terms, this is more than treble the \$1,200 total tax expenditures (in \$2001) estimated by Flood and Yates for 1985. The increase arises primarily from the exemption of owner-occupied housing when capital gains taxation was introduced.

The benefits of these tax expenditures for owner-occupied housing, however, are not distributed evenly across the population. The costs of the negative expenditures are borne solely by home purchasers. All owners enjoy the benefits of the positive expenditures. Section 2.3 of this paper summarises estimates of the distributional impact of the indirect assistance provided to owner-occupiers based on data from the 1999 Australian Housing Survey.

The survey data show that the benefits of the tax expenditures to home ownership result in low income owners receiving zero benefits (because their low incomes mean that they do not pay any tax) and high income owners in the top household income quintile receiving more than twice as much as households in the fourth quintile and more than three times as much as households in the third quintile. The indirect assistance to home owners provided through the tax system has a progressive impact only for households in the second income quintile (largely as a result of benefits provided to the high proportion of older outright owners whose current income is relatively low).

On average:²

- outright owners receive more than five times the amount of assistance provided to purchasers;
- high-income outright owners receive a total tax benefit of close to \$9,000 per household per year;

¹ The estimates of tax expenditures presented here do not estimate the revenue that would be raised by removing the relevant exemptions. The existence of tax concessions to owner-occupation most probably has encouraged home ownership, particularly amongst high wealth high income households and possibly has resulted in higher marginal and average tax rates than would otherwise have been the case because of the narrower income base on which taxes are imposed. In the same way, their removal might lead to reversals of behaviour regarding home ownership and to compensating changes in tax rates with changes in the tax base. These issues are discussed in Treasury's annual Tax Expenditures Statement, (eg Treasury, 2002). The estimates presented indicate the extent of the indirect assistance provided to owner-occupier households.

² The estimates that follow are based on conservative assumptions that yield an average per household total tax expenditure of \$2,800 (or just over \$3000 in \$2001), which is only two thirds of the estimate based on the aggregate data for 2001 presented in section 2.2 but which is 90 per cent of the average over the period. Section 2.5 of the paper provides a sensitivity analysis and presents distributional results consistent with these aggregate data.

- home purchasers in the bottom 80 per cent of the income distribution receive a benefit of less than \$500 per household per year through the tax system.

In broad terms, those who benefit most are high-income households who live in high valued dwellings and have little housing debt. While the benefits to high-income older households are considerably greater than those enjoyed by younger households, households with a head over 65 years old make up just 4 per cent of high-income home owners. Conversely, young lower-income purchasers aged between 25 and 45 with incomes in the three lowest quintiles, who account for only 14 per cent of purchasers in this age range, receive minimal assistance. It is this group of households for whom 1986 and 1996 census data indicate that home purchaser rates declined the most dramatically over the decade. It is this group who are most in need of assistance if home ownership policies are to expand home ownership.

Section 2.4 provides results that are spatially disaggregated. These show that the perverse distribution of indirect assistance to owner-occupiers by income and by age is exacerbated by spatial variations in dwelling values, housing equity and household income across regions. The average level of indirect assistance to owner-occupier households in NSW, for example, is 3.5 times that provided to owner-occupier households in Tasmania and the average level of indirect assistance provided to owner-occupier households in Sydney is 4.5 times that provided to that owner-occupier households in Tasmania.

In general, the spatial distribution of the indirect assistance provided to owner-occupiers through the tax expenditures associated with the Commonwealth income tax system is such that it benefits those households already the most advantaged by high incomes and high equity in owner-occupied housing. These data mirror those discussed in the previous section for Australia as a whole. They suggest that in virtually every region, almost half of the total value of tax expenditures is distributed to households in the top income quintile, with none going to those in the lowest income quintile (because these households are presumed to have a zero marginal tax rate).

Section 2.5 provides a brief sensitivity analysis of the extent to which the tax expenditures estimated from survey data vary with the assumptions made. The simulations highlight the results that can be expected. The lower is the gross rental return, the more important is the negative tax expenditure associated with the inability to deduct interest costs and the greater is the burden borne by home purchasers. In all instances, the distribution of benefits by household income and age and across the different regions follows the same patterns as indicated in sections 2.3 and 2.4. The conclusions reached remain unchanged. The greatest benefits go to those outright owners who are in the top income bracket on the highest incomes and who own dwellings with the highest capital values (which, on average, means in NSW or, more specifically, in Sydney). The least benefits go to households in the lowest income quintiles and to those who still have significant mortgages on their properties. Most of those owner-occupier households who have relatively low equity in their dwellings are young households although not all young highly geared purchasers are low income households since it is often only higher income households who are able to service higher value mortgages.

The results presented in this paper suggest that, as a consequence of the considerable degree of tax reform that has occurred in Australia in the past 15 years, concerns about the structure of housing assistance that were highlighted well over a decade ago have become more pronounced. The indirect assistance provided through tax expenditures has increased and, on average, continues to provide most assistance to those households who need it least.

The outcomes for direct assistance are similar. Policies in the 1980s were generally ineffective in assisting into home ownership those households for whom home ownership was both beneficial and sustainable and who would not have achieved it in the absence of the support provided. There is no indication that current policies are any different and considerable evidence that they are more costly now than they were in the 1980s. Deposit assistance continues to be used as an instrument of stabilisation policy.

The final chapter in this paper points to some of the costs associated with providing non-targeted support to home-ownership, questions the wisdom of providing the maximum levels of assistance to those who need it most and signals some of the policy options that might be considered at a Commonwealth level.

These policy options include:

- inclusion of estimates of the tax expenditures for owner-occupied housing in Treasury's annual Tax Expenditures Statement;
- introduction of mortgage interest deductibility for new entrants into home ownership in return for payment of an imputed rent tax once the net effect is positive (as equity builds up) and a capital gains tax on sale. Such a policy could require restrictions to limit potentially adverse effects;
- introduction of a capital gains tax for gains on owner occupied housing above a given value (such as \$1m) with deferral of tax liability until death for asset rich, income poor households;
- better targeting of FHOG;
- recouping FHOG.

Detailed consideration of policy options is beyond the scope of this paper. This notwithstanding, the results presented, which clearly highlight the extent to which the indirect assistance provided for housing dominates the direct assistance, suggest that a reconsideration of current housing policy is called for. The paper provides aggregate estimates of indirect assistance of \$21 billion in 2001. This is far in excess of the direct assistance of approximately \$1 billion per year in the last 2 years provided under the First Home Owners' Grant, the less than \$1 billion per year in Commonwealth funding provided for public rental through the Commonwealth State Housing Agreement, and the just under \$2 billion per year provided in Rent Assistance through the social security system. Unlike much of the direct assistance, the indirect assistance provided to home ownership is poorly targeted.

The results highlight the need for a broad interpretation to be taken of housing assistance. They point to the significant, if unintended, impact of Commonwealth tax policies on the housing system. The overwhelming value of indirect assistance through the Commonwealth taxation system suggests that housing policy needs to be evaluated and developed at a national level.

Whilst home ownership is likely to remain both the dominant and preferred tenure in Australia, the question of how it is, and how it best can be, supported is one that needs to be exposed to as critical an assessment as paid to the much less generous support provided to those in rental housing. The current system of evaluation of indirect compared with direct assistance for housing suggests one rule for the rich and one for the poor.

1. HOME OWNERSHIP ASSISTANCE IN AUSTRALIA

1.1 Background

Australia has had a long history of high home ownership rates. The proportion of households who own their own homes reached a peak of 70 per cent more than forty years ago and has remained at more or less at this level since then. One factor that has contributed to this high home ownership rate has been generous direct and indirect housing assistance funded by the Commonwealth government. An overview of Australia's home ownership policies until the mid 1990s and details of the early home purchase subsidy schemes can be found in Bourassa et al (1995). A broader overview of housing subsidies prior to 1990 can be found in Wood (1990).

Direct assistance has been provided primarily through a variety of deposit assistance programs targeted at marginal first home buyers. Such assistance, however, was suspended in 1990 with the cessation of the First Home Owner's Scheme, the last in a long series of deposit assistance schemes that dated back to the 1960s. The withdrawal of Commonwealth funded assistance occurred at a time when the first concerns were beginning to be expressed about the sustainability of these historically high home ownership rates in light of declines observed in home ownership rates amongst younger households (Yates, 2000). Direct assistance was not reinstated until July 2000 in conjunction with changes to the tax system to be considered below.

Past critics of direct assistance schemes that provided deposit assistance to home purchasers argued these merely brought forward home purchase for those who ultimately would have entered home ownership without such assistance (Kendig et al. 1987; Paris 1993, Thorns 1988). Bourassa et al. (1994), for example, estimated that elimination of the First Home Owners Scheme would have delayed purchase by an average of just two years for young households. This provided one rationale for their cessation in 1990. A second explanation for the scheme's demise was that the assistance provided was insensitive to regional differences in house prices and did not assist those who were most in need of it (Bourassa et al. 1995).³

When home ownership is the major tenure, however, a focus on the direct assistance provided to first homebuyers provides a narrow base from which to assess the extent of assistance provided to owner-occupied housing. A significant volume of indirect assistance for owner-occupation has been, and continues to be, provided through the tax system. The main source of this assistance is that provided through the (Commonwealth) income tax system via a system of exemptions or concessions for owner-occupied housing. Details of these will be provided below. In short, unlike other owners of housing in Australia, owner-occupiers are exempt from capital gains tax and pay no tax on the (imputed) income derived from their housing. Unlike mortgaged landlords, however, interest payments for mortgaged owner-occupiers are not tax deductible so that home purchasers cannot take advantage of negative gearing opportunities.

For the tax system that operated in Australia until the mid 1980s, the indirect assistance provided through the income tax system both overwhelmed the direct assistance provided to home purchasers and disproportionately benefited higher income outright owner-occupiers no longer in need of assistance (Flood and Yates 1987, 1989).

The Flood and Yates study, which provided a comprehensive assessment of the extent of housing subsidies in the mid 1980s, generated the first detailed estimates of the tax expenditures associated with owner-occupied housing in Australia. These estimates were

³ At various stages this direct deposit assistance from the Commonwealth has been supplemented by home purchase assistance schemes operated by State governments but new funding for these, too, effectively ceased with the withdrawal of Commonwealth support. Until 2000, when the new tax system was introduced, there was a considerable degree of fiscal imbalance between the three levels of government in Australia. This imbalance has been addressed through a system of intergovernmental grants of both a tied and untied nature from higher to lower levels of government. In part this explains the dominant role of the Commonwealth in funding housing assistance. The implications of changes in the tax system form part of the rationale for the analysis to be presented in this paper. The additional indirect assistance provided to homeowners through the operation of the current pension system is outside the scope of this paper.

revisited by Flood (1993) as background for an Industry Commission report on Housing Assistance (Industry Commission, 1993). Despite the considerable changes that have taken place since these early studies, however, there has been no subsequent attempt to examine the structure of indirect housing assistance to owner-occupiers in Australia and no attempt to determine whether or how this has changed in light of significant changes that have taken place since the mid 1980s. This paper addresses this shortcoming. In particular, it examines the extent to which the indirect assistance provided to home ownership in Australia through the Commonwealth taxation system has increased or decreased and the extent to which that provided is more or less targeted to those who may be seen as most in need of it.

The work presented in this paper, therefore, represents only a partial update of the Flood and Yates study on direct and indirect assistance. The update of assistance provided by the Commonwealth government will be finalised with the publication at the end of 2003 of work on direct assistance currently being undertaken by the Australian Institute of Health and Welfare. The AIHW have worked collaboratively with AHURI on this project to complete the assessment of both indirect and direct assistance to households across all tenures.

1.2. Changes affecting assistance to home ownership

A number of changes are likely to have affected the magnitude and impact of assistance provided to home owners since the mid 1980s. Of these, changes to the tax system, changes in the structure of direct assistance and changes in the value of owner-occupied housing wealth and related changes in rents are critical.

Tax reform

In July 2000, a new tax system (ANTS) was introduced.⁴ A key component of this was the introduction of a broad based goods and services tax (GST) with a concomitant reduction in the reliance on income taxes as a source of government revenue and the abolition of a range of narrow based indirect taxes by both the Commonwealth and the States. The introduction of the GST resulted in a consumption tax in which the vast majority of, but not all, goods and services are taxed at a flat rate of 10 per cent rate. The tax is a value added tax with credits received for any GST already paid. There are two types of exemptions from the tax: GST free in which supplies are not taxed and credit is available for any embedded GST (this is equivalent to zero rating) and tax exempt (or input taxed), in which supplies are not taxed, but no credit is available for any embedded GST. Residential rents and sale of residential dwellings are input taxed.

The failure to zero rate residential housing led to concerns that dwelling prices of new houses would rise because of the effect of higher input costs. Official estimates suggested the impact of the GST would increase the price of new homes by 4.7 per cent (Costello, 1998:97). The First Home Owners' Grant (details of which will be outlined below) was introduced to compensate for this projected increase.

Along with the broadening of the consumption tax base, tax reforms have also broadened the income tax base. In terms of their potential impact on housing, these changes to the income tax base are likely to be as or more significant than changes in the consumption tax base. The most significant of these relates to changes in capital gains taxation under the current government as a part of the Review of Business Taxation (Ralph, 1999). These changes, however, built on more significant changes introduced in 1985 as a result of an earlier reform of the tax system under a previous government (Keating, 1985).

Prior to 1985, capital gains in Australia were untaxed. The reforms of 1985 introduced a capital gains tax (CGT) that applied to real, realised capital gains made on assets purchased after 19 September 1985. Any capital gains over an indexed cost base were included in taxpayer's income and were taxed at the appropriate (marginal) income tax rate. Owner-occupied housing was exempt from this broadening of the income tax base.

⁴ Details of The New Tax System can be found in Costello (1998), on the tax reform website, <http://www.taxreform.gov.au/>, or on Treasury's home page, <http://www.treasury.gov.au/>, via the tax reform links

In 1999, as a result of the Ralph Review of Business Taxation, indexation of the cost base of the asset was frozen as at 30 September 1999 and a discount approach to estimating capital gains tax was introduced. Under the discount method, there is no indexation of the cost base, but realised capital gains are discounted by 50 per cent for individuals and trusts. Effectively this approach results in 50 per cent of nominal capital gains being added to taxable income upon realisation. Taxable income is then taxed according to the current income tax scale. This system applies to all new assets but owners of existing assets were given a choice of assessing their capital gains tax liability under either of the capital gains tax regimes.⁵ As with the 1985 tax reforms, owner-occupied housing remained exempt.

The additional revenue raised from the introduction of a broad based consumption tax and by the broadening of the income tax base, was partly used to fund cuts to income tax rates from 1 July 2000. Reductions in income tax rates serve to reduce the benefits arising from untaxed income associated with housing.⁶

The First Home Owners Grant

After a decade of no direct assistance for home ownership from the Commonwealth, the First Home Owner's Grant (FHOG) was introduced on 1 July 2000 in order to offset the anticipated impact on house prices of the introduction of the GST. These grants provided first home buyers with a one-off \$7,000 payment which was seen as providing more than adequate compensation for expected price increases on dwellings with a construction cost (that is, excluding land value) of up to \$150,000 (Costello, 1998:97). Unlike its predecessor, the First Home Owner's Scheme (FHOS), there was no means test on applicants and no restriction on the value of property that could be purchased with this assistance. Eligible applicants were also entitled to an additional grant of \$7,000 if they purchased or built a new home between 9 March 2001 and 31 December 2001.⁷

Housing wealth in Australia

A stated rationale for the re-introduction of this direct assistance provided to first home buyers was to deal with problems of access arising from higher house prices. However, high house prices and increasing wealth, in turn, affect the amount of indirect assistance provided to home owners through the tax system. Over the past decade, Australia has experienced rising housing wealth as a result of a long boom in house prices. This trend has been associated with a rising house price to income ratio.⁸ A number of factors have underpinned rising real house prices. Amongst these are a steady growth in the number of households, a period of unprecedented real income growth, increased availability of mortgage finance and declining interest rates associated with a low inflation environment (RBA 2002:31). At the same time, however, these latter factors have encouraged increasing household debt.

In 2001, the total value of housing wealth in Australia was equal to just under \$1,400 billion, which amounted to 49 per cent of gross household wealth. The increase in value from \$926b in 1990 represents an annualised growth in real housing wealth of almost 4 per cent per annum. Whilst some of this (less than 2 per cent) arises from the increase in the number of dwellings over the period, more than 2 per cent per annum arises from a growth in real housing wealth per household. This growth over the past decade signals a significant financial

⁵ Current information can be obtained from the Australian Tax Office website, www.ato.gov.au. The taxpayer may use whichever method is most advantageous. Over time, the discount method is likely to be more attractive as a result of freezing of the indexation factor. The relative benefit provided by the new discount method over the old indexation method will vary with the level of inflation and the extent of real capital gains. Wood (2000:17) shows that, unless rates of property price inflation are more than double the rate of inflation, property owners will have a higher capital gains tax liability under the 1999 tax system.

⁶ The personal income tax rates that have applied since 1989-90 are presented in the Positioning Paper.

⁷ This additional grant was reduced to \$3,000 on 1 January 2002 and ceased on 1 July 2002. The \$7,000 grant under the original scheme, however, has continued beyond July 2002 for eligible first home buyers. Details of this scheme and subsequent changes to it can be found on the FHOG website, <http://www.firsthome.gov.au>.

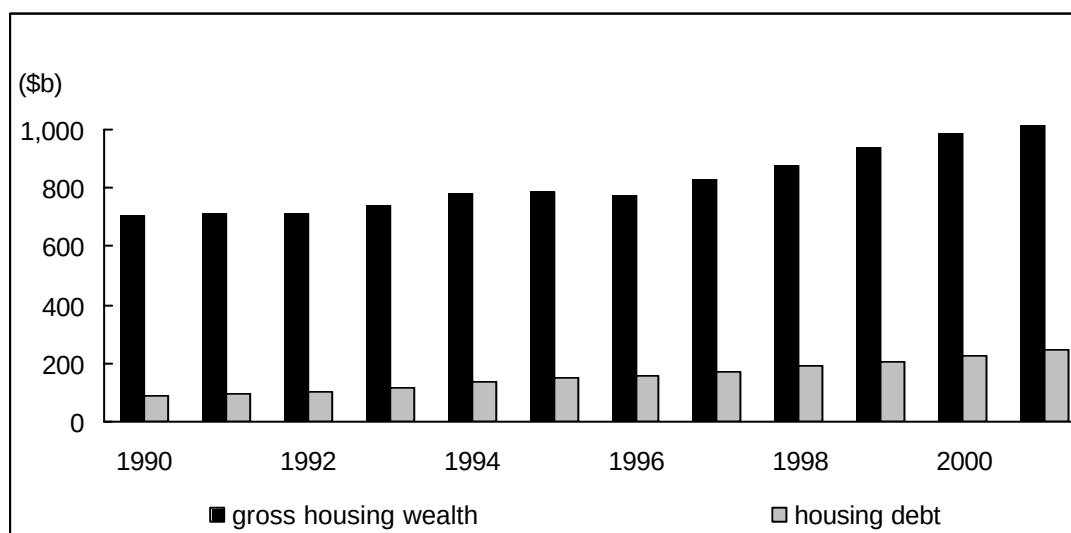
⁸ In the May 2002 quarterly Statement on Monetary Policy, the Reserve Bank of Australia reports an increase in the house price to average earnings ratio from 5.5 in 1990 (down from its previous peak of 6.5 in 1989) to just under 8 in 2001.

benefit derived by those who own Australia's housing stock. This benefit, however, is partially offset by the increase in housing debt.

By 2001, owner-occupied housing was estimated to account for just over \$1,000b of this total, whilst the mortgage debt outstanding on owner-occupied housing amounted to \$246b, resulting in a 76 per cent net equity in owner-occupied housing and net owner-occupied housing wealth of just under \$800b in 2001.⁹ The real value of owner-occupied housing wealth and the mortgage debt associated with home ownership over the period 1990 to 2001 are illustrated in Figure 1 below. Between 1990 and 2001, the real value of owner-occupied dwellings in Australia increased by an average of \$27b per year, with an annual variation ranging from a decline in aggregate value of \$11b in 1996 to an increase in aggregate value of \$61b in 1999.¹⁰

This increase in the real value of housing wealth has generated an increase in the real value of actual and imputed rents.¹¹ Key components of the estimated rental value of owner-occupied housing are summarised in the first 5 columns of Table 1 below. These data suggest a growth of more than 3 per cent per annum in the aggregate real value of each of these key components of income from owner-occupied dwellings (gross rents, net rent, and net rent less interest) with an implied growth of approximately 1 per cent per annum in their real values per household over the decade to 2001.

Figure 1: Value of owner-occupied housing assets and liabilities (\$2001)



Source:

Australian National Accounts Household Balance Sheet, ABS Cat No 5204.0, Table 46

RBA Statistical Tables B16+D02 (mortgage loans outstanding only), <http://www.rba.gov.au>

The final two columns in Table 1 give the real and nominal values of the annual increase in the value of owner-occupied dwellings as implied by the data illustrated in Figure 1. Whilst these capital gains remain unrealised for the vast majority of households, they do reflect the increases in value of the owner-occupied stock.

⁹ The two most readily available and comprehensive data sources for housing wealth (from ABS and Treasury) report total housing wealth either for households or for the private sector as a whole. These data need to be disaggregated to provide estimates of owner-occupied housing wealth held by the household sector. Data on the increasing real value of housing assets and liabilities held by households over the decade were provided in the Positioning Paper for this report as were estimates of the contribution made by owner-occupied housing to these data and the methodology for deriving these estimates.

¹⁰ These data reflect a combination of an increase in the housing stock and an increase in the unit value of this stock. The data pre-date the house price boom of 2002 and post-date that of 1989 and so the average capital gains presented in this paper reflect neither of these significant upswings. However, the overall value of dwellings does reflect the effect of the boom at the end of the 1980s.

¹¹ Time series data for these are available in the National Accounts data and were reported in the Positioning Paper.

Table 1: Income from owner-occupied dwellings (\$2001)

	Imputed rent	Operating costs	Net rent	Interest	Net rent less interest	Real value of nominal capital gains	Nominal capital gains
	\$b (\$2001)	\$b (\$2001)	\$b (\$2001)	\$b (\$2001)	\$b (\$2001)	\$b (\$2001)	\$b
1990	38	7	30	12	18	62	48
1991	40	8	32	12	19	36	28
1992	42	8	33	10	22	5	4
1993	43	9	33	9	23	43	35
1994	44	10	34	9	24	51	42
1995	44	10	34	12	22	41	36
1996	45	10	34	14	20	13	11
1997	47	10	37	12	24	55	49
1998	50	10	39	13	27	56	50
1999	52	10	41	13	28	70	64
2000	54	10	43	15	28	78	74
2001	54	11	42	17	25	84	84

Source: Positioning Paper, Tables 7 and 11, in turn, primarily based on Australian System of National Accounts, ABS Cat. No 5204, Table 57 Income from Dwelling Rent and Table 46 Household Balance Sheet.

2. INDIRECT ASSISTANCE TO HOME OWNERSHIP

2.1 Measures of indirect assistance

The growth in the real value of housing wealth and in the value of services provided by Australia's housing stock along with the changes to the tax system highlights the need for a reassessment of the extent of indirect assistance provided to home ownership through the tax system. This assistance arises primarily because the income from housing is treated differently for owner-occupiers than it is for landlords.

Landlords are required to pay tax on the rent generated by any rental property (after interest costs and operating costs are taken into account) and are required to pay tax on any capital gains that accrue when this property is sold. Owner-occupiers on the other hand, are exempt from both of these tax liabilities. These exemptions give rise to a non-tenure neutral treatment of housing (housing is taxed differently depending on its use) and result in what are called "tax expenditures" to owner-occupied housing - they provide an implicit subsidy to owner-occupiers and reflect a loss of potential tax revenue in the Commonwealth budget.

The estimates of tax expenditures presented in the following sections of this report are not estimates of the revenue that would be raised by removing the relevant exemptions. They are estimates of the extent of the indirect assistance provided to owner-occupier households because of the existence of such exemptions.

The existence of tax concessions to owner-occupation most probably has encouraged home ownership, particularly amongst high wealth, high income households and possibly has resulted in higher marginal and average tax rates than would otherwise have been the case because of the narrower income base on which taxes are imposed. Their removal might lead to reversals of behaviour regarding home ownership and to compensating changes in tax rates with changes in the tax base. It is for these reasons, that the estimates presented are not estimates of revenue foregone. These issues are discussed in Treasury's annual Tax Expenditures Statement, (eg Treasury, 2002).

Tax expenditures can be assessed against a number of different benchmarks.¹² One key advantage for this paper's use of tenure neutrality as a benchmark for determining the extent of assistance provided to home ownership through the taxation system is that it can be applied consistently for any tax relevant base - both to the income and consumption taxes that are the key taxes implemented at a national level in Australia and to the various taxes and charges such as land taxes and stamp duties that are implemented at a state level in Australia. These latter taxes are outside the scope of this study, but similar issues arise when owners of housing are treated differently depending on whether their housing is owner-occupied or rented. Differential treatment of housing depending on its use is likely both to encourage owner-occupation at the expense of ownership of rental housing.

The tax reforms that have taken place in the Australian tax system since the mid 1980s have both introduced new forms of assistance to owner-occupiers as well as maintaining past forms of assistance as assessed against a tenure neutral benchmark.

Within the income tax system, new forms of assistance have arisen through the introduction of the capital gains tax (CGT) in 1985 and its subsequent reformulation in 1999. This tax applied to all assets other than owner-occupied housing. This introduced a tax concession to owner-occupiers that had not been present prior to the broadening of the income tax base brought about by capital gains taxation. Under the pre-1999 regime, the CGT applied to real, realised gains on assets purchased after 1985. In 1999, cost indexation was frozen and the capital gains tax now applies to nominal realised gains with a discounted rate for individuals.¹³

¹² The Positioning Paper outlines what is called a hierarchy of measures including Treasury's commonly accepted benchmark (which is shown to have consistency neither over time nor between countries), tenure neutrality (which can be consistently defined for any given tax base in any country), tax neutrality (which is difficult to define). It provides an overview of these various options and provides a justification for the use of tenure neutrality as a benchmark.

¹³ Taxpayers may choose whichever method is advantageous but over time the discount approach is more likely to be advantageous because of the freezing of the indexation factor (Wood, 2000).

The existing forms of assistance that have been maintained within the income tax system arise from the non-taxation of imputed rent (and the non-deductibility of expenses incurred in earning that income). Although imputed rent is included in the income tax base in only a limited number of countries, its exclusion is widely accepted as contributing to a non-tenure neutral treatment of housing. Haffner (2002) provides a good overview of the current and changing tax treatment of imputed rent in 11 European countries. Her summary table is reproduced in Table 2.

Table 2: International treatment of imputed rent taxation

	Taxation of imputed rent	Mortgage interest rate deduction
Belgium	Still exists	Still exists (limited)
Denmark	Replaced by property tax in 2000	Still exists (unlimited, lower tax rate applies)
Finland	Replaced by property tax in 1993	Still exists (unlimited)
France	Removed in 1965	Removed in 1997 for construction, in 1998 for existing dwellings
Germany	Removed in 1987	Removed in 1987, other deductions extended
Italy	Still exists, deductions negated impact in 2000	Still exists (limited)
Netherlands	Still exists	Still exists (unlimited)
Norway	Still exists	Still exists (unlimited)
Sweden	Replaced by national property tax in 1991	Still exists (unlimited)
Switzerland	Still exists, but abolition proposed	Still exists (limited in 2001, further limit proposed)
United Kingdom	Removed in 1963	Removed in 2000
United States of America	Not taxed	Still exists (limited to loans less than \$US 1million)

Source: Haffner (2002) for European countries; Bourassa and Grigsby (2000) for USA

The exemption of net imputed rent from the tax base results in a positive tax expenditure for owner-occupiers. The inability to deduct mortgage interest payments results in an offsetting negative tax expenditure.¹⁴

¹⁴ Chapter 2 of the Positioning Paper outlines some of the debates over the inclusion or exclusion of one or both of the income measures included in Table 2. The Positioning Paper also provides an explanation as to why negative gearing is not regarded as a housing specific tax expenditure and, therefore, why it is not included in this paper. Use of tenure neutrality as a benchmark explains why the impact of the GST is excluded from consideration. In Australia, residential rents are input taxed with the result that both landlords and owner-occupiers are not required to pay tax on the rental services provided by housing but are unable to claim the tax paid on any expenditures associated with the operating costs associated with dwelling ownership. In this sense, the treatment of housing is tenure neutral. However, the exemption of rent, whether actual or imputed, from the sales tax base adds a tax advantage to housing vis a vis other goods and services.

2.2 Aggregate estimates of indirect assistance

Aggregate estimates of the tax expenditures arising from the two major forms of indirect assistance indicated above (that is, from the capital gains tax exemption and from the non-taxation of imputed rent) can be derived from the annual National Accounts data presented in Table 1 and from annual taxation data from the Tax Office.

Table 3 below summarises these estimates. The tax expenditures associated with the capital gains tax exemption are based on the tax regime introduced in 1999.¹⁵

Table 3: Aggregate tax expenditures, Australia (\$2001)

	Marginal tax rate on average income	Capital gains tax exemption	Imputed rent exemption		
		Discount method	Non taxation net imputed rent	Non deductibility of interest	Net effect of imputed rent exemption
	%	\$b(\$2001)	\$b (\$2001)	\$b (\$2001)	\$b (\$2001)
1990	38.15	12	11	-5	7
1991	38.15	7	12	-5	7
1992	38.15	1	12	-4	9
1993	38.15	8	13	-4	9
1994	36.9	9	12	-3	9
1995	35.5	7	12	-4	8
1996	35.5	2	12	-5	7
1997	35.5	10	13	-4	9
1998	35.5	10	14	-5	9
1999	35.5	12	15	-5	10
2000	35.5	14	15	-5	10
2001	31.5	13	13	-5	8

Source: Positioning paper, Table 11 and Table 12, in turn, primarily based on Australian System of National Accounts, ABS Cat. No 5204, Table 57 Income from Dwelling Rent and Table 46 Household Balance Sheet and Annual Tax Packs and Budget Papers.

The tax expenditures associated with the non-taxation of imputed rent are separated into the positive tax expenditures arising from the non-taxation of net rental income and the negative expenditure arising from the non-deductibility of mortgage interest. Over the time period covered by this study, marginal tax rates on average incomes declined from 38.15 per cent prior to 1993 to 31.5 per cent by 2001. The effect of this decline in tax rates is to offset the increase in indirect assistance arising from increases in the real value of untaxed income associated with the rising values of rents and capital gains.

The results presented in Table 3 indicated that, under the current income tax system, the average real value of the tax expenditures associated with capital gains taxation amounted to \$13b in 2001 and would have averaged almost \$9 billion per year had the discount approach been implemented throughout the period.

On average over the period, the aggregate estimates of the net benefit from the tax expenditures associated with the non-taxation of imputed rent are of the same order of magnitude as those provided by the capital gains tax exemption. In real terms the net benefit has been relative stable, amounting to \$8b in 2001 and averaging the same real value over the period under consideration. In part, this stability arises from an increasing real value of the exemption of the net rental income being offset by an increasing real cost of non-deductible mortgage interest costs.

¹⁵ The marginally higher and more volatile estimates based on the pre-1999 indexation method are presented in Table 11 in the Positioning Paper and full details of the relevant tax scales are provided in Table 10. Details of assumptions employed in deriving the results presented in Table 3 are outlined and discussed in chapter 3 of the Positioning Paper. Key assumptions relate to the exclusion of the superannuation surcharge from the marginal tax rates employed, to the use of annual capital gains to approximate the liability incurred by accrued capital gains upon realisation, and to the disregard of the grandfathering clause regarding capital gains on properties owned before 1985.

These aggregate estimates suggest that the tax concession accorded to owner-occupied housing as a result of the capital gains tax exemption alone is equivalent to more than 1 per cent of GDP. This is of the same order of magnitude as that accorded to superannuation in 2001.¹⁶ The total tax expenditures to owner-occupied housing of \$21b in 2001 are equivalent to approximately 3 per cent of GDP.

Table 4 presents the equivalent data on a per household basis.

These data show the indirect assistance provided to owner-occupier households amounted to \$4,200 per household in 2001, consisting of \$2,600 for the CGT exemption and \$2,600 per household for the non-taxation of imputed rent, less \$1,100 for the non-deductibility of mortgage interest. The data show these tax expenditures have been both significant and relatively constant throughout the decade. The table does not highlight the significant increase in the value of tax expenditures to owner-occupied housing brought about by the introduction of capital gains taxation in 1985 and by the exemption of owner-occupied housing from this tax.

This increase can be seen by comparing the results in Table 4 with those of Flood and Yates (1987). Using the same basic methodology as employed in this paper, they estimated total tax expenditures amounted to \$4.4 billion measured in current \$2001 values. This gave an implied estimate of the real value of assistance of \$1,200 per owner-occupier household made up of a positive benefit of \$2,400 from the non-taxation of net imputed income and a \$1,200 cost associated with not being unable to deduct their mortgage costs. Thus, the results suggest that the real value to owner-occupiers of the imputed rent tax expenditures that were untouched by the tax reforms since 1985 is broadly of the same order of magnitude in 2001 as it was in 1985.

The major difference between the 1985 and 2001 results, however, arises from the additional tax expenditure introduced post 1985 as a result of the introduction of a capital gains tax that exempted gains on owner-occupied housing. The value of this exemption has meant the real value of total tax expenditure for owner-occupied housing in 2001, at \$4,200 per household, was more than treble the 1985 value of \$1,200 per household.

Table 4: Per household tax expenditures, Australia (\$2001)

	Non taxation capital gains - discount method	Non taxation net imputed rent	Non deductibility of interest	Net effect of imputed rent exemption	Total
	\$ pa(\$2001)	\$ pa(\$2001)	\$ pa(\$2001)	\$ pa(\$2001)	\$ pa(\$2001)
1990	2,800	2,700	-1,100	1,600	4,400
1991	1,600	2,800	-1,100	1,700	3,300
1992	200	2,800	-900	1,900	2,100
1993	1,800	2,800	-800	2,000	3,800
1994	2,000	2,700	-700	1,900	4,000
1995	1,600	2,500	-900	1,700	3,200
1996	500	2,500	-1,000	1,500	2,000
1997	2,000	2,700	-900	1,800	3,700
1998	2,000	2,800	-900	1,900	3,900
1999	2,500	2,900	-1,000	2,000	4,500
2000	2,800	3,000	-1,100	2,000	4,700
2001	2,600	2,600	-1,100	1,600	4,200

Source:

Table 3 above, and Annual Tax Packs and Budget Papers, various years

Australian National Accounts Household Balance Sheet ABS Cat. No. 5204, Table 46

System of National Accounts, ABS Cat. No 5204, Table 57

Household and Family Projections, ABS Cat No 3236.0

¹⁶ The concessions to superannuation, in turn, represented 30 per cent of total tax expenditures (estimated by Treasury to have a value of \$30 billion in 2001).

The benefits of these tax expenditures for owner-occupied housing are not distributed evenly across the population. All owners enjoy the benefits of the positive tax expenditures. The costs of the negative tax expenditures, however, are borne solely by home purchasers. It is not clear, on a priori grounds, what the overall implication of this asymmetric distribution is likely to be. Positive benefits depend on the value of owner-occupied dwellings, the capital gains enjoyed and on the homeowner's marginal tax rate. Negative costs depend on the amount paid out in interest costs and also on the homeowner's marginal tax rate. Outright owners may have high or low incomes, and hence high or low marginal tax rates, depending primarily on their life stage. Home purchasers, on the other hand, generally tend to have higher incomes than those who do not or cannot enter owner-occupation. A complex range of factors influence dwelling values. Life stage and location are two that will be examined below.

The following section provides estimates of the extent to which different households from the increased indirect assistance provided to owner-occupiers under the Australian tax system.

2.3 Distributional estimates of indirect assistance

The distributional information presented in this section is based on the 1999 Australian Housing Survey with a final sample of 13,800 households across Australia. An overview of this survey can be found in ABS (2000c). In the first instance, capital gains are based on a conservative assumption of an underlying trend rate of 3 per cent per annum growth rate in *nominal* house prices. Gross rents are estimated by applying the gross rental rate of return implicit in the aggregate data reported in the previous section to the dwelling values reported in the survey. Net rents are derived from the estimated gross rents by subtracting reported operating costs. Interest paid is derived from the value of the mortgage debt outstanding and the current rate of interest on loans to owner-occupiers.

This section provides updates of the preliminary estimates provided in the Positioning Paper for Australia as a whole.¹⁷ The following section presents data at a state wide level to supplement the Australia wide level reported here and provides a brief indication of the sensitivity of the results to the assumptions outlined above.

These assumptions generated an average total tax expenditure benefit of \$2,800 per household in 1999.¹⁸ This arises from owner-occupation of dwellings that had an Australia wide average value of \$222,000 in 1999 and for which there was an average of \$94,000 in outstanding mortgage debt.

Figure 2 illustrates how the tax expenditures for all owners, outright owners and owner-purchasers have been distributed according to household income given the assumptions outlined above. The results illustrated in Figure 2 clearly show the strong bias towards high-income outright owners that arise from the positive benefits of the net imputed rent and capital gains exemptions in the current income tax system. The data that underpin the results are presented in Tables A.1 and A.2 in Appendix A.

High-income owner-occupiers received an average total benefit of \$4,700 in 1999 from the tax expenditure to their owner-occupied housing. Owner-occupiers in the lowest income quintile received \$0. These concessions, which apply to all owners, are offset for purchasers by the non-deductibility of interest costs. Outright owners received an average total benefit of \$4,400 close to five times the benefit than that received by purchasers. High-income outright owners received a total tax benefit of \$8,800 per household in contrast to \$2,100 received by high-income purchasers. Low-income outright owners and low-income purchasers received \$0. The impact of age on these results will be shown below.

¹⁷ The detailed methodology employed in estimating the tax expenditures is presented in chapter 3 of the Positioning Paper with the background to, and rationale for, the assumptions made being provided in section 3.2 of that paper. The data presented in this report differ marginally, but not in any substantive way, from the preliminary estimates presented in the Positioning Paper because of some minor errors in the treatment of data with missing values in the first set of results.

¹⁸ This is equivalent to just over \$3,000 in 2001, and is well below the average per household estimate of \$4,500 for 1999 reported in Table 4. This is primarily due to the extremely conservative assumption made about the extent of capital gains. The sensitivity of the results to this assumption will be reported below.

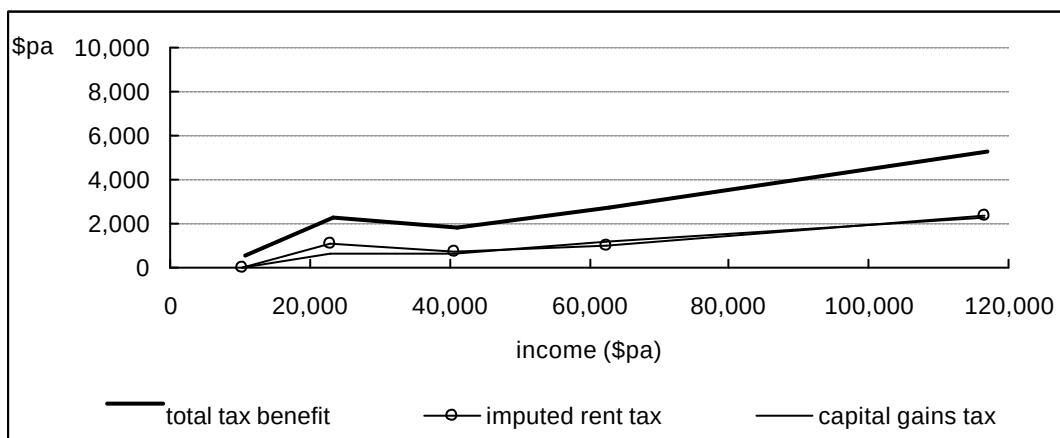
Households in the bottom quintile receive no benefits from this form of assistance because their incomes are below the tax threshold. Households in the top income quintile receive average benefits that, in absolute terms, are three times higher than those received by households in the second and third income quintiles. Outright owners in the top income quintile receive a benefit that is four times higher than the benefit received by low-income outright owners. Purchasers in the top income quintile receive a benefit that is more than six times that received by purchasers in lower income quintiles and more than four times that received by purchasers with moderate to high incomes.

As can be seen from the data reported in Tables A.1 and A.2, these outcomes can be attributed as much to the progressivity of the marginal tax rates in the current Australian income tax system as to the differentials in dwelling values. Marginal tax rates for high-income earners are almost 2.5 those of low-income earners. Dwelling values for high-income households are less than double those of lower income households.

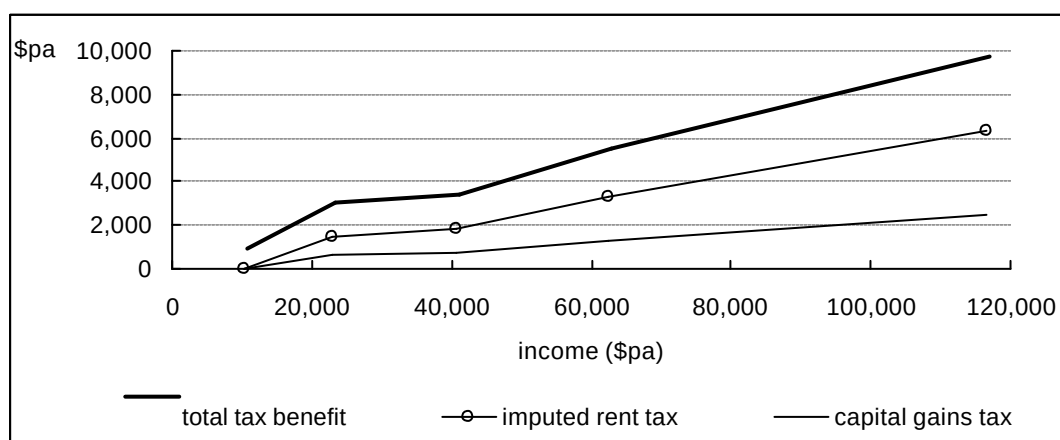
Those who benefit most from these tax expenditures are high-income households who live in high valued dwellings and have little housing debt. In part, the change from home purchase to outright ownership varies with a household's life cycle. Older households, for example, are more likely to be outright owners than are younger households.

Figure 2: Tax benefits by household income and tenure type, Australia 1999

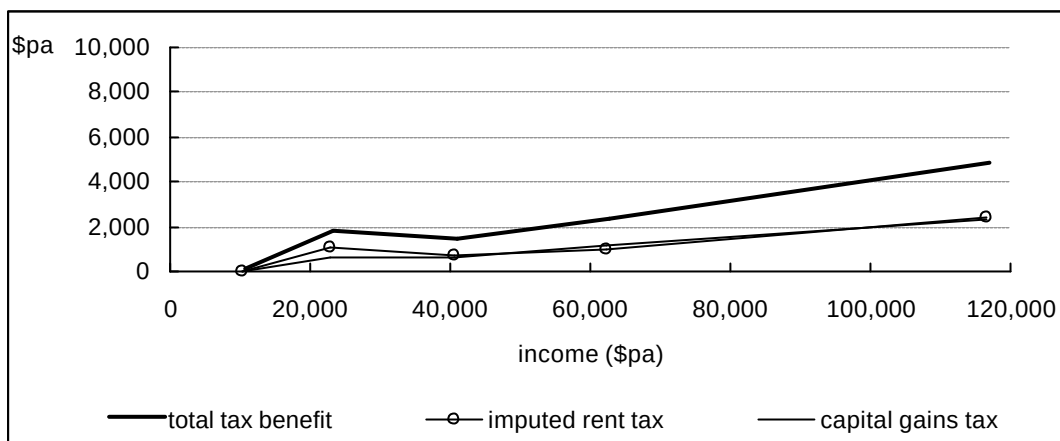
All owners



Outright owners



Purchasers



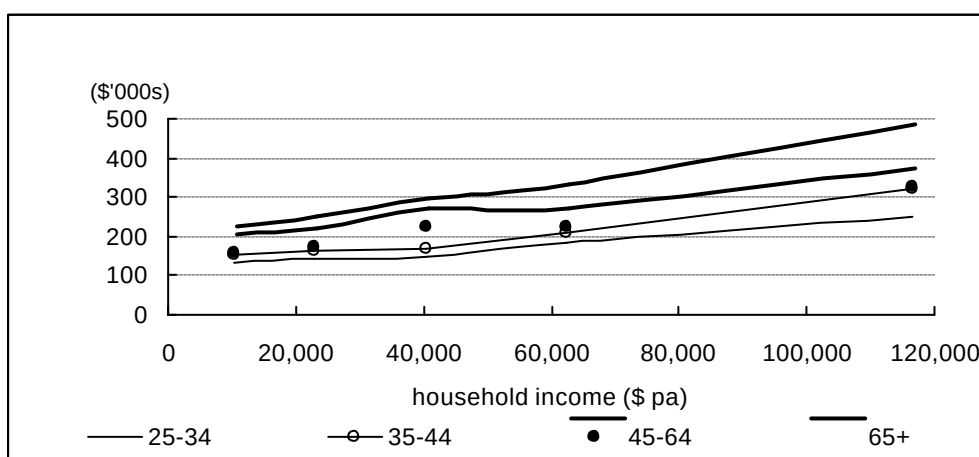
Source: Australian Housing Survey 1999, confidentialised unit record files

Figure 3 illustrates the strong income and life-cycle effects that are associated with tax benefits that accrue as a result of the net housing wealth. The data that underpin the results illustrated in Figure 3 are reported in Table A.3. For the data illustrated, Table A.3 shows that high-income households with a reference person over age 65, for example, occupy dwellings with an average value of \$437,000. This is almost 2.5 times the value of dwellings occupied by the much greater number of older low income households (\$178,000 for older households in the first income quintile) and is significantly greater than the average value of dwellings occupied by younger high income households (\$249,000 for under 35s).

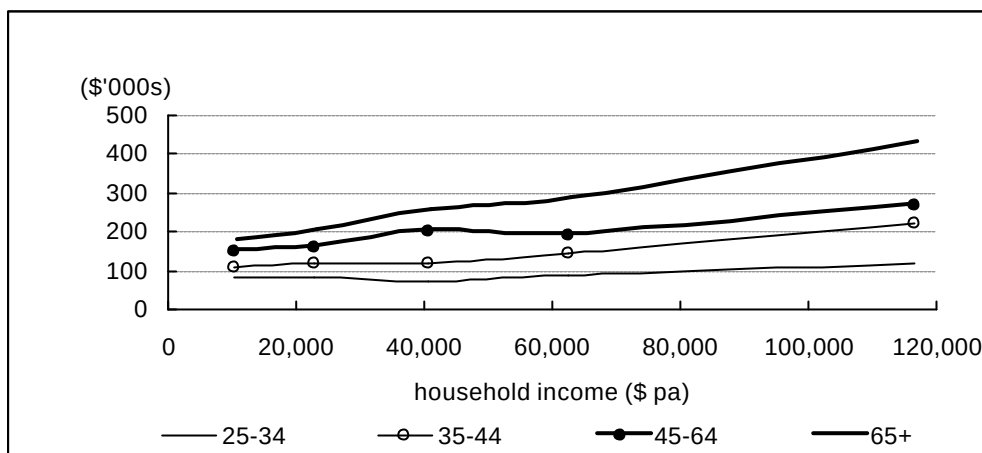
Table A.4 and Table A.5 report the breakdown of these data for outright owners and purchasers. In general, but not in all cases, dwelling values for households who own their dwellings outright tend to be higher on average than dwelling values for households who are purchasing their dwellings. By definition, equity in housing is significantly greater for the former, and particularly for younger households.

Figure 3: Dwelling value and equity by age and income

Dwelling value



Equity



Source: Australian Housing Survey 1999, confidentialised unit record files

The relatively high values of dwellings occupied by older owners are more likely than not to be a result of the capital gains that have accrued as a result of the ageing in place that occurs for many older households. Relatively high dwelling values are also associated with relatively high dwelling equity for older households, who have an average equity of 99 per cent in their home. This arises because the vast majority of older owners own their dwellings outright.

The average equity in owner-occupied dwellings over all households, whilst not as high as that for older households, is still a very high 81 per cent with even households in the youngest age group reported in Table A.3 (those in the 25-34 year age group) having an average equity of 50 per cent. Younger households have a considerably higher average mortgage debt than do older households, with an average debt of \$92,000 for those in the 25-34 year age group compared with an average debt of \$1,000 for those 65 years and older. At the same time, the average dwelling values of younger households (of \$185,000) is also lower than those occupied by older households.

Lower dwelling values and higher housing debt at every level of income mean that young households benefit less from the tax concessions to owner-occupied housing than do older households with the same level of income. The age breakdowns of the tax expenditures illustrated in Figure 2 are presented in Figure 4. The data that underpin these results are presented in Tables A.7 and A.8 for outright owners and purchasers respectively. The average data for all owners (not illustrated) is presented in Table A.6.

These data show that high-income households aged 65 years and older, on average, received almost \$12,000 in 1999 in tax benefits arising from the exemption from the income tax system of the income from their owner-occupied dwellings. Those older households who are outright owners enjoy most of this. The benefit derived by those who still have an outstanding mortgage debt is considerably less. The average annual benefit to high income households of \$12,000 exceeds the total income of \$8,400 received by a single aged pensioner from the pension system and is of the same order of magnitude of the \$15,700 received annually by a married couple on the pension.¹⁹ Owner-occupier households aged 65 years who are on pension levels of income, on the other hand, receive no indirect assistance through the tax expenditures associated with their housing. Older households in the first income quintile, with incomes below \$307 per week or \$16,000 per year receive no tax benefits. Those in the second income quintile, with incomes below \$596 per week or \$30,000 per year, receive a mere \$2,200 per year - less than 20 per cent of that received by high income households aged 65 years or more with incomes of more than \$75,000 per year.

At the opposite end of the age spectrum, households in the 25-34 year age group received an average tax benefit of \$1,000 in 1999 of which \$2,700 benefited young households who owned their dwellings outright whilst the benefit to young households with a mortgage was a negative \$700 per household. Negative benefits applied on average only to purchasers under

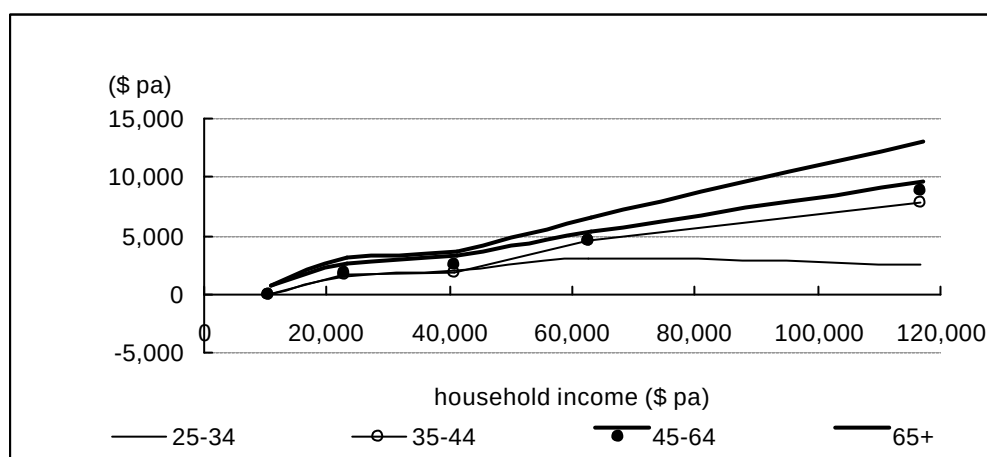
¹⁹ These amounts are based on payments in June 1999 and exclude rent assistance of \$37.90 per week for a single person and \$35.70 for couples.

the age of 35 and are larger for higher income young households, because of their greater capacity to service mortgage debt.

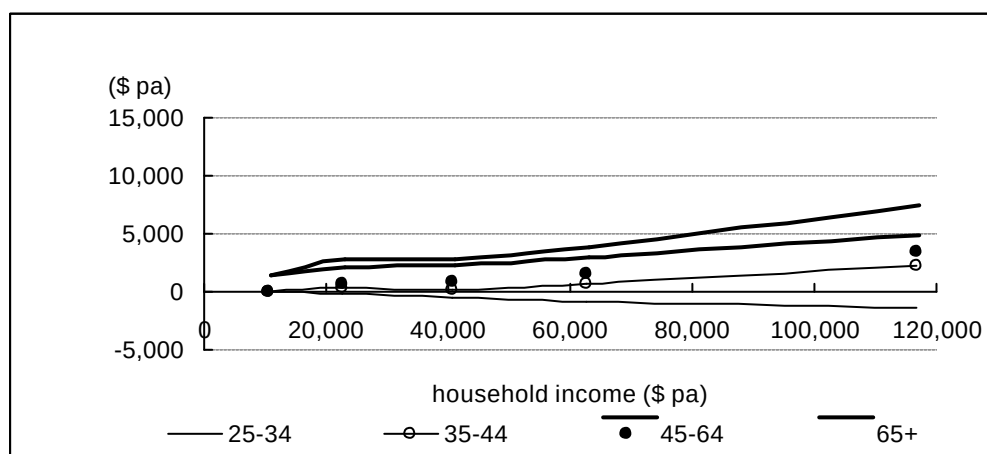
While the benefits to high income older households are considerably greater than those enjoyed by younger households, households with a head over 65 years old make up just 4 per cent of high income home owners. Households aged between 35 and 64 years old account for 81 per cent of all high-income owners and two thirds of all high-income households. Conversely, young lower income purchasers aged between 25 and 45 with incomes in the three lowest quintiles receive minimal assistance. It is this group of households for whom 1986 and 1996 census data indicate that home purchaser rates declined the most dramatically over the decade (Yates, 2000). It is this group who are most in need of assistance if home ownership policies are to expand home ownership.

Figure 4: Tax benefits by age and household income, 1999

Outright owners



Purchasers



Source: Australian Housing Survey 1999, confidentialised unit record files

2.4 Spatial variations in indirect assistance

The previous section has highlighted the perverse distribution of indirect assistance to owner-occupiers by income and by age. The differences recorded are exacerbated by spatial variations in dwelling values in rents and in the differences in the dollar values of capital gains that, in part, have contributed to the differences observed.

Tables A.1 to A.8 in Appendix A provide the detailed data used to generate the Australia wide data illustrated in Figures 3, 4 and 5 above. The same tables are repeated in Appendix B through to Appendix I for each state and territory, with Appendix J providing data for Sydney, selected for illustrative purposes as the highest cost metropolitan region. This section provides an overview of the spatial variations reported in these Appendices. The following section

provides an indication of the extent to which the aggregate results presented are sensitive to the underlying assumptions made in order to generate capital gains and imputed rent data from the data directly available from the housing survey. Both section 2.4 and section 2.5 can be skipped without any loss of continuity. Any key results will be commented upon in the conclusions in section 3.

Table 5 below summarises the data on mean dwelling values, mean equity in housing and mean income reported in each Appendix as an indication of the factors that reflect these spatial variations. The final column reports the mean tax expenditures per household that arise from the interaction of dwelling value, equity and income. On average, average total tax expenditures in each state in 1999 varied from a low of \$1,200 per household in Tasmania (as a result of the lowest average dwelling values, the lowest average equity in owner-occupied housing and the lowest average household incomes amongst the states or territories) to a high of \$4,300 per household in NSW. The NSW average, in turn, is dominated by the even higher tax expenditures of \$5,500 per household in Sydney. In other words, on average, households in NSW receive more than three times the assistance provided to households in Tasmania.

Table 5: Mean dwelling values, equity and household income across regions: owners, 1999

Appendix		Dwelling value	Equity	Income	Tax expenditures
		\$	\$pa	\$pa	\$pa
A	Australia	222,000	180,000	54,600	2,800
B	NSW	297,000	248,000	58,800	4,300
C	Vic	203,000	166,000	55,600	2,600
D	Qld	173,000	129,000	49,900	1,600
E	SA	147,000	117,000	47,800	1,600
F	WA	206,000	162,000	53,000	2,400
G	Tas	125,000	99,000	42,600	1,200
H	NT	218,000	141,000	77,000	1,600
I	ACT	192,000	142,000	67,600	1,500
J	Sydney	374,000	314,000	66,000	5,500

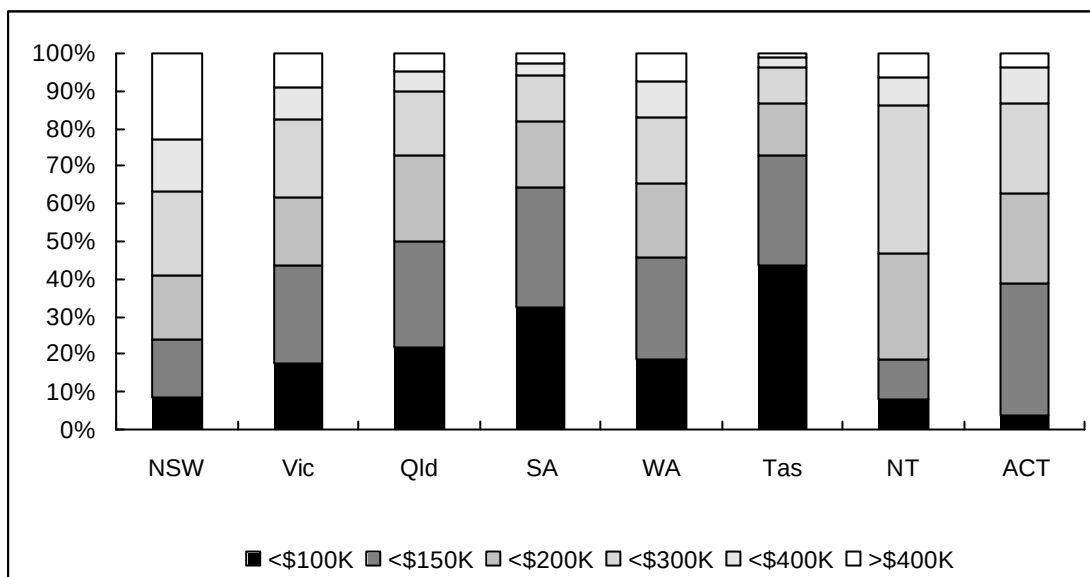
Source: Australian Housing Survey 1999, confidentialised unit record files

In general, the spatial distribution of the indirect assistance provided to owner-occupiers through the tax expenditures associated with the Commonwealth income tax system is such that it benefits those households already the most advantaged by high incomes and high equity in owner-occupied housing.

Figures 5 to 8 provide a summary of the distribution of these values within each state or territory and Figure 9 does so for Sydney.²⁰ Figure 5 shows the relatively higher proportion of high valued dwellings (over \$400,000) in NSW compared with all of the other states or territories. Figure 6 shows the even higher proportion of dwellings in which the owner-occupiers have high equity (over \$200,000). In part this arises from the impact of house price inflation increasing dwelling values whilst not affecting the mortgages of existing owners; in part it reflects a high proportion of outright owners. A high proportion of low cost dwellings (below \$100,000) in South Australia and Tasmania contribute to the low average dwelling values in those states.

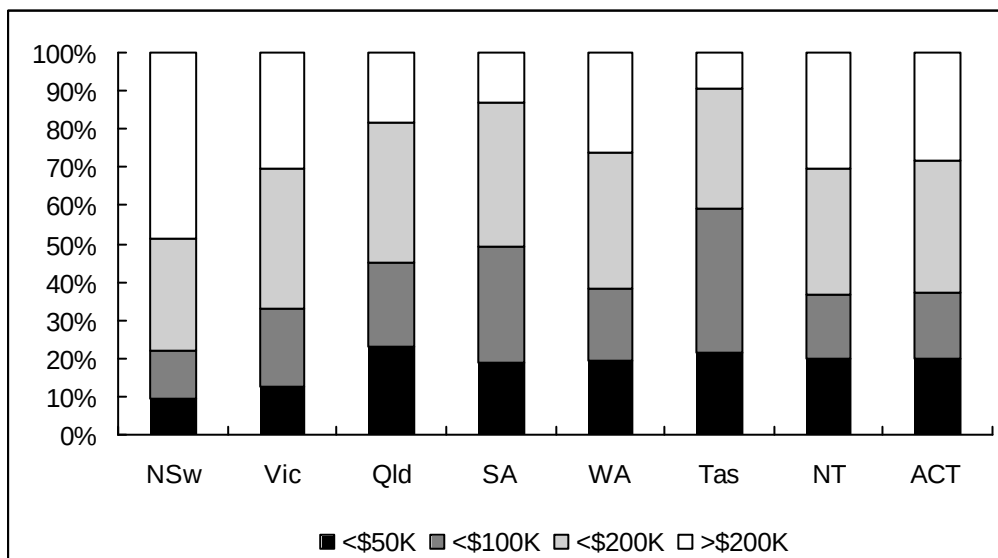
²⁰ Whilst the data in Table 5 and Figures 5 to Figure 7 reflect the actual distribution of dwelling values, equity and income in each of the regions illustrated, the mean tax expenditure data in Table 5 and the distributional tax expenditure data in Figure 8 (and in the final column of Figure 9) are approximate only as they are based on Australia wide quintile data to facilitate the summary presentation provided here. As can be seen from Figure 8, the proportion of households in each Australia wide quintile is not constant across the regions. The detailed tables in the Appendix provide accurate distributional data. The mean data, however, is still based on the assumption that the same average marginal tax rate applies in all regions.

Figure 5: Distribution of values of owner-occupied dwellings within each state, 1999



Source: Australian Housing Survey 1999, confidentialised unit record files

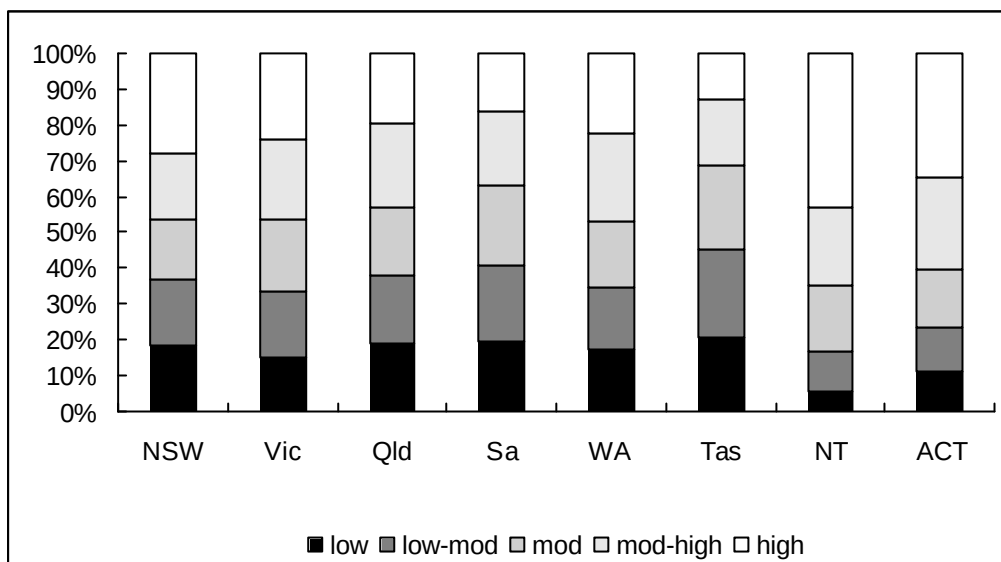
Figure 6: Distribution of equity in owner-occupied dwellings within each state, 1999



Source: Australian Housing Survey 1999, confidentialised unit record files

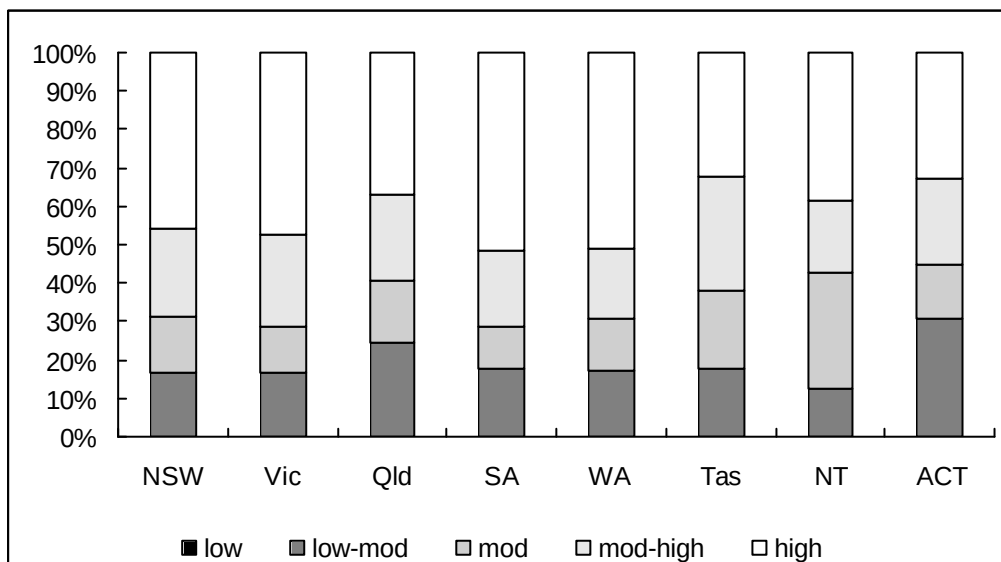
The differences that arise in the benefits from the exemption of capital gains and rental income from owner-occupied dwellings that differ spatially because of differences in dwelling values and housing equity are exacerbated by spatial differences in the distribution of household incomes. These are summarised in Figure 7 with the distributional outcomes for tax expenditures illustrated in Figure 8.

Figure 7: Distribution of income of owner-occupiers within each state, 1999



Source: Australian Housing Survey 1999, confidentialised unit record files

Figure 8: Distribution of tax expenditures within each state, 1999



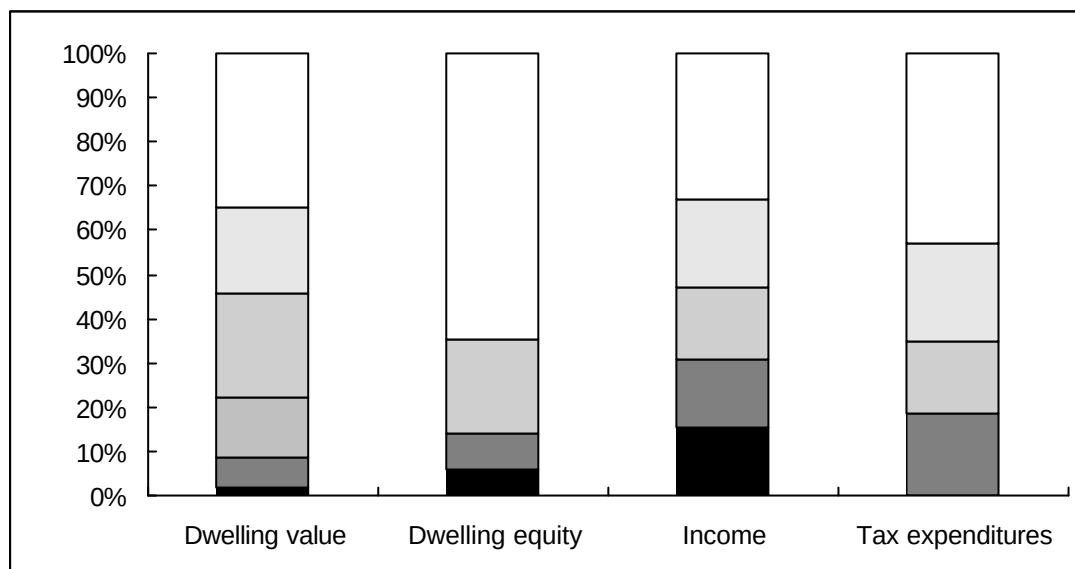
Source: Australian Housing Survey 1999, confidentialised unit record files

Figure 9 below provides a summary for Sydney of the data presented in Figures 5 to 8.²¹

These spatially disaggregated data mirror those discussed in the previous section for Australia as a whole. They suggest that in virtually every region, almost half of the total value of tax expenditures is distributed to households in the top income quintile, with none going to those in the lowest income quintile (because these households are presumed to have a zero marginal tax rate).

²¹ The legends for each of the variables illustrated are as given in Figures 5 to 8. They are not included in Figure 9 in the interest of readability.

Figure 9: Distribution of key variables in Sydney, 1999



Source: Australian Housing Survey 1999, confidentialised unit record files

2.5 Sensitivity of results

The results presented in section 2.3 and 2.4 above have been based on conservative assumptions that the gross rental value of dwellings was equal to 5 per cent of the dwelling value and that nominal capital gains were equal to 3 per cent of dwelling values. Actual housing costs were as reported in the housing survey. The net rental rate after interest costs employed, however, underestimates the true rate because it includes non-deductible costs.²² Likewise, the gross rental rate assumed is below that implied by the data recorded in the National Accounts and represents a conservative estimate based on the two rental investor surveys that were undertaken by the ABS during the 1990s. The data from these investor surveys suggest that a gross rental return of 7 per cent is an equally plausible assumption to the 5 per cent employed in this report. On the other hand, anecdotal experience for the period since the 2000-2001 boom in house prices suggests that the assumption of a 5 per cent gross rental return is generous, at least for higher value dwellings. As a result of these observations, simulations in this section have been based on gross rental returns as low as 3 per cent of dwelling value to as high as 7 per cent of dwelling value. In all cases, the same approach has been employed to generate net rent after interest costs from the assumptions made about gross rental values.

The capital gains assumption of 3 per cent is an estimate of the relatively flat increases in dwelling prices during the 1990s. Between 1990 and 1999 the index for established house prices increased from 100 to 130 (a 30 per cent increase over 9 years). Between 1990 and 2001, it increased from 100 to 153 (a 53 per cent increase over 11 years) and between 1987 and to 2001 it increased from 62.6 to 152.8 (a 144 per cent increase over 14 years). The simulations reported here are based on nominal capital gains that vary from a low of 3 per cent per annum to a high of 7 per cent per annum.

Table 6 provides an example of the impact of the changes in the assumptions regarding these key parameters. The boxed cells indicate the outcomes for the assumptions reported in detail in section 2.3.

²² As outlined in the Positioning Paper, this arises because housing costs in the survey embody both deductible (operating costs and interest payments) and non-deductible costs (repayment of principal). The tables in this paper provide estimates of the interest component of housing costs based on outstanding mortgage debt and current interest rates but the estimates of net rent after interest data are based on the housing cost data in the survey.

Table 6: Sensitivity analysis for estimates of total tax expenditures

		Average total tax expenditure per household (\$pa)		
	gross imputed rent	capital gains		
		3%	5%	7%
all owners	3%	1,200	2,000	2,800
	5%	2,800	3,600	4,400
	7%	4,400	5,200	6,000
outright owners	3%	2,800	3,600	4,400
	5%	4,400	5,200	6,000
	7%	6,000	6,800	7,600
purchasers	3%	-700	2,000	800
	5%	900	1,700	2,400
	7%	2,400	3,200	3,900

The simulations highlight results that are to be expected. The lower is the gross rental return, the more important is the negative tax expenditure associated with the inability to deduct interest costs and the greater is the burden borne by home purchasers. If gross rental returns are set at 3 per cent when capital gains are also at 3 percent, average tax expenditures per household fall from the \$2,800 per household reported in the text to an overall average of \$1,200. The benefit to outright owners falls from \$4,400 per household to \$2,800 per household and that for purchasers from a small positive \$900 per household to a negative amount of \$700. However, even when assumptions as low as these are employed, high-income outright owners gain an average benefit of \$5,500 per year.

In practice, periods of relatively low rental returns are likely to be associated with periods when capital gains are relatively high with the reverse holding when capital gains are relatively low. If capital gains are 7 per cent when gross rental returns are 3 per cent, the estimates of average total tax expenditures are much the same as those reported in section 2.3.

By way of contrast, if both capital gains and gross rental returns are 2 percentage points higher than assumed for the results presented in section 2.3, then average tax expenditures per household rise from the \$2,800 per household reported in the text to an overall average of \$6,000. The benefit to outright owners rises from \$4,400 per household to \$7,600 per household and that for purchasers from \$900 per household to \$3,900 per household. On these assumptions, high-income outright owners, on average, gain a massive \$15,500 benefit per household. The estimates of tax expenditures per household when gross imputed rent is assumed to be 5 per cent and nominal capital gains are assumed to be 6 per cent gives an average household benefit of \$4,000 which, in 2001 amounts to \$4,400 and is approximately equal to that derived from the aggregate data presented in section 2.1.

In all instances, the distribution of benefits by household income and age and across the different regions follows the same patterns as indicated in sections 2.3 and 2.4. The conclusions reached remain unchanged. The greatest benefits go to those outright owners who are in the top income bracket on the highest incomes and who own dwellings with the highest capital values (which, on average, means in NSW or, more specifically, in Sydney). The least benefits go to households in the lowest income quintiles and to those who still have significant mortgages on their properties. Most of those owner-occupier households who have relatively low equity in their dwellings are young households although not all young highly geared purchasers are low income households since it is often only higher income households who are able to service higher value mortgages.²³

²³ Indicative distributional data have been incorporated in the text, but detailed data have not been reported as they add little to the results reported in detail in the earlier sections and in the Appendices of this report.

This pattern of indirect assistance for home ownership through the tax system, that provides significant levels of support to established high income owners and, in some instances, negative levels of support to young home purchasers, is in clear contrast with direct housing assistance that is explicitly directed to support home purchase.

2.6 Estimates of direct assistance

Home purchasers have been the prime targets of the major form of direct assistance provided for home ownership by the Commonwealth government. Since the first home owners grant was introduced in July 2000, an estimated total of \$2.4 billion has been provided through the initial and additional grants with over 300,000 grants to first home buyers being paid under the initial scheme and 40,000 additional grants for new homes (Commonwealth Treasury, 2002). A further \$784m has been budgeted for 2002-03 (Costello, 2002).

However, as with the indirect assistance provided to home ownership, currently this assistance is poorly targeted. As indicated in section 1.2 above, it is provided to first homebuyers with no means test on income and no restrictions on the value of property that can be bought. By explicit acknowledgement, its primary function has been one of fiscal stimulus (Costello, 2001). There has been little attempt to justify it as a solution to the problems of access to home ownership faced by many young lower income households. Because there are no constraints imposed on these loans, no data is collected on how they have been distributed. However, anecdotal evidence points to a number of high income, high wealth households who can afford home ownership without any assistance but who have benefited from it (Wainwright, 2002). Data provided by the NSW Office of State Revenue show that almost 50 per cent of the 2000 and 2001 grants in NSW went to first home buyers purchasing a dwelling with a market value in excess of \$200,000 and almost 4 per cent (more than 4,000 loans) went to first home buyers purchasing a dwelling with a market value in excess of \$500,000.²⁴

Whilst this scheme has provided assistance of up to \$14,000 per first homebuyer household, it provides a once-off grant, rather than the on-going annual assistance provided by the tax expenditures described above. Some indication of the relative size of its impact in relation to aggregate estimates of annual tax expenditures of approximately \$4,000 per household can be seen averaging the annual expenditure over all owner-occupier households. On this basis, the annual grant of approximately \$1 billion has provided the equivalent of \$200 per owner-occupier household per year since 2000.

The current scheme is more generous than past scheme, in terms of the total amount paid out. The 1980s First Home Owners Scheme (FHOS) provided a maximum subsidy per eligible household of the same order of magnitude as the initial version of its 2000 First Home Owners Grant (FHOG) successor. However, with an outlay of only \$290m in 1985 (approx \$500m in \$2001) and declining amounts in the years to its abolition in 1991, the FHOS was considerably less generous than the current \$1,000m per year FHOG scheme currently in place. This, presumably, was because the 1980s version, unlike the 2000 version, was highly targeted with both income tests and constraints on the maximum value of dwelling that could be bought. It was also introduced at a time when bank lending rates were around 12 per cent which placed additional constraints on the capacity of many to take advantage of it. The 2000 version was introduced at a time when interest rates had declined to levels more in keeping with those of 30 years earlier.

²⁴ Data provided on request from the OSR. At current market rates of interest, an income of well into the top two quintiles is required to support the loan required to purchase a \$200,000 dwelling with a 10-20 per cent deposit.

3. OVERVIEW AND CONCLUSIONS

3.1 Background

Well over a decade ago, Flood and Yates (1987:viii) concluded that, as a result of the tax benefits provided to homeowners, indirect housing assistance had "increasingly overwhelmed the housing assistance programs that represent formal housing policy." In large part, this arose from assistance to outright owners rather than to purchasers. The benefits were poorly targeted, with most of the assistance going to higher income households.

The results presented in this paper suggest that, as a consequence of the considerable degree of tax reform that has occurred in Australia in the past 15 years, the perverse outcomes that led to these concerns being expressed about the structure of housing assistance well over a decade ago have become more pronounced. The indirect assistance provided through tax expenditures has increased and, on average, continues to provide most assistance to those households who need it least.

Disaggregation of the benefits of the indirect assistance provided shows that, within each income quintile, it is older households who derive the greatest benefit. In part this arises because of their higher incidence of outright ownership, but the same result also applies for all outright owners. Thus, it is probable that this result arises because older households have been owner-occupiers for a longer period of time than have younger households and, as a result, have benefited more from the underlying growth in the value of their dwellings. Low-income older households, who are economically the most vulnerable, do not receive this benefit because their income is below the income tax threshold.²⁵ When market conditions are such that there is an underlying increase in real housing prices, this result is likely to be replicated in any country with a mature home ownership sector and with tax systems that favour home ownership.

The outcomes for direct assistance are similar. Policies in the 1980s were generally ineffective in assisting into home ownership those households for whom home ownership was both beneficial and sustainable and who would not have achieved it in the absence of the support provided. There is no indication that current policies are any different and considerable evidence that they are more costly now than they were in the 1980s. Deposit assistance continues to be used as an instrument of stabilisation policy.

Whether or not the poorly targeted assistance currently provided to home ownership is justified will, in large part, depend on costs of providing it as well as the benefits that are perceived to arise from it. The costs to the government budget of exempting a significant source of income from its revenue base forms the most obvious of these costs. Whilst the \$21 billion estimate of benefits received does not provide an estimate of the costs of providing the assistance for reasons indicated in section 2.1, it does provide an indication of the likely order of magnitude of these costs. Additional costs arise from the distortions to household behaviour that arise from the tax concessions provided to owner-occupation. Tax incentives favouring home ownership encourage households to buy rather than rent, to invest in housing rather than other assets, and to maintain higher standards of housing consumption than might otherwise be the case. These costs of these outcomes are not inconsiderable. Green and Vandell (1999) and Capozza et al (1997) suggest that tax expenditures less generous than those that exist in Australia have increased US house prices by up to 15 per cent in high house price areas²⁶. Bourassa and Hendershott (1992, 1995) provide supporting evidence for Australia. Voith (1999a) suggests they may have contributed to greater lot sizes and hence to

²⁵ Similar conclusions have been reached in relation to the value of the mortgage interest deduction in a number of the US studies because of the interaction of this with the standard deduction (Capone, 1995; Follain and Ling, 1991; Follain, Ling and McGill, 1993).

²⁶ Green and Vandell show that a revenue neutral redistribution of tax expenditures associated with mortgage interest deduction in the US would increase house values by 10.4 per cent for low income households. Capozza et al (1997) impose variations in taxes across regions in the US on a formal asset price model that takes into account variations in supply elasticities. They estimate that a .03 decrease in the average marginal federal tax rate would result in an overall decrease real house prices by 5.5 per cent, with declines of up to 12.5 per cent in high price regions. Removal of the property tax exemption would reduce overall house prices by 4.7 per cent with declines of up to 15 per cent in high cost regions.

suburban sprawl. Voith (1999b) and Voith and Gyourko (1998) suggest they create incentives for communities to enact exclusionary zoning that contributes to geographic sorting of households by income. These effects depend on the extent to which subsidies are capitalised into land and house prices and this, in turn, depends on the relevant supply elasticities. In the Australian context, Ellis and Andrews (2001) have argued that the degree of urbanisation, with an "unusual concentration of Australia's population in two large cities" has contributed to these pressures.

Many of these outcomes impose costs on those who cannot access home ownership. Increases in dwelling prices add to affordability constraints, reduce access to housing for marginal first home buyers and contribute to higher rents. Any declines in home purchase rates that arise from these market pressures mean that the capacity of home ownership to sustain its role in sheltering the aged from housing related poverty is diminished and pressures to provide rent assistance are increased. In other words, the costs of providing indirect assistance for home ownership are not borne solely by those who benefit from the assistance provided. They are also borne by those who are excluded from home ownership.

Over the past decade or so, there has been a growth in the literature on the social as well as the economic costs and benefits associated with home ownership. Much of this is reviewed and summarised in a companion set of reports by Rohe et al (2000) and McCarthy et al (2001). These reports suggest there is evidence of considerable (but, in their words, not irrefutable) evidence of social and economic benefits associated with home ownership but both question whether the benefits are worth the costs. Neither report provides any evidence that suggests that these benefits increase with the age or income of the household. Both reports caution against encouraging home ownership for all.²⁷

Over a number of years, however, Castles (1997, 1998) has developed the argument that home ownership has been a cornerstone of the welfare state in Australia. It has been a major factor in preventing many households who rely on the age pension as their main source of income from living in after housing poverty. The results presented above suggest that older households do, in fact, benefit more than younger households from the assistance provided to home ownership through the tax system. However, it is higher rather than lower income households who benefit the most. Older home owners in the lowest income group receive less benefit from the indirect assistance provided to home ownership through the tax system than older renters on pensions do through rent assistance. The extent of the assistance provided to home owners who do not need it raises questions whether this benefit is worth the cost or whether alternative approaches to assisting home ownership could be employed.

3.2 Policy options

Ongoing assessment of the value of tax expenditures to owner-occupation

This questioning of the benefits provided to home owners suggests that, in the first instance, any government concerned with fiscal responsibility and accountability should at least have regular estimates of the extent of the assistance provided. As an indirect form of assistance, tax expenditures do not appear in annual budget papers. However, the indirect assistance provided to owner-occupied housing also does not appear in annual Tax Expenditures Statements, despite the requirement that such estimates be provided as a requirement of the Charter of Budget Honesty Act 1998. The benchmark used for the estimates in this report is consistent with Treasury's claim that "the principal criterion of benchmark design is that it should represent a consistent taxation treatment of similar activities or classes of tax payers. That is, a benchmark taxation treatment should neither favour nor disadvantage similarly placed activities or classes of taxpayers." (Treasury, 2002: p13). Treasury exclude imputed rent from their income tax benchmark and, although they recognise the exemption of the

²⁷ In particular, they suggest that home ownership may not be appropriate at either an individual or society level for households with either volatile or flat income trajectories. Such households, or low income households who may be unable to maintain their housing at a reasonable standard, may not be able to afford home ownership in the long run.. Others in their list are households for whom stable or increasing property values are unlikely, those who face "unhealthy social conditions" and those who locate in neighbourhoods where there is inadequate infrastructure and services (Rohe et al 2000:31).

taxpayer's main residence from the capital gains tax as a tax expenditure, they do not provide estimates of the value of this exemption.

For the tax expenditures estimated in its annual Tax Expenditures Statement, Treasury make no attempt to estimate the cost to the government budget, arguing that "for the purposes of [that] report, it is neither practical nor desirable to incorporate potential responses to the removal of a tax expenditure into the estimates." (p3). In their words, to do so in cases where the level of activity is likely to be significantly affected by the concession could give the impression that the tax expenditure has very little material effect when, in fact, the financial benefits derived by the recipients could be large. The sheer magnitude of the aggregate values of the tax expenditures provided to owner-occupied housing through the Commonwealth tax system suggest there should be sufficient concern about the extent of this assistance to warrant regular monitoring.

Both the magnitude and the perverse distribution of these tax expenditures also suggest that some consideration could, or should, be given to policies that reduce the costs associated with the indirect assistance and to policies that redirect the benefits to those most in need of assistance. In general, this will require a reduction of the benefits to high-income households and outright owners and an increase in the level of assistance to lower income first home buyers at their point of entry into the housing market. Because the indirect assistance considered in this paper is that which is provided through the Commonwealth income tax system, it is the politically unpalatable policies at a national level that provide an obvious starting point for policy options.

Mortgage interest deductibility and taxation of imputed rent and capital gains

One possibility is to implement what some might regard as a Faustian bargain. In the same way that capital gains taxes were implemented in Australia in 1985, this could involve retaining the existing income tax base for current homeowners but removing the exemptions for all new entrants into home ownership. This would mean that young households could claim mortgage interest deduction when assistance was most needed. In return, however, they must pay an imputed rent tax once the net effect is positive (as it will become as equity builds up) and a capital gains tax on realisation of any increase in the value of their dwelling. Such a policy, of course, could induce behavioural responses, with households using debt for non-housing purposes. It is critical, therefore, that the potentially adverse effects of such responses are dealt with through appropriate regulation (such as once off access to deductibility up to a fixed mortgage amount for first home buyers as was imposed when mortgage interest deduction was temporarily introduced in 1982).

Imposing an annual tax on homeowners as they age may be seen a negating one of the significant benefits of the high home ownership rates that persist in Australia (namely that of protecting older households on pension levels of income from living in after housing poverty). However, as the results presented in this report illustrate, low income older homeowners currently receive less benefit from the indirect assistance provided by tax expenditures than their non home owning counterparts receive from rent assistance. Low tax rates on asset rich income poor households, as at present, will limit the adverse effects on low income households of any attempt to reduce the level of tax expenditures and will sustain the role of owner-occupation in underpinning the social security system. Also, as with the current capital gains tax, any problems that arise can be dealt with by deferral of liabilities until the asset is sold. A policy such as that suggested above could encourage home ownership by helping to reduce the financial burden at the early stages of home purchase. It could also assist in reducing the upward pressure on house prices as a result of the capitalization of current subsidies.²⁸

²⁸ Any concern that a reduction in the indirect assistance provided to home ownership would reduce the incidence of home ownership and place upward pressure on rent assistance for aged pensioners needs to be assessed against this countervailing impact of a reduced pressure on dwelling prices and improved affordability at the point of entry into the housing market. Such an assessment is beyond the scope of this paper.

Other policies that focus on providing assistance at the point of entry into homeownership or that focus on sustaining home ownership for marginal first home buyers and paying for this assistance with revenue recouped from better off established home owners may be equally effective. As indicated, however, any subsidy to home ownership that is not recouped is likely to contribute to upward pressures on dwelling prices and to add to the affordability problems faced by those households who are unable (or unwilling) to become home-owners. This point will be returned to below.

Taxation of capital gains over a given limit

An alternative approach to taxing the income generated from owner-occupied housing could be to ignore the potentially controversial and conceptually difficult taxes on net imputed income and focus, instead, on what are effectively unearned capital gains arising from increases in land values associated with spatially concentrated demand pressures, particularly in metropolitan housing markets. Whilst capital gains taxes are politically unpopular, there is scope for introducing these in an incremental fashion by including only those gains over a high value (such as \$1m). Indexation of this to a general price level would ensure only owners of dwellings with real capital gains would be caught in the tax net. Imposing a life time cap on the total amount paid in capital gains would be a further option, although it is one which would limit the capacity of the tax to have a strong redistributive effect. Deferral of any tax liability until death would provide a further softener to asset rich income poor households.

Improved targeting of FHOG

The above policies focus on reducing and redirecting the significant levels of indirect assistance that currently are provided through the income tax system. Consideration can also be given to reducing and redirecting the less significant levels of direct assistance provided through the First Home Owners Grant. Several lessons can be learned from the past. The precursor to FHOG, for example, achieved a similar impact as a cyclical measure at a much lower budgetary cost by targeting the assistance provided. A return to the income and dwelling price targeting built into FHOG is likely to have any change in its impact on marginal first home buyers and will limit the extent to which higher income buyers are encouraged to create potentially damaging speculative pressures on housing markets.

Recouping FHOG

A more administratively complex innovation in relation to the direct assistance provided for home ownership for moderate income earners would be to subject it to similar constraints as imposed on home ownership assistance provided for low income earners moving from public housing into home ownership. The shared equity programs that have been proposed by a number of States provide models for how this might be done. Alternative ways of recouping FHOG might also be considered in the interest of best using limited resources.

3.3 Conclusion

Detailed consideration of policy options is beyond the scope of this paper. This notwithstanding, the results presented, which clearly highlight the extent to which the indirect assistance provided for housing dominates the direct assistance, suggest that a reconsideration of current housing policy is called for. The paper provides aggregate estimates of indirect assistance of \$21 billion in 2001. This is far in excess of the direct assistance of approximately \$1 billion per year in the last 2 years provided under the First Home Owners' Grant, of the just under \$1 billion per year in Commonwealth funding provided for public rental through the Commonwealth State Housing Agreement, and the just under \$2 billion per year provided in Rent Assistance through the social security system. Unlike much of the direct assistance to those in rental housing, the indirect assistance provided to home ownership is poorly targeted, providing most assistance to those who need it least.

The results highlight the need for a broad interpretation to be taken of housing assistance. The overwhelming value of indirect assistance provided through the Commonwealth taxation system suggests that housing policy needs to be evaluated and developed at a national as well as at a State level. Whilst home ownership is likely to remain both the dominant and preferred tenure in Australia, the question of how it is, and how it best can be, supported is

one that needs to be exposed to as critical an assessment as paid to the much less generous support provided to those in rental housing. The current system of evaluation of indirect compared with direct assistance for housing suggests one rule for the rich and one for the poor.

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