Taxes and the housing bubble – how we ruined a rational tax system

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Ask Australians how the Howard Government has changed our tax system. Everyone will mention the GST, but how many will recall the 1999 changes to business taxation?

The GST swept over the country with the noise and fireworks of a summer thunderstorm. It dominated the 1998 election, costing the Government its popular vote (but not its Parliamentary majority). With the compromises negotiated by the Democrats, however, its impact has been slight. Some old anomalies have gone; some new ones have come, but there have been few losers or winners from the GST.

A year after the 1998 election the Howard Government introduced sweeping changes to business taxation, known as the Ralph 'reforms' (in recognition of the banking executive John Ralph, chairman of the three person review committee advising the Treasurer). The main provisions were a reduction in the company tax rate from 36 to 30 percent, and a change in the capital gains provisions which halved the rate of tax on capital gains, and, as an imperfect tradeoff, abolished indexation of capital gains.

Compared with the GST, these changes were barely noticed in 1999, but over time they were to have a much more profound and deleterious effect on the Australian economy. They helped in inflating the real estate bubble, and more generally they changed the incentives in our tax system. They have rewarded speculation, while penalising hard work and patient long-term investment.

While the GST generally removed distortions from the tax system, the Ralph changes went in the opposite direction; they undid the carefully-crafted reforms of the Hawke/Keating Government.

The Hawke/Keating Government had made two major reforms in the interface between business and individual taxation. One was dividend imputation, which provides credits for company tax paid on dividends. The other was a capital gains tax, embodying two basic economic principles – that all income should be taxed in the same way, and that tax should apply only to real (inflation-indexed) capital gains. For a period Australia had an economically rational tax system.

With little protest, these provisions were abolished in 1999. The Labor Party, to its discredit supported the changes. The traditional 'left' lobby groups were largely silent. Perhaps they had been exhausted by the GST campaign; perhaps they were mesmerised by the popular myth that the Howard Government is competent in economic management; perhaps they didn't understand the virtues of rational economic policies (they are forever complaining about 'economic rationalism'); or perhaps with their backgrounds in the non-numerical disciplines of law and politics they couldn't handle the mathematics of inflation and tax rates.

But the mathematics are not complex. The new regime favours short-term investment in growth assets, and, over the medium-term, penalises investments in capital-stable businesses.

To illustrate, consider two examples, each starting with a million dollars invested in 1999 – a short-term real-estate investment and a small business, such as a family farm, to be passed to the next generation thirty years on.

If our real-estate investor had bought into the Sydney market in 1999, and sold in 2003, the profit would have been $700,000 in nominal terms. Under the Hawke/Keating regime, tax would have been imposed on the *real* (inflation-adjusted) value of this capital gain, which is about $500,000. At a 48.5 percent marginal tax rate, the tax payable would have been around $250,000. Under the new regime, however, the tax payable is on only half the *nominal* gain – or about $175,000.

What about the patient investor, investing in 1999 and selling a business in 2029? Assuming no real increase in the value of the business (a realistic assumption for many small businesses), there would have been no capital gains tax payable under the old provisions – because there would have been no real capital gain. Under the new provisions however, assuming three percent annual inflation, there would be a 'profit' of $1.4 million, upon which $350,000 capital gains tax is payable.

While the changes were economically irresponsible, they were politically brilliant. In the short term there were no losers. They gave the 'aspirational classes' a ticket on the gravy train of speculation; they could enjoy some of the benefits hitherto reserved for the very rich. They could sit back and become paper millionaires, using their rising home equity to finance an orgy of consumption (and a consequent blowout in the balance on current account). Swinging voters, who had once been committed to the political economy of the Australian notions of equity and reward for effort, became converted to the politics of greed.

Your taxes at work

The encouragement of speculation was a bonanza for the finance and property sector, which thrives on transaction commissions. The paper economy swelled – it now accounts for $130 billion in our national accounts, the same as agriculture, mining and manufacturing combined. Or, from another perspective, that's almost $20,000 a household to support a bureaucratic overhead. (Because it's a private sector bureaucratic overhead, that's a good thing by the warped economic measures of the Howard Government.)

It was hardly surprising that when equity markets collapsed in the late 1990s investors turned to real estate; it's a typical pattern in investment markets. Real estate investments were already highly favoured by tax provisions which allow for tax deductions on both interest and depreciation – effectively a double-counting of capital deductions. The capital-gains concessions added to the attractiveness of real-estate investment. The Australian Consumers' Association, in its submission to the Productivity Commission inquiry on housing, has estimated that the capital gains concessions reduced the projected tax rate on a typical real-estate investment from 50 percent to 29 percent. It is little wonder that funds flooded into real-estate investment, resulting in a boost in asset price inflation and a corresponding fall in housing affordability.

Belatedly, the Productivity Commission in its draft report on housing, has acknowledged that Australia has one of the world's most permissive tax allowances for investor housing, and that the capital gains tax changes have 'lent impetus to the recent surge in investment in rental housing', but it has not gone so far as to make any specific recommendations – in part because these incentives have applied to a wider set of investments such as share portfolios. In any event, the Commission points out that in any subsequent deflation in house prices some of these benefits will be removed.

In other words, those who got out of real estate early have done well from the tax system, and the suckers who got in late will be doubly penalised.

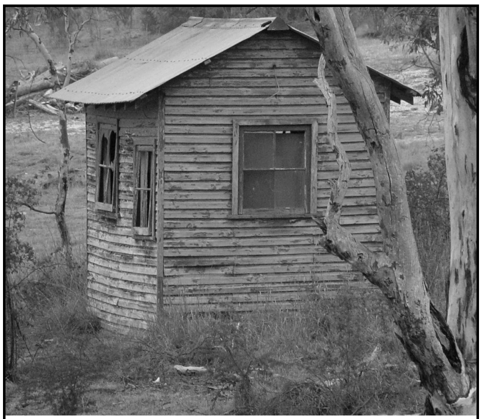
Tax systems, where possible, should help stabilise the effects of price fluctuations, not amplify their consequences. These consequences will be most heavily felt by those who entered the housing market late in the cycle, but they will also be felt by established house owners who have used mortgage redraw and similar provisions to finance current consumption. Just as in a bull market a wealth effect creates illusory income, a bear market causes hesitation and uncertainty – and for those who are heavily indebted their losses are far from illusory.

To put it mildly, the Commission has copped out. It has identified a problem, manifest in one part of the economy, but because that problem exists more widely, has chosen to ignore it. When the Commission was handling tariff and protection-related inquiries, it was fearless in recommending lower rates of tariff protection – it did not say that because tariff protection was widespread it was powerless to make any recommendations with respect to particular industries. In this instance, however, it has taken the easy way out, making sure it gives no offence to the main political parties.

We had a chance, in 1999, to block the Ralph changes and to retain a rational capital gains tax policy. But the 'left' was asleep on its watch, while a troika drawn from the boards of financial firms devised changes that would legitimise the destruction of our capital gains tax system and inflict long term damage on the economy. The Ralph 'reforms' used the tax system to undermine basic economic incentives. Speculation was to be rewarded; patient hard work, in capital-stable businesses, was to be penalised. The changes eroded the progressivity of our tax system, to the point that it has now become a matter of faith that only people with incompetent accountants pay tax at the top marginal rate; therefore, the argument goes, we should be dropping the top marginal rate, rather than removing distortions which encourage tax avoidance. This tax package was written for the top end of town, and the Howard Government bought it enthusiastically.

Ironically, the justification for the Ralph changes was that they would aid international competitiveness. But their effect has been the opposite. Because of the need to suppress the housing boom and the corresponding blowout in personal debt, the Reserve Bank has had to sustain one of the developed world's highest real interest rates, with a consequent rise in the exchange rate. The cost of a high Australian dollar is being borne by export and import-competing businesses.

By now we should not be surprised that the Howard Government should deliberately damage our economic incentives. This government has been a loyal servant of big business, particularly the financial sector, while parroting its concern for 'battlers'. By the time the battlers come to sell their businesses and pay tax on illusory capital gains, John Howard will be distant and insignificant memory, competing with Billy McMahon, Pauline Hanson and Graham Richardson for historical recognition.



Affordable housing 2004

The Howard Government is unlikely to change; its sights are set on this year's election, not the long term health of the economy. It is already denying responsibility for the housing bubble; and has been deflecting attention on to state taxes. Labor, however, has a chance to redeem itself by restoring equity and rational incentives into its tax and housing policies. Labor needs to re-gain its reputation for economic competence; a starting point is to expose the irresponsibility of a government which delegated the design of our tax system to the financial sector.