SUBMISSION BY THE

Housing Industry Association

to the

Commonwealth Government

on the

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HIA is the leading industry association in the Australian residential building industry, supporting the businesses and interests of over 40,000 builders, trade contractors, manufacturers, suppliers, building professionals and business partners.

HIA members include businesses of all sizes, ranging from individuals working as independent contractors and home based small businesses, to large publicly listed companies. 85% of all new home building work in Australia is performed by HIA members.

Forward

The Housing Industry Association (HIA) welcomes the review of the Australian taxation system.

The residential building industry is one of the most highly taxed industries in the economy, contributing a disproportionately high level of revenue to government, compared to the overall proportion of the economic activity generated by the sector.

Shelter is a basic human requirement and without access to housing, families and individuals are denied the opportunity to contribute to society to their true social and economic potential. It is the bedrock upon which all other aspects of society are built, such as health, education and employment.

It is appropriate therefore that Australia is undertaking a once in a generation review of the taxation system and our federation. As a consequence of an underlying structural budget deficit, growing demand for government services such as health and welfare, an aging population and a convergence of responsibilities between different tiers of government, a realignment of the taxation and transfer system has become inevitable.

Part of that realignment must be a reconsideration of the existing and future tax burden, to ensure that no part of the economy is carrying an unfair or disproportionate share, leading to distortions and inefficiency in the overall economy. New housing faces an inequitable burden through a range of taxes, levies and charges, many of which are inefficient, reducing housing affordability and limiting growth in the wider economy.

Confronting and relieving the taxation burden on new housing will go a long way towards addressing the affordability challenges being faced by many Australians.

Independent research shows that the level of taxation on new housing can be up to 44% of a new house and land package, which limits the capacity of the industry to create employment, increase housing stock and provide shelter to the public that is both affordable and meets their needs. With the 2015 Intergenerational Report anticipating that Australia could need 200,000 new homes each year to 2055, the strain of taxation on the sector is unsustainable.

The high quantum of taxation on new housing is particularly concerning from an economic perspective in that many of the taxes levied on new housing are highly inefficient. Governments need to collect revenue so it is able to deliver services to the community, but there are alternatives to many of the current inefficient taxes on new housing which are more equitable and will enable the economy to perform at a higher level.

The residential building industry is one of the best placed industries to drive employment and economic growth as Australia’s manufacturing bases declines and the mining boom wanes. Only with well-guided tax reform, can new housing can reach its full potential as an economic driver.

The residential building industry is committed to working with the Commonwealth to address these issues.

Shane Goodwin
Managing Director

Key Points

With high structural budget deficits and an ageing population, Australia is faced with an urgent need for economic reform. There is a significant risk that in the absence of tangible progress on economic reform, Australia will experience declines in real per person income and subsequent erosion in our standard of living.

Avoiding this outcome is why significant policy reform is needed. This reform needs to incorporate the addressing of the vertical fiscal imbalance between the states and territories on the one hand, and the Commonwealth on the other. This would facilitate the reconciliation of commonwealth, state and territory government expenditure forecasts against revenue projections.

Economic reform in Australia needs to simultaneously meet the two complementary objectives of ensuring economic growth while enhancing the wellbeing of Australians through growth in real per person incomes.

HIA has identified headline issues for consideration in the process. Detailed discussion of each of these is included in this paper, along with summary responses to a number of the specific questions posed by the Tax Discussion Paper which relate to the residential building industry.

In this submission, unless stated otherwise, a reference to new housing or to residential building/construction applies to all forms of new dwellings and their construction or renovation, including detached housing, low/medium density (such duplex, 'walk up' apartments, town houses and long row housing) high rise apartments, as well as the procurement and development of the land on which the dwelling is constructed and the product and materials from which they are constructed.

Taxation on housing is disproportionately high
On a proportional basis, new housing is one of the highest taxed sectors in the economy. This has serious implications for housing affordability, which in turn affects geographic labour mobility and the otherwise natural and efficient turnover of property in the community.

Taxation on housing is inequitable
The treatment of taxation on new housing is inequitable, which discriminates between families, inhibits economic activity and distorts investment decisions. This applies specifically to the application of GST on new homes and not on existing properties, and the requirement for new home buyers to pay for upfront development levies or fund affordable housing quotas, both of which should otherwise be a general community expense.

Multiplier effect of improved productivity in housing
Residential building is a significant employment generator, which can be enhanced further by improved productivity in the sector. For example, research shows that just a 1 per cent improvement in productivity through removing inefficient taxes on housing will have a significant positive economic impact across the entire economy.

GST treatment with respect to housing
GST is levied on new housing, but not on existing residential property. Therefore, new housing is currently treated inequitably with respect to existing homes and the GST. Should increases to the rate of the GST be a central component of tax reform, any increases should not be applied to residential building. Further the opportunity should be taken to reduce the GST currently applied to new housing through a range of exemptions, and removal of the 'double dipping' cumulative imposition of the tax at multiple stages of the building process, a situation that exacerbates the inequitable treatment of new housing.

Stamp duty on property conveyances
Stamp duty on property conveyances is the most inefficient tax in Australia's taxation system. It inhibits labour mobility and workforce participation, constraining the rate of productivity growth and economic growth in the Australian economy. Removing stamp duty is the primary housing taxation reform required and needs to be a core objective of an overall taxation reform strategy. Stamp duty on new property is also another example, like GST, where a 'double dipping' cumulative imposition of the tax can occur at multiple stages of the building process. This stamp duty treatment of new housing as 'trading stock' exacerbates the inefficiency of this tax and the inequitable treatment of new housing relative to existing property.

Federal/state reforms to improve affordability
Tax reform should include the replacement of inequitable and inefficient infrastructure levies on new home building with broader based community tax measures. Federal government endorsed market-based solutions should be implemented, such as public infrastructure savings bonds and facilitation of the use of innovative models such as taxation increment funding (TIF).

About the Housing Industry Association

The Housing Industry Association (HIA) is Australia's only national industry association representing the interests of the residential building industry, including new home builders, renovators, trade contractors, land developers, related building professionals, and suppliers and manufacturers of building products.

As the voice of the industry, HIA represents some 40,000 member businesses throughout Australia. The residential building industry includes land development, detached home construction, home renovations, medium-density housing, high-rise apartment buildings and building product manufacturing.

The residential building industry is one of Australia's most dynamic, innovative and efficient service industries and is a key driver of the Australian economy. The residential building industry has a wide reach into manufacturing, supply, and retail sectors.

The aggregate new housing industry contribution to the Australian economy is over $150 billion per annum, with over one million employees in building and construction, tens of thousands of small businesses, and over 200,000 sub-contractors reliant on the industry for their livelihood.

HIA develops and advocates policy on behalf of members to further advance new home building and renovating, enabling members to provide affordable and appropriate housing to the growing Australian population. New policy is generated through a grassroots process that starts with local and regional committees before progressing to the National Policy Congress by which time it has passed through almost 1,000 sets of hands.

Policy development is supported by an ongoing process of collecting and analyzing data, forecasting, and providing industry data and insights for members, the general public and on a contract basis.

HIA is well placed to comment on economic and housing policy matters. For over 30 years HIA has been a significant part of the economic commentariat, conducting targeted research and analysis on matters pertinent to new housing and the impact of housing policy on the broader economy. Consequently HIA has developed a highly regarded economics unit on a scale not seen in other industry bodies.

To complement the work of the HIA in-house economics unit, the association regularly commissions cutting edge 'at arm's length' independent research to support public policy debate in the sector.

A selective list of HIA's publication, reports, research notes and forecast is attached as Appendix I illustrating the breadth of HIA's focus.

The association operates offices in 23 centres around the nation providing a wide range of advocacy, business support including services and products to members, technical and compliance advice, training services, contracts and stationary, industry awards for excellence, and member only discounts on goods and services. HIA participates in over 35 committees that develop the National Construction Code and Australian Standards applicable to new housing.

PART I: BACKGROUND

Overview

The taxation burden on new housing

The tax burden on new housing is onerous. On its journey from vacant land to finished dwelling, a new home or apartment will pass through the taxation toll gate numerous times. In many instances, stamp duty is paid multiple times as transactions occur during the new dwelling's life cycle.

GST is then added to the final price of new homes to which a final stamp duty bill on the entire home price is added. This is all in addition to other levies such as developer contributions and infrastructure charges.

The most obvious effect of this taxation burden is to inflate home purchase costs for the buyers of both new and existing homes. By obstructing the pipeline of new home building, housing costs are forced up for both renters and homebuyers. This has a cascading effect, resulting in higher wages and prices across nearly all areas of the economy.

An effective tax regime would recognise the major inefficiency of transaction taxes such as conveyancing stamp duty and 'upfront' development infrastructure charges. While such levies elevate public revenues in the short term, research demonstrates that they have detrimental effects on economic activity and competitiveness.

Specific taxes on individual industry sectors distort the pattern of consumption and production from what would be optimal without the tax. Broad-based taxes that apply to all sectors equally do not create the inefficiencies of distorting the preferred patterns of consumption and production. Switching from a specific industry tax to a broad-based one removes such inefficiencies, allowing for a real increase in the value of consumption.

In addition to the readily identifiable taxes on new housing such as GST and conveyancing stamp duty, there is a broad range of hidden taxes - such as excessive development infrastructure contributions being used to fund community and regional infrastructure beyond what is directly required for the residential development on which the levy was imposed.

Across all tiers of government, the taxation of housing contributes almost $40 billion to revenue each year, which equates to 11.3% of total local, state and commonwealth government revenue.

Among Australia's largest industrial sectors (those with a value added of more than $10 billion per annum), the residential building industry is the second most heavily taxed in relative terms. Independent analysis undertaken for HIA by the Centre for International Economics (CIE) demonstrated that taxation (inclusive of explicit direct and indirect taxes, ambiguous taxes, and hidden taxes) throughout the production of a new house in Sydney was estimated to account for 44%[1] of the final purchase price. The analysis also showed that similarly large tax burdens were evident in other capital and regional cities around the country.[2]

Improving efficiency in the new housing sector

The residential building industry is a significant vehicle for job creation in the Australian economy, and in the post mining construction environment, it is the States that have a vibrant housing sector that are performing well.

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[1] *Taxation of the Housing Sector*, Centre for International Economics, September 2011
[2] *Taxation generated by the Housing Sector: an extension*, Centre for International Economics, January 2013

Along with the contraction in the mining sector, Australia is experiencing a long term structural decline in domestic manufacturing.

During the three months to February 2015, there were an estimated 480,000 total jobs in the residential building industry, compared to the three months to February 2014, when there were an estimated 463,000 total jobs. Residential building is therefore estimated to have added over 16,000 total jobs to the economy over that 12 month period.

This contrasts with direct employment in mining operations, where there were around 220,400 jobs in the three months to February 2015. This compares with the three months to February 2014, when there were 269,100 jobs in that sector, representing job shedding to the tune of 48,700.

Residential building can be the substitute needed by the economy as the mining sector winds down, however, this will require further policy action by governments to facilitate in improving efficiency in the industry. While issues such as planning reform and access to land are also key to solving Australia's housing challenge, tax reform in the residential building industry must be the priority, as significant and immediate benefits are able to be achieved.

Independent research[3] commissioned by HIA makes significant findings in this regard. It has been demonstrated that a reduction in inefficient taxes on housing to lower the residential cost of building by approximately 1.0% would increase GDP by up to $1.3 billion a year, with a flow-on impact would be $3.38 of additional GDP per increased dollar of activity in residential housing.

Improving affordability and fairness in new housing

New home buyers are increasingly required to bear the excessive cost component of housing infrastructure, costs that permeate across housing stock and add to Australia's housing affordability problems. Local councils and state governments cannot afford to finance this cost 'up front' either, which has been the key driver of the increasing movement towards a so- called 'user-pays' housing infrastructure model over the last 15 years.

This should not mean that all infrastructure must be paid for by the developer. The financing of some forms of infrastructure should be a community responsibility.

Development specific infrastructure - which provides essential access and service provision and without which the development could not proceed - is considered to be a core requirement for housing development and should be provided in a timely manner to facilitate affordable development. Infrastructure items within the boundaries of the development will be provided by the developer as part of the cost of development.

However, broader infrastructure that benefits the wider public – such as parks, ovals and community infrastructure – should not be funded just by the new home buyers in the community.

The cost of housing infrastructure adds substantially to the construction costs for new housing developments, and the associated levies are ultimately borne by the new home's first purchaser. The higher cost of new homes due to infrastructure costs also has detrimental effects on affordability in the established homes sector of the market, leading inevitably to a significant increase in mortgage repayments and indebtedness for all home buyers.

The efficient provision of housing-related infrastructure is equally as important as the efficient provision of larger infrastructure projects. The Henry Tax Review found that of the vast array of taxes paid by the new home building industry, around half were highly inefficient, including excessive infrastructure charges.[4]

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[3] *Construction and the Wider Economy – a general equilibrium analysis*, Centre for International Economics, Nov 2012
[4] *Australia's Future Tax System*, Chapter 6: Land and resource taxes. 2010

With the move towards direct charging of developers and new residents, there is inequitable treatment of new and existing residents. If rates of new residents are not selectively reduced, there will be subsequent double dipping by councils, as the new residents are levied at the same rate as existing residents, despite the fact that the new residents have already contributed towards the capital costs of the facility, whereas existing residents have not.

In 2010, HIA held a national summit[5] on the delivery of infrastructure to support residential development. The summit outlined the case for change and the need for leadership to affect change in the area of infrastructure funding. It is considered that there are alternative funding models that can be implemented quickly and can have an immediate impact on housing supply and housing affordability.

At the conclusion of the summit, HIA called for federal intervention to support borrowing programs for state and local governments facing infrastructure challenges. This could include incentives for local governments to borrow or the establishment of an Infrastructure Bank to attract superannuation funds to invest in local and state infrastructure. A range of ideas and proven solutions, for example Tax Increment Funding (TIF) and community bonds (MUNI bonds) which work effectively in other comparable economies were also explored. See Appendix II for more information on these options.

It is also important to recognise that the GST is applied to new, but not existing properties. This creates a price differential between the two and is a further example of the inequity of the taxation treatment of new home buyers. HIA's policy position with respect to the taxation on housing is set out in Appendix III. This policy was informed by all of the research that is outlined in this submission and was unanimously adopted at the last National Policy Congress of members in May 2015.

Supporting small business through the taxation system

The backbone of Australia's residential building industry is the small family owned contracting business, responsible for their own work, setting their own hours and moving flexibly from site to site. Working predominantly on a contract basis is the incentive these small businesses have to perform to the highest standards.

Small businesses dominate the residential building industry and are the key providers of training, and employment of apprentices for the broader building and construction industries.

Over the last decade government policy at all levels has eroded the position of small contracting businesses as the engine room of home building. In a misguided approach, primarily targeted at broadening their revenue bases, the Commonwealth, state and territory governments have progressively 'deemed' that many classes of contractors should be covered by regulations that had previously only ever applied to employees. At a federal level this has included taxation measures, while states and territories have also spread the coverage of payroll tax to capture an increasing share of small businesses in their net.

If Australia is to remain at the international forefront of residential building efficiency this slow constriction of small contracting businesses must not just be stopped, but reversed. Reforming the tax system with respect to small business to reduce complexity would provide more impetus for enterprise.

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[5] *Building Better Cities, Financing Urban Infrastructure: Australia's housing future summit*, 2010.

Capital Depreciation

A key problem with respect to depreciation and small business is that there is a complex system with many different rates, and while the recently announced small business accelerated depreciation measures are welcome, this requires the business to actually have money to invest in a new asset before there is a benefit. Even then, there is a sunset clause on the policy. Streamlining existing depreciation arrangements, to provide more certainty and improve cash flow for small business would be highly beneficial. This could include greater opportunities for immediate write off for low value assets.

Abolition of Payroll Tax

Payroll tax is a disincentive to employ staff and should be abolished. Its application to legitimate independent contracting arrangements through deeming provisions is counterproductive. Abolition of inefficient taxes such as payroll tax should be considered as part of an overall debate about broadening the tax base.

Capital Gains Tax

When selling an asset or business, Capital Gains Tax (CGT) detracts from the amount of capital which may be used to re-invest in other more productive assets. The sale of business assets upon retirement is often a means of privately funding life after work, and therefore CGT acts as a handbrake for small business people paying for their own retirement and not being a burden on the public purse.

PART II: TAXATION ON HOUSING

A New housing supply

The housing market in Australia faces a very high tax burden, especially new residential construction. This taxation burden inhibits the adequate supply of new dwellings to house Australia's growing and ageing population and acts a constraint on productivity growth.

To take one prominent example, discussed in detail below, stamp duty on residential property conveyances generated an estimated $9 billion in revenue in 2013/14. Research undertaken for HIA by Independent Economics[6] demonstrates that stamp duty is the most inefficient tax in Australia's entire taxation system. As a tax on moving, stamp duty on conveyances discourages households from moving home when this decision may better suit their needs in terms of size, location or other amenities. Thus, households do not get the best use out of the available housing stock.

It is well documented that Australia is currently building a record number of new dwellings with the total volume to exceed 200,000 in 2015. Three of the eight states and territories – New South Wales, Western Australia, and Victoria have driven this national record, with current indications that Western Australia will experience a significant reduction in new home building activity as 2015 progresses. No doubt pent-up demand for housing has been a factor with the industry only averaging around 156,000 housing starts over the preceding decade, well below underlying demand.

Research conducted by HIA[7] finds that within this record national volume, the construction of detached houses has peaked at a level below current demand. This undersupply of detached housing, which has occurred despite this segment of the new home building market reaching a level 8 per cent higher than the long term average, is due to supply side constraints. As well as the high direct taxation burden identified in this submission, a lack of 'shovel-ready' residential land, long planning and zoning delays, and excessive user pays infrastructure charges are examples of costs and taxes that are pricing the remaining cohort of demand for new detached housing and lower density housing out of the market. This is because these costs and taxes add considerably to the holding costs and therefore financing costs of purchasing a new detached house or townhouse.

This current situation highlights the debilitating impact that a high taxation burden on the new home building industry is having. Independent research undertaken for HIA by the CIE provides the most comprehensive and definitive measurement of the taxation of new housing conducted over the last several decades[8]. This CIE report assesses the extent and impact of taxation levied on the housing industry in Australia and compares this to taxes levied on other industries.

The research measures three types of taxes: explicit taxes (direct and indirect); ambiguous taxes; and hidden taxes. Further details are provided in Appendix IV.

The core reason for the current imbalance between demand and supply of new detached houses is the disproportionately high taxation of the new home building industry. For example, excessive delays in obtaining title for residential lots have created a holding cost barrier which has priced potential detached house buyers out of the market. This excessive delay is a hidden tax. Similarly, upfront developer charges imposed by state governments and local councils that are excessive, ineffective or contribute to general revenue are an ambiguous tax.

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[6] *Economic Impacts of Negative Gearing of Residential Property,* Independent Economics, June 2014
[7] National Outlook, Autumn edition, May 2015
[8] *Taxation of the Housing Sector*, Centre for International Economics, September 2011

As will be discussed in detail further, the taxation of new housing is disproportionately high, inefficient and inequitable - and therefore very distortionary, and is a constraining force on Australia's productivity growth and economic growth.

In the absence of a taxation reform program that incorporates housing as an integral component, Australia will not build sufficient homes to house Australia's growing and ageing population. This event in itself will further constrain productivity growth and economic growth, erode Australian living standards, and place additional pressure on health and social housing budgets in relation to adequately housing the nation's ageing population.

Research undertaken by HIA highlights the need for a higher average level of new housing supply per annum over the next 40 years, relative to past decades. This outcome is implied in core parameters applied in the *Intergenerational Report 2015*. HIA's research - *Housing Australia's Future*[9] - released last year provides a comprehensive scenario-based demographic analysis of Australia's future housing requirements. One finding is that with an average population growth rate of 1.3 per cent – as assumed in the IGR – and a moderate annual rate of increase in real (household) income growth, Australia would need to average in excess of 186,000 new dwellings per annum over the next 40 years to adequately house its growing and ageing population.
This is a conservative housing supply estimate, yet it cannot be met under the current taxation arrangements for the new home building industry.

B Housing taxation

Independent research undertaken for HIA by the CIE demonstrates that housing in Australia, especially the new housing sector, is very heavily taxed in both absolute and relative terms[10]. The research also demonstrates that a large number of the taxes levied on new housing are inefficient and also inequitable.

The Australian housing sector is heavily taxed in absolute terms

The Australian new housing sector contributes in excess of $40 billion in taxation revenue each year to federal, state and local governments in Australia. This value equates to 11 to 12 per cent of the total revenue collected by all tiers of government and makes housing the second largest taxation contributor of all sectors in the Australian economy. Only one sector, wholesale and retail trade, contributes more and its contribution is only marginally larger (13 per cent of all revenues in aggregate). The next largest contributing sector is transport at 7.5 per cent. To reinforce this important finding - there are 111 sectors in the Australian economy and the one providing shelter – new home building – is the second most heavily taxed.

The CIE research also finds that the burden of tax falling on the housing sector is considerably higher than the average for all other sectors. New housing in particular is inequitably taxed, accounting for around 1.2 per cent of value added in the economy yet contributing 2.8 per cent of government taxation revenues. In terms of GST alone, the residential building industry accounts for 13 per cent of all GST revenue raised by the Commonwealth Government.

For new housing, the GST is the largest tax, with over $7 billion collected in 2013-14. However, this tax burden is not equitably shared across all housing as the GST applies to new housing, but not to existing dwellings. This is another example of the inequitable treatment between new and existing housing stock, which is also a dynamic that inhibits productivity growth in the Australian economy.

In addition to the readily identifiable taxes such as GST and stamp duty on property conveyances, there are a range of hidden taxes that not only add to housing costs but cause a wasteful use of

[9] *Housing Australia's Future, Demographic Analysis of Australia's housing requirements*, HIA Economics, October 2014
[10] *Taxation of the Housing Sector*, Centre for International Economics, September 2011

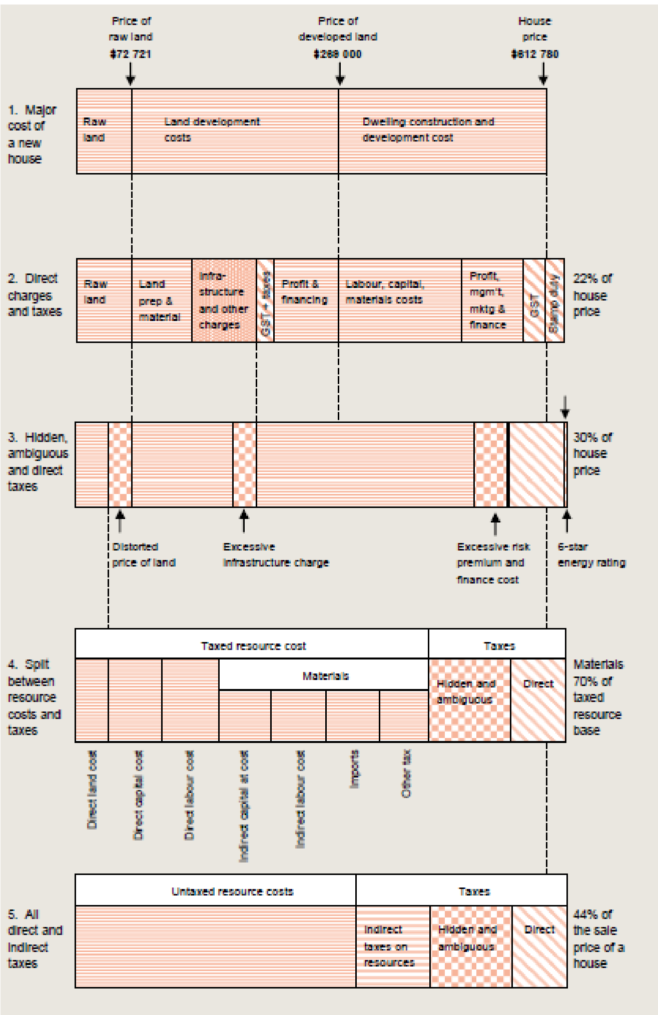
resources and impose deadweight losses on the economy. The average tax burden on the new housing sector is estimated at 31 per cent of the value of output compared with an economy-wide average of 24.4 per cent. When hidden taxes are added in, the tax on new housing is an estimated:[11]

- 44 per cent of the purchase price of a new house in Sydney;
- 41 per cent in Perth;
- 39 per cent in Adelaide;
- 38 per cent in Melbourne;
- 38 per cent in Albury;
- 37 per cent in Townsville;
- 36 per cent in Brisbane; and
- 36 per cent in Wodonga.

The breakdown of taxes for Sydney is presented as an example (see table 1). For the average Sydney house, The CIE Report estimates that the percentage of tax as a share of the total dwelling cost is 17 per cent for hidden and ambiguous taxes, 14 per cent for generic taxes accruing to direct and intermediate inputs (indirect taxes), and 12 per cent for direct taxes.[12]

Table 1

1.1 Breakdown of costs and taxes of a new home: Sydney



Source: TheCIE.

[11] *Taxation of the Housing Sector*, Centre for International Economics, September 2011; and, *Taxation generated by the Housing Sector: an extension*, Centre for International Economics, January 2013
[12] This analysis is also undertaken in the CIE reports 2011 and 2013 for apartments as well as detached houses.

In absolute terms housing is the second largest contributor of tax to Australian governments, contributing around 12 per cent of all revenues in aggregate.

It is not only the Commonwealth that extracts large amounts of taxation from housing and the residential building industry. State and local governments also rely heavily on taxes and charges on residential properties for their revenue. Residential property taxes and charges contribute over 40 per cent of total state and local government taxation revenue. Even larger (in absolute dollar terms) than the GST revenue from new homes is the total of state stamp duties on new and existing residences. In addition, almost equally large again are council rates.

In addition to these taxes there are other imposts on housing as previously outline in this submission, including infrastructure charges, a raft of levies and compulsory fees, as well as other generic taxes levied across most sectors such as income taxes, fuel taxes, payroll taxes and import duties.

In the new housing sector, GST and stamp duties cascade on top of these already high taxes - escalating them further. The CIE research illustrates this 'cascading taxation' where GST and stamp duty is payable more than once in the new home building process, aggregating to a disproportionately large amount. The aggregation of stamp duty is unique to the new home building industry, exacerbating the pre-existing large inefficiency and distortion created by stamp duty on property conveyances. This situation must be a prime area for targeted reform in the early stages of an overarching taxation reform framework.

On any objective basis of measurement the taxation burden borne by Australia's residential building industry is disproportionately large. Among the 111 sectors identified in the Australian Bureau of Statistics' input-output tables, residential building (that is, new dwellings) ranked 11th highest in terms of total tax burden on the production and use of products. This is allowing for the inclusion of sectors such as alcohol and tobacco, which are highly taxed due to the large negative externalities that may arise from their consumption. Ranking less highly (37th) was the total taxation of the ownership of dwellings, which while still taxed relatively highly, further highlights the considerable inequity in the tax treatment of new versus existing dwellings.

When the total tax burden as a percentage of production costs is averaged across all these sectors the proportional tax burden is 24.4 per cent, as previously noted. The average tax burden for new housing is a considerably higher 30.9 per cent.

When considering the tax burden as a percentage of the production cost of commodities and services with a value added higher than $10 billion, new housing is the second most heavily taxed of the 27 sectors that meet this criterion.

Many of the taxes levied on new housing are very inefficient

A number of the taxes imposed on the housing sector, and on new housing in particular, are inefficient. The *Australia's Future Tax System* report, commonly referred to as the 'Henry Tax Review' found that among the vast array of taxes paid by the housing sector, about half of them were highly inefficient. In particular, the Henry Tax Review singled out: stamp duties; the existing land taxes; the effects of zoning on raw land prices; excessive requirements in the building code; the effects of planning delays and uncertainties in planning on risk premiums and finance charges of developers; and inefficient and excessive costs within infrastructure charges.

The analysis conducted by the CIE provides compelling evidence of this situation. Simulation results using the CIE-REGIONS model confirmed that many of the taxes applying specifically to housing are relatively inefficient in terms of the costs they impose on the rest of the economy. The research found that more than half of the taxes falling on housing can be considered as inefficient (see table 2 below). As outlined further below, model simulations also suggest that the Australian economy could be given a boost by replacing these inefficient taxes with more efficient broad-based ones.

Table 2

Potential scale of inefficient or excessive tax on a dwelling

	Sydney	Melbourne	Brisbane
	A$ per dwelling	A$ per dwelling	A$ per dwelling
Stamp duty	24 228	22 156	10 073
Land tax	1 457	1 117	909
Excessive land price	40 381	19 789	9 493
Planning delays and uncertainties[a]	38 094	22 609	23 297
Excessive infrastructure charges	24 801	-	20 557
National Broadband Network	3 000	3 000	3 000
Building code excesses	9 583	10 926	11 609
Total — Greenfield	**141 545**	**79 597**	**78 938**
Stamp duty	23 718	16 248	10 194
Land tax	2 971	463	1 931
Excessive land price	11 087	7 174	9 391
Planning delays and uncertainties[a]	37 426	21 371	23 630
Excessive infrastructure charges	2 818		13 696
National Broadband Network	Na	Na	Na
Total — Infill	**78 020**	**45 257**	**58 843**

[a] Estimated through removing excessive delays and uncertainties. Therefore, estimates also reflect resulting reduction in other taxes such as the GST.
Data source: TheCIE 2011.

Independent research undertaken for HIA by Independent Economics[13] corroborates this finding. Model simulations using the independent extended comprehensive general equilibrium (CGE) model found that stamp duty on property conveyancing was the least efficient tax with a marginal excess burden (as a percent of net revenue) of 68 per cent. Stamp duties therefore have a very high economic cost.

Taxes levied on housing primarily exist at the state government level, although there are clearly also a high number of inefficient taxes at the local government level. Moreover, taxes such as the GST compound the impact of these inefficient taxes.

The most prominent inefficient or excessive[14] taxes on housing are: stamp duty; the excessive component of the land price; planning delays and uncertainties; and the excessive portion of infrastructure charges.

Removing these taxes on new housing and replacing them with more efficient taxes has the potential to provide the Australian economy with a significant boost in terms of efficiency and productivity.

Removing these taxes on new housing would also improve new home affordability. As outlined above, the independent research conducted for HIA by CIE provides compelling evidence that the new housing sector is very heavily taxed in absolute terms and that more than half of the taxes are inefficient. In relative terms, new housing is taxed to a considerably higher extent than existing property and therefore is also taxed in an inequitable manner.

[13] *Tax Reform and Housing,* Independent Economics, June 2014
[14] Where charges or regulations are applied at a level above the economically efficient level, or above that necessary to fund provision of the good or service for which they are charged (as may occur in the case of infrastructure charging) then the charge or regulation is considered to be a tax as defined by the Productivity Commission.

The taxes on housing fall largely on the home buyer

The demand for housing is relatively inelastic in the shorter run. Housing is required as shelter, and Australian households generally desire a home of their own, whether this residence is accessed through the rental market or by purchase. As the population grows, so too does the number of households, which increases the demand for dwellings. A range of factors underpin a robust underlying (or demographic) demand for housing in Australia. Despite the current strong national new home building cycle, demographic demand continues to exceed housing supply, as evidenced by the peaking of detached house construction this cycle at levels below current underlying demand for dwellings.

A number of constraints act on the supply side of the housing market. Many of these constraints (such as inefficient planning and approval processes) exemplify Australia's inefficient taxation system and cause housing supply to be less responsive than is desirable. However, in the longer term housing supply is expected to be more elastic than it is in the short run.

These demand and supply conditions combine to see much of the burden of any housing tax fall on the home buyer. The CGE modelling completed by the CIE suggests that more than 90 per cent of the welfare loss due to any tax (or in other words, the incidence of the tax) on housing falls on the buyer. Only a small per cent of the burden (2 to 6 per cent) falls on the owners of land, producers and suppliers. When direct, indirect and hidden taxes are included, the total tax on a new house can be as much as 44 per cent of its purchase price (in the case of Sydney), as outlined previously.

The cost of financing taxation provides one clear indication of how taxes on new housing greatly reduce housing affordability. For example, for a young couple in Sydney, the cost of financing the extra cost of a home due to taxes can amount to around 33 per cent of their after tax incomes (based on 25 to 34 year olds' national average take-home income). In their first year this couple have to pay double this when they pay stamp duty. Where the couple have paid a 10 per cent deposit, the extra cost of tax will roughly double their monthly repayments.

Conversely, when these taxes are reduced it can have a dramatic impact in terms of decreasing the cost (and hence the price) of a new home. The removal of taxes from the housing sector would see the majority of benefits accruing to households. This is because households bear more of the tax burden than producers before the tax cut, which is in turn due to the fact that the demand for housing is generally less elastic than the supply in the longer term. CIE modelling shows how the cost of new dwellings falls as different categories of taxation are removed (table 3).

Table 3

Notional impact on cost of dwellings from removal of taxes — Greenfield

Item	*Sydney*	*Melbourne*	*Brisbane*
	$/dwelling	$/dwelling	$/dwelling
1. Current cost of house to home buyer	639 533	511 202	534 726
2. Scenario 1: less direct property specific taxes (stamp duty, GST, land tax)	-81 855	-68 521	-60 523
3. Scenario 2: less non-tax component of ambiguous taxes (excessive infrastructure charges)	-118 637	-72 381	-90 835
4. Scenario 3: less hidden indirect taxes	-196 524	-114 579	-120 109
5. Scenario 4: less generic taxes	-267 916	-180 250	-189 159
Notional post-sale cost of dwelling	371 617	330 952	345 567

Data source: TheCIE 2011. Note, numbers may not match precisely with estimates in table 3.3 due to sequencing of taxes.

__The taxes on housing are distortionary__

It is widely accepted that stamp duty on property conveyances is a highly inefficient tax which creates large distortions and imposes economic costs. The research previously referred to conducted for HIA by the CIE and Independent Economics demonstrates that a number of taxes on new housing are distortionary. Stamp duty is unequivocally the most distortionary tax on housing, and indeed in the entire economy. It has a very high economic cost.

Abolishing stamp duty on conveyances is a top priority for housing tax reform. It would result in a substantial gain in household living standards by reducing artificial barriers to both investing in housing and to moving when people's housing needs change. It would also make housing more affordable for both renters and owner-occupiers.

In considering tax reform options it is important to focus on the key axioms of good tax policy (as outlined at the outset), the need for structural reform of Australia's taxation system, and the interaction of the Tax White Paper process with the Federalism White Paper process and the IGR 2015. A short term focus on 'tinkering' with the current system, be that in relation to superannuation, capital gains treatment, or negative gearing provisions - to provide three examples, will create additional distortions to a pre-existing taxation framework which is highly distortionary.

Negative gearing is a prime example. In 2014, HIA commissioned Independent Economics (IE) to investigate the effects of negative gearing of residential property. To assess the effects of residential negative gearing, an alternative policy for taxation of rental property income was necessary in order to provide an 'anchor' point of comparison. For that purpose, the report considered a recommendation of the Henry Tax Review to discount net residential income/losses by 40 per cent, which would reduce the level of tax deductions available from negative gearing by the same proportion. The report analysed the effects that such a discount to residential negative gearing would have on housing affordability, overall living standards, and the Australian economy.

The two key findings of the IE research were:

- Under current housing policy settings, discounting residential negative gearing would lower Australian living standards by making the tax system less efficient. The discount would add to the already high tax burden in the housing market, exacerbating the current undersupply of housing and therefore further reducing the efficiency of the housing market; and,

- Discounting residential negative gearing would also reduce housing affordability. Adding to the tax burden on rental properties reduces the incentive to invest in housing, and therefore reduces housing supply. This lower supply raises the cost of housing for both renters and owner occupiers.

The research found that under current housing policy settings, discounting residential negative gearing would be a retrograde step for both overall living standards and housing affordability in Australia.

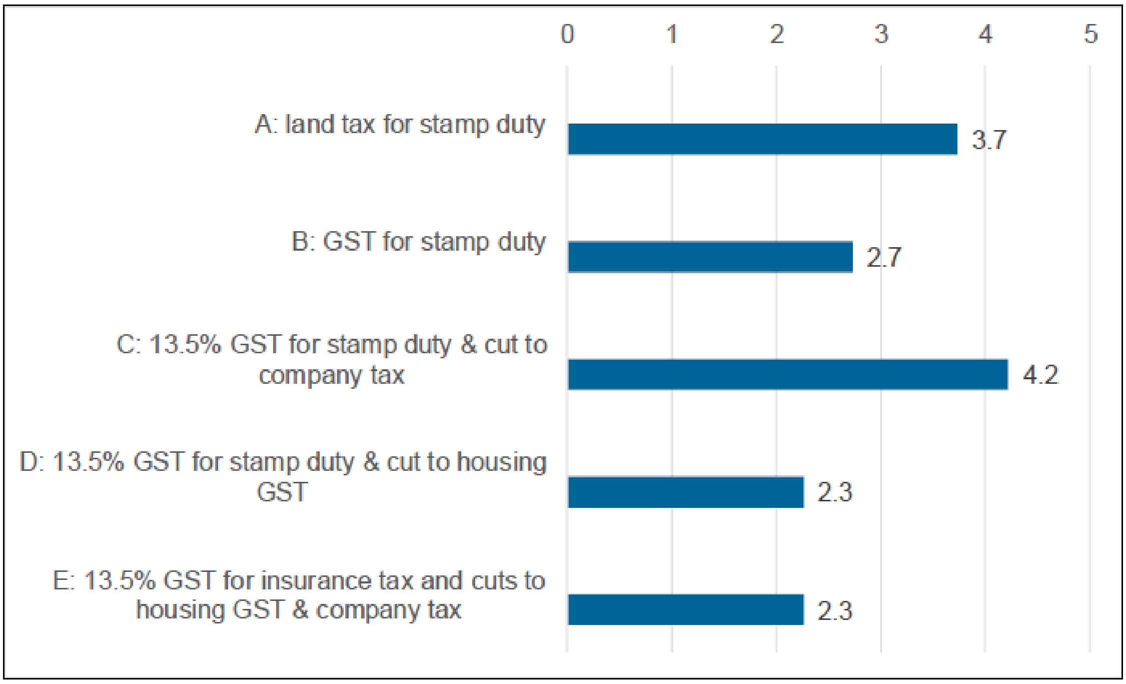
It is important that the focus of the Taxation White Paper process, and related reviews, is on reducing current distortions to Australia's taxation system - of which stamp duty is the primary example – not creating additional distortions to the current taxation system.

A credible analysis of the impacts of reducing negative gearing on residential property needs to consider other (contemporary) policy settings. The IE research specifically examined the role of stamp duty on conveyances, which are a large distortion in the current housing market. In addition, policies which restrict housing supply by artificially restricting the supply of residential land were also considered.

The IE research clearly demonstrates that abolishing stamp duty on property conveyances is the top priority for housing tax reform. Removing this fundamental distortion from the housing market would have important benefits for both living standards and housing affordability.

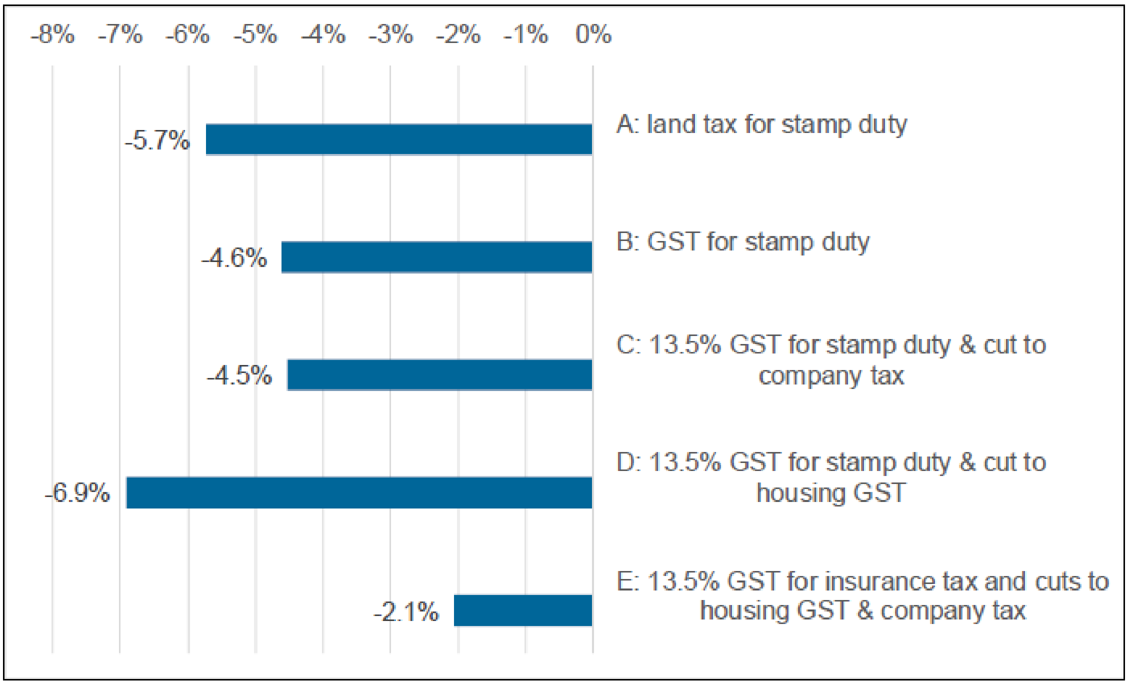
This is where a primary focus of the Tax White Paper process needs to be – removing existing distortions in Australia's taxation system.

Chart B Effects of tax policies on Australian living standards ($billion, 2013-14 annual terms)



Source: Independent Extended CGE model simulations

Chart C Effects of tax policies on housing rents



Source: Independent Extended CGE model simulations

Federal/state vertical fiscal imbalance and housing affordability

It can be clearly demonstrated that many taxes on new housing (largely state-levied) are inefficient. An integral element of why these (highly distortionary) taxes constrain economic growth and productivity growth resides in the fact that these taxes reduce housing affordability.

There is a range of measures available to the Commonwealth to address declining housing affordability. Fundamentally, however, sustainable and long-term restoration of housing affordability involves reform to Commonwealth-state and territory financial relations. Despite the introduction of the GST, the states and territories continue to rely on a large number of narrowly-based and highly distorting taxes for their revenue collection. In particular, the states and territories rely too heavily on property taxes.

A heavy reliance from all three tiers of government on residential property for taxation has caused property taxes to grow rapidly. Local government revenue from levies on new developments and also from property rates have also escalated at a fast pace. Moreover, this substantial increase in the reliance of state and local governments on revenue from residential property has been most prevalent in respect of new residential development. Unfortunately, because taxes 'down the line' (e.g. the GST) cascade on top of these state and local government taxes, they are a primary cause of economic loss.

The reliance on revenues generated by new home building and housing more generally exacerbates the cyclical nature of the industry. Stamp duty revenues, for example, are a volatile source of state government revenue yet in times of strong housing activity is a substantial (and highly inefficient) source of revenue. In the current housing cycle total property tax revenue exceeds that received from payroll tax.

There is an inherent tendency to refrain from considering options to reduce property taxation in periods when the revenue streams are large. This tendency can, in turn, amplify the magnitude of a downturn in housing activity. Indeed, a reliance on revenue from residential property and the new home building industry can prove difficult to 'break free' of in a cyclical downturn. For example, there are instances where the excessive charges on residential infrastructure, which can be accurately defined as an ambiguous tax, have been increased (principally at a local government level), in periods where new residential construction activity have been declining.

The additional volatility that a reliance on property taxes embodies in the housing cycle compounds the fact that state and territory taxes applied to housing generally fail badly on the key principles of good tax policy previously outlined – simplicity, certainty, equity, neutrality, and efficiency. Part of the inefficiency of these taxes stems from the differing treatments which occur across state borders. Conversely, the removal of these taxes would generate significant economic gains, as outlined in the next section.

The complicated distribution of GST revenues and Commonwealth Special Purpose Payments needs to be a key consideration of taxation reform. Cleary the current 'model' doesn't work and this has resulted in considerable inequity and inefficiency among the three tiers of government. Systematic reform would yield a more effective incentive system for a more efficient tax base across levels of government, including the level of government that necessarily resides at the heart of such reform, namely state governments.

All available options should be considered in the context of the reform of Australia's taxation system and of the current vertical fiscal imbalance between the Commonwealth and state and territory governments. A range of reforms for consideration include: the states and territories directly receiving a percentage of income tax revenue while forfeiting the complicated and at times less than transparent allocation of revenue through Commonwealth Special Purpose Payments; or a 'top-up' of GST revenues to occur through a lift in the rate of GST where the revenue allocation is directed to the states and territories (but only with a range of measured GST relief provided to new housing). It is a long-standing principle that the level of government which is providing a service or function should also have the direct responsibility for the raising of tax revenues. A revised income tax or GST distribution model would help ensure that equity is restored to the distribution of tax revenue. Such a model would necessarily involve an element of ‘competitive federalism’.

It is clear from earlier sections of this submission that there is a range of state and territory taxes that need to be rationalised. In the first instance, targeting the largest and most inefficient (and hence the most distorting) taxes for removal would be a sign of a successful taxation reform approach.

It has been clearly demonstrated through HIA-commissioned research and elsewhere that two prominent examples of inefficient or excessive taxes on new housing are stamp duty on residential conveyances and excessive infrastructure charges levied on new residential developments. It is equally important to note that housing taxation reform provides many benefits to the Australian economy beyond those directly affecting the new home building and housing affordability.

C Benefits of housing taxation reform

Removing specific, mainly state-based taxes, and replacing them with broad-based taxes will provide a number of benefits, including the expansion of economic activity. A range of studies support this view, including independent research conducted for HIA by the CIE and IE, and the Henry Tax Review.

To take one example, research undertaken for HIA by IE demonstrates that a range of policy options aimed at abolishing stamp duty all provide a substantial increase in Australian living standards, with the minimum gain being $2.3 billion per annum. Such reform raises living standards by reducing reliance on a tax that has large disincentive effects. These are unsurprising and compelling results, which reflect that fact that stamp duty has the highest marginal excess burden of any tax in Australia. This research also confirms that abolishing conveyancing stamp duty, when considered within a range of policy scenarios, has the largest impact on the affordability of housing rents.

As a transaction cost on housing, stamp duties lock home owners into their existing residences. Home owners should be able to, in a relatively costless manner, sell their existing residence and purchase another property that is more attune to their needs as life circumstances change (e.g. a bigger home as the family grows or a smaller home as the children leave the family home to live independently). This allows available housing stock to be used in its most efficient manner. In a similar manner, stamp duties act as a constraint on labour mobility. The large transaction costs on buying and selling a home act as a barrier to home owners moving elsewhere to seek better paid employment or, in some cases, moving to gain employment at all.

The OECD has noted that among their member nations, Australia has the fourth highest transaction costs on houses at just under 14 per cent of property value. The OECD also highlights the problems that high property transaction costs cause in terms of reduced residential activity and labour mobility.

The existing tax system therefore creates disincentives for Australians to relocate to the areas where their skills are most in demand. This is a key example of the current tax system constraining Australia’s productivity growth. Encouraging workforce participation is going to be increasingly important in coming decades. The core projection in the IGR is that the ratio of the working aged population to those aged over 65 will decline from 4.5 to 2.7. While this figure is contentious, clearly the ratio is going to exhibit a downward trend. Eliminating the large restriction to labour mobility created by stamp duty would be a very positive reform to encourage increased workforce participation.

Stamp duty is the most prominent example of a tax that fails the axioms of good tax policy. This is largely due to:

- the broader 'reach' of this inefficient tax in terms of it reducing the ability of households' to make a preferred housing choice; and
- restraining labour mobility.

There are a range of taxes on new housing that fail the axioms of good tax policy. There are economy-wide benefits to reducing these taxes, as evidenced by research undertaken by the CIE.[15] This research investigated what impacts changes in the residential construction sector have on the rest of the economy and what impacts changes in the rest of the economy have on construction.

Among possible economic changes in the residential construction sector, productivity increases in the sector provide sizable flow-on benefits to the rest of the economy. A 1.0 per cent total factor productivity increase for the residential construction sector can generate a step change in national GDP of $863 million a year. The impact ratio, or flow-on effect in other words, is estimated to be $4.19 of additional GDP per increased dollar of activity in residential construction. This modelling assumed a situation of full employment. Under this assumption, productivity improvements in residential construction free up resources, which can be absorbed by other industries and therefore allow them to expand.

While causing the residential construction sector to expand by 0.15 per cent, the productivity improvement would also enable mining to expand by 0.07 per cent, manufacturing by 0.01 per cent and the rest of the economy by 0.06 per cent.

In a situation of less than full employment the CIE research found that a 1.0 per cent productivity improvement would generate an impact ratio of an additional $5.10 of economic activity in Australia per increased dollar of activity in residential building. The step change in economic activity would be nearly $1.2 billion per annum. In this situation, in addition to the residential construction sector expanding by 0.18 per cent, the productivity improvement would enable mining to expand by 0.13 per cent, manufacturing by 0.04 per cent and the rest of the economy by 0.08 per cent.

A 1.0 per cent productivity improvement could be generated through reductions in planning approval times, for example. Excessive delays in planning approval times are common within the residential Building industry and add considerably to holding costs. The excessive component of planning approval times is a hidden tax on residential construction. Other examples of reform that could generate an improvement in productivity include: the removal of workplace restrictions; and the reform of environmental controls, building regulation, and apprenticeship training.

A reduction in inefficient taxes on residential construction would also provide considerable benefit to the wider economy. As identified in the research undertaken by IE and the CIE, and by the Henry Tax Review, many taxes on housing are distortionary and inefficient.

A reduction in inefficient taxes on housing in the Australian economy that lowered the cost of residential building activity by approximately 1.0 per cent would increase economic activity by $780 million per annum. For every dollar of extra activity created in residential building there would be an expansion in national economic activity of $2.26. Under a situation of less than full employment the increase in economic activity from a cut in inefficient taxes would rise to $1.3 billion per annum. The expansion in economic activity would be $3.38 for every dollar of extra activity created in residential building

There is no easy path to abolishing stamp duty or any other major taxation reform. Such reform is, nevertheless, imperative. It will, necessarily, involve a move to a considerably broader-based tax. It

[15] *Construction and the Wider Economy – a general equilibrium analysis*, Centre for International Economics, Nov 2012

is important to reinforce that such reform does bring considerable benefit – as demonstrated above.

D Some Opportunities for Immediate Reform

There are major structural reforms needed to remove the burden of taxation on new housing, particularly in addressing the application of GST and conveyancing stamp duty. In moving to a new taxation model, carefully thought through transitional arrangements will need to be implemented for reasons of equity and to ensure the Commonwealth, state and territories are appropriately funded through a new tax base.

In the interim, there are incremental, unilateral policies that can be implemented to reform housing taxation while the overarching Taxation White Paper process is progressing.

These areas include tackling residential land supply, user-pays infrastructure charges and cascading stamp duty.

Residential land supply

There is a lack of 'shovel ready' residential land in key markets in Australia, including Sydney and Brisbane. Excessive delays in gaining title to residential land add considerable cost and are a hidden tax on new housing which acts to shut a proportion of potential new detached house buyers out of the market.

State and territory governments can provide a more transparent and structured framework for residential zoning and land release; and could expedite the availability of shovel ready land. This individual reform would effectively reduce the taxation on new housing.

An overarching national body responsible for an integrated database and assessment of current and future land supply requirements and wider analysis of Australia's future housing needs would be an efficient way to ensure a timely availability of land. Such a body could be modelled on the previous Indicative Planning Council (IPC) and sit within the Treasury or the department of Prime Minister and Cabinet.

Infrastructure charges

Over the last ten to fifteen years there has been an increasing move towards 'user pays' charging for physical and social residential infrastructure. It has been established that many of these infrastructure charges are excessive or what is often termed 'gold plating'. This excessive component to infrastructure charges is an ambiguous tax on new housing.

A focus by state and territory governments on alternative methods of infrastructure financing could lower the taxation of the new home building industry. Bond financing and Tax Increment Finance are two examples of more efficient and equitable methods of funding residential infrastructure over a longer timeframe, which would lower taxation and therefore improve housing affordability.

A national body such as an IPC would be helpful in generating an integrated model for infrastructure financing.

Cascading taxation

As previously identified in this submission, GST and stamp duty can be paid more than once in the process of building a new home. This 'double taxation' is not only taxing the same item on more than one occasion, but also increases the inequitable treatment of new housing relative to existing property, as GST is not levied on existing property at all. Stamp duty being payable more than once means that a new housing 'product' is, incorrectly, being treated effectively as trading stock.

While consideration of GST reform in this regard would need to occur under the wider Tax White Paper process, reform of cascading stamp duty could be undertaken by the states and territories. Modelling undertaken by the CIE for HIA demonstrates the benefits for each state and territory of reducing an inefficient tax such as stamp duty.[16] The inefficiency of stamp duty is exacerbated by the levying of this tax more than once in the new home building process. Removal of this cascading effect would generate more efficient outcomes and increase the average level of new housing activity over the longer term, therefore generating additional revenue for states and territories.

Housing is shelter and new housing should not have GST applied to it. Under the original GST framework new housing was to be exempt.

Should the rate of GST be raised in the future then there would need to be appropriate compensating treatment of new housing. Zero rating or treating new housing as GST exempt are examples.

If the rate of GST was increased, including for new home building, then the cost of new housing relative to existing property would rise. The risk of this situation generating a recession in Australia would be very high.

Clear evidence of this possibility was provided at the time of the introduction of the GST during 2000. On that occasion, there was disruptive front-loading of economic activity to leading up 1 July, with activity dropping off substantially once the tax came into effect. The economy's annual rate of growth slowed from 4.1 per cent in the June 2000 quarter, to just 1.1 per cent in the December 2000 quarter. The consequent erosion of confidence meant that it took until the end of 2001 for the economy to return to its 3 per cent 'trend' rate of growth.

During 2000, new home building was one of the economic sectors most adversely affected by the introduction of the GST. New home starts fell from 172,500 in the 1999/2000 year to just 114,580 in 2000/01 as a result of the introduction of the GST, the lowest annual total in modern history. Given that new home building is currently the only growth area of domestic demand, unfavourable changes to GST would be certain to drag the economy firmly into recessionary territory.

[16] *Construction and the Wider Economy – a general equilibrium analysis*, Centre for International Economics, Nov 2012

PART III: RESPONSES TO QUESTIONS

Following are responses to the questions directly related to the residential construction sector and provision of housing in Australia. They are expressed in context of the detailed analysis previously provided in the main body of this submission.

1. **Can we address the challenges that our tax system faces by refining our current tax system? Alternatively, is more fundamental change required, and what might this look like?**

The challenges facing the Australian taxation and transfer system, and the Australian economy, cannot be addressed by merely fine-tuning. It will require substantial and structural change.

Over time, progressive changes to the taxation system have created distortions and exemptions that have collectively proved inefficient and detrimental to the Australian economy. This will not just require changes to rates or basic parameters of taxation, but a new philosophical approach.

Using the housing industry as an example, to maintain productivity and increase employment, it is important that the economy moves from inefficient transactional taxes such as stamp duty on conveyancing, to broader based community taxes.

2. **How well does Australia's utilization of its available taxes align with the evolving structure of Australia's economy and changes in the international economy?**

The Australian taxation system has not kept pace with changes in the structure of the national and international economy. Nowhere is this more apparent than with regard to the delivery of new housing.

In an environment where employment with a single entity was a lifetime prospect, in particular with a strong domestic manufacturing sector, taxes such as a modest stamp duty may have had a more benign effect on the economy. It would be an accepted cost associated with buying a house, which would likely remain the family home well into retirement. In today's world where taxes and charges can be as much as 44% of the cost of a new home, where employment is more transient and labour is much more mobile, stamp duty is an inhibitor to geographic labour mobility, productivity and affordability.

Equally, with growing pressures on land supply and state governments pursuing policies of densification in metropolitan areas, stamp duty is an inhibiter to downsizing, thus freeing up land for development or providing opportunities for larger families to access larger blocks that are closer to services, amenities and places of employment.

3. **How important is it to reform taxes to boost economic growth? What trade-offs need to be considered?**

Independent research commissioned by HIA[17] clearly demonstrates that improving productivity in residential building not only benefits the sector itself, but also the wider economy. Central to achieving this aim is the need to reform the inefficient and disproportionately high levels of taxation on housing. Higher productivity in residential building generates a positive economic benefit for mining, manufacturing and the rest of the economy including the export sector.

[17] *Construction and the Wider Economy – a general equilibrium analysis*, Centre for International Economics, Nov 2012

A 1.0% increase in productivity in residential building will generate between $860 million and $1.15 billion worth of additional economic activity per annum, depending on the state of the labour market. The flow-on impact to the wider economy is between $4.19 and $5.10 of additional economic activity for every dollar of activity in residential building.

4. To what extent should reducing complexity be a priority for tax reform?

Reducing complexity must be a priority.

The residential building industry is dominated by small businesses, which do not always have the resources to manage complex taxation affairs and therefore need to operate in a taxation system that has simplicity as a core principle. According to the Australian Bureau of Statistics,[18] 94% of the construction industry is small businesses, as defined by ABN holders with an annual turnover of less than $2 million.

5. What parts of the tax system are most important for maintaining fairness in the tax system? Are there areas where fairness in the tax system could be improved?

Running parallel to the well documented economically inefficient taxation arrangements with respect to new housing is an inherent unfairness and impediment to new home buyers.

The GST is currently applied to new housing but not to existing homes. This obviously contributes to a significant price differential between the two, so that somewhat perversely, the purchasers of a new home pays a 10% penalty on an activity that creates employment and economic activity, whereas the purchaser of an existing home does not.

Should an outcome of the White Paper on Taxation be consideration of an increase in the rate of the GST, this must not encompass new housing, otherwise it makes the current unfair and inefficient system worse.

Another element of unfairness within the taxation system is the means by which residential construction infrastructure is funded. The advent over recent years of developer levies means that new home buyers are being asked to pay 'up-front' for benefits that will be enjoyed by the entire community for decades to come. However, existing suburbs will likely have had these costs, rightly spread across the entire community.

Under the current regime, residential land developers are also required to meet the costs of social and community infrastructure up front as well as the residential infrastructure costs applicable only to their particular development. This charging structure adds to the cost of supplying new units of dwelling stock, thereby undermining the provision of affordable housing. In effect, new home buyers who constitute less than 10 per cent of the population effectively foot the infrastructure bill for the remaining 90 per cent of population.

Alternative mechanisms for funding residential infrastructure would significantly enhance housing affordability in Australia, both for new dwellings, but also for existing stock through knock-on effects. HIA has conducted research into these alternatives which culminated in a summit in 2010 which drew a range of international speakers to provide examples of successful models in use overseas.[19] Possible solutions to the current infrastructure problem might include:

- Commonwealth government infrastructure bonds: would be tax preferred and would see the commonwealth government support state and local governments to build new, and to revitalise existing, infrastructure;

[18] *Counts of Australian Businesses* (8615.0), ABS, 2014.
[19] *Building Better Cities, Financing Urban Infrastructure*, 2010.

- State government infrastructure bonds, modelled along the lines of the US local authority municipal bonds system;
- Tax Increment Funding (TIF): which a local (or state) government authority would designate TIF areas from which future tax revenues would be used as security against which long-term loans (from the commonwealth or the states) for capital expenditure could be raised.
- Enabling superannuation funds to invest in the provision of residential infrastructure.

Equally, the recent move by some state governments to require developers to provide a proportion of 'affordable' new homes (typically 10-15%) in a new project is also inequitable. The aim of providing new affordable housing is a prerogative of government, however, this is a policy decision made on behalf of the community and in accordance with voters expectations and therefore it should be funded by the community rather than by the narrow base of new home buyers in specific developments.

9. To what extent does taxation affect people's workforce participation decisions?

Taxation, and by extension its impact on housing affordability, can have a significant influence on workforce participation. One of the distortions caused by the level of taxation and housing is the impact on the ability of people to relocate to respond to employment opportunities.

Housing affordability is of particular relevance in communities experiencing a rapid increase in population, such has occurred over the last decade as a result of the resources boom, where large increases in rents and house prices have been experienced. Affordability is also a problem in larger cities, where housing prices can make it challenging for families to live in proximity to places of employment.

In the 2014 the Productivity Commission found that a well-functioning housing market is critical for labour mobility and efficient allocation of resources across the economy.

It noted that previous inquiries undertaken by the Commission have also recommended replacing stamp duties with a more efficient form of taxation, such as a broad based taxes, to improve flexibility and efficiency in the housing market. The Commission stated that a more flexible housing market will also support geographic labour mobility, allowing more workers to move to areas with better employment opportunities.

In identifying this distortion, the Productivity Commission again recommended in the 2014 report that state and territory governments should remove or significantly reduce housing-related stamp duties, and increase reliance on more efficient taxes, such as broad based taxes.[20]

17. To what extent are the concessions and exemptions in the fringe benefits tax system appropriate?

Concessions and exemptions for FBT are recognised as an important means to allow certain organisations to attract staff in competition with other employers. This is particularly valuable when seeking to attract professional staff that are in high demand but drawn to the NFP sector for idealistic reasons. Greater access to FBT concessions can make an important difference in bridging the gap between commercial sector salaries and what a NFP can afford to pay.

[20] *Research Report into Geographic Labour Mobility*: Productivity Commission, April 2014, Recom. 12.2. Page 30.

19. To what extent is the rationale for the CGT discount, and the size of the discount, still appropriate?

Arrangements for the Capital Gains Tax (CGT) discount should remain unchanged in the tax review process. Any alterations to the current CGT policy would represent an additional distortion to Australia's taxation system and risk adding to inefficiencies and deadweight in the economy.

The CGT discount recognises the need for investors who take a longer term approach to housing as an investment class and therefore acts as a sustainable tool for boosting housing supply. The existence of the CGT discount penalises speculative practices in asset markets like High Frequency Trading (HFT). HFT is believed to have contributed to large, disruptive asset movements in financial markets during the GFC.

Any changes to CGT will impose costs on small businesses and individuals in order to comply with the new arrangements. These costs arise from the necessary changes to internal accounting procedures, software and the need for retraining and professional advice.

Applying a different CGT regime to different asset classes would represent a distortion to the taxation system and must be avoided.

21. Do the CGT and negative gearing influence savings and investment decisions, and if so, how?

Negative gearing is an important measure to encourage investment in rental accommodation and enables the market to offer rents at a level that would otherwise be higher.

Independent economic modelling[21] commissioned by HIA finds that reducing negative gearing concessions in the current housing policy environment would exacerbate existing distortions, increase rents and reduces housing affordability. Whilst focus on reform to reduce two large distortions in the current environment - inadequate residential land supply and one of Australia's most inefficient taxes, stamp duty on property conveyances - would provide very significant positive effects on housing affordability, consumption of housing services, and living standards.

These findings are consistent with the recommendations of the 'Australia's Future Tax System'[22] report which states:

> *"Reducing net rental losses and capital gains tax concessions may in the short term reduce residential property investment. In a market facing supply constraints, these reforms could place further pressure on the availability of affordable rental accommodation within the private rental market. These reforms therefore should only be adopted following reforms to the supply of housing and reforms to housing assistance."*

It is also important to note that despite some of the uninformed commentary, the evidence overwhelmingly supports the case that negative gearing is a 'mum and dad' investment and it is not the case that a small number of wealthy taxpayers receive the 'lion's share' of benefit from negative gearing. Data from the 2011/12 ATO Tax Statistics demonstrate the following:

- 79.2% of the number of taxpayers reporting rental income have a total income before deductions less than $100,000
- Only 0.7% of taxpayers reporting rental income earn over $500,000, and those reporting net rental losses account for less than 0.5%
- 68.6% of the value of deductions is claimed by taxpayers earning less than $100,000

[21] *Economic Impacts of Negative Gearing of Residential Property,* Independent Economics, June 2014
[22] Australian Treasury, 2010.

The notion that negative gearing is disproportionately benefiting individuals on high and very high incomes is not supported by the data from the ATO. It is an important measure to promote investment in housing and encourage wealth creation and savings for retirement.

As with CGT, applying different taxation measures to different asset classes with respect to negative gearing creates a distortion in the taxation system, which influences investor behaviour in a way that may be contrary to other government policy aims.

23. What other ways to improve the taxation of domestic savings should be considered? How could they be applied in the Australian context?

Amongst advanced economies, Australia is one of the most progressive in terms of promoting adequate retirement provision. The policy of compulsory superannuation contributions will help ensure that the most Australian workers can look forward to a more comfortable retirement compared with their peers overseas.

Addressing one important social imperative – the need to plan for an adequate retirement – should not be at the expense of an equally important social imperative – the ability to access adequate shelter. Many young workers struggle to step on the first rung of the property ladder, and superannuation savings represent an opportunity to rectify this. Consideration should be given to a scheme whereby First Home Buyers can access a portion of the funds in their superannuation accounts in order to purchase a new home. FHBs would be required to repay the funds to their super account within a certain period, with a 0 per cent tax rate applying to the income used to make the repayments.

This would represent a cost to government in terms of lost revenue. However, there would also be higher GST receipts resulting from more homes being built, as well as increases in income tax and corporate taxes resulting from larger construction sector. The large spin-off effect from construction to the rest of the economy would result in the tax base outside of residential construction also increasing. The additional government revenue generated by increased new home building resulting from the scheme would more than mitigate this revenue loss.

There are also considerable potential for superannuation funds to ease the dependence of the residential mortgage market on conventional funding channels. The use of superannuation funds to finance lending to the mortgage market would have several attractive characteristics. First, the dependence of the mortgage sector on wholesale financing would be reduced by such a change. Second, this structure would provide superannuation investors seeking low risk with an opportunity to receive a somewhat higher return than would be received by investing in government bonds and other low risk investments.

39. Does the R&D tax incentive encourage companies to conduct R&D activities that would otherwise not be conducted in the absence of government support? Would alternative approaches better achieve this objective and, if so, how?

Technological advances are a primary method of boosting productivity. It is an undisputed fact that Australia needs to lift its rate of productivity growth and that the Australian manufacturing industry for building materials is struggling to compete in a global market. Furthermore, R&D can have an important role to play in improving housing affordability, through improved construction techniques and product development of building materials, for example. R&D also has the capacity to generate improvements in the flexibility of the housing stock to cater for the requirements of an aging population and therefore ameliorate budgetary pressure on the healthcare system. With this in mind, HIA supports the continuation of incentives for companies to undertake R&D.

41. What effect is the tax system having on choice of business structure for small businesses?

In the residential building industry, the most common business structures used are:

- Sole trader
- Partnership
- Company
- Trust

The choice of business structure depends upon a range of circumstances, including business size, licensing considerations, personal preferences, asset protection strategies and tax treatment. Many smaller trade contracting businesses remain unincorporated for licensing and regulatory reasons, whilst builders will more commonly operate through a company partnership or, where the licensing laws allow, a trust.

The method by which tax liability is calculated differs depending on the structure. Taxation considerations include the way income and profits are treated, land tax, local rates, payroll tax implications and other forms of taxes and levies.

Operating through an incorporated entity remain the most advantageous from a risk management and tax point of view but companies remain relatively expensive to set up and the reporting and regulatory requirements are more onerous and intensive than other legal entities.

Company tax imputation system means that company profits are no longer subject to the traditional double layer of tax. Contributions made by the company for employee superannuation may be claimed as a tax deduction.

Profits accumulated within the company are taxed at the 30% company tax rate, which may be lower than the marginal tax rates of the shareholders. Companies can also retain after tax profits indefinitely, so that tax payments can be deferred for shareholders with higher personal tax rates.

Sole traders have some advantage in the income tax rate being set against the personal tax rate, which enables tax losses being offset against other income but sole trades are unable to split income. Partnerships can enable income splitting but there are capital gains tax disadvantages particularly when the partnership is dissolved.

Trusts remain the only collective investment vehicle available as a flow through entity. This is an important reason why they are commonly used for widely held investment vehicles for the holding of real property and securities. However, in the building and construction industry the use of trusts can be limited because of builders and contractor licensing laws.

HIA supports a review of other forms of entities (such as the S-corporation which is available in the United States) to allow a flow-through of income to the individual and hence achieve the same result as would be available from the use of a trust.

42. What other options, such as a flow-through entity (like an S-Corporation), would decrease the overall complexity and costs for small business involved with choosing a business structure? How would such an entity provide a net benefit to small businesses?

HIA notes that in the United States an S-corporation is not subject to corporate income tax. Instead, profits are passed along to the shareholder’s personal tax return.

This structure has some advantage of saving founders/shareholders from double taxation and administration costs. S-corporation election can also apply to consultants, contractors, and service providers who are not incorporated.

In principle, HIA supports a regulatory framework that allows small business entities to use a single simplified structure rather than the complicated ownership structures such as trusts.

If such a structure allowed the retention of income at the corporate tax rate, it would allow most of the benefits that can currently be obtained via the use of a company and discretionary trust via a cheaper and simpler vehicle to administer.

Ideally, business profits that are reinvested in a business should be taxed at a uniform corporate tax rate regardless of the form of entity, as this reduces complexity and red tape and simplifies operating structures.

43. Is the interaction of the personal and business tax systems a problem? What can be done to manage the personal-business tax interactions?

Businesses need to retain capital in the business for growth, to provide a reserve against adverse trading conditions, and to meet future contingent liabilities. If corporate and individual tax rates were more closely aligned, there would be fewer incentives to change behaviour based on the taxation system. Any system of taxation which creates different classes of taxpayer who pay tax at different rates will inevitably generate anomalies of this kind.

The tax policy environment needs to be conducive to flexible and entrepreneurial working arrangements, which take account of industry efficiency and consumer cost implications. Independent contractors and those running businesses, should be able to be taxed under a flat rate, regardless of the form of business and avail themselves of access to business deductions.

HIA considers that the rules relating to the alienation of personal services income (APSI) which are contained in Part 2-42 of the Income Tax Assessment Act (1997) (the ITAA 1997)) are working well and act as a sound delineator of who is a business and contractor versus an individual who is deriving his or her income in an ‘employee like’ way, and hence should be taxed and treated under the personal income tax laws.

The APSI rules attribute income derived by an entity rather than the individual (e.g. a company or trust) to the individual. An individual or entity deriving PSI will not be able to claim deductions for rent, mortgage interest payments, rates and land tax to the extent that those expenses are incurred in gaining or producing the individual’s APSI. Nor will a deduction be available for a payment made to the individual’s spouse (or other associate) for any non-principal work.

There are several reasons why the APSI rules, in their current form, work.

Firstly they enable taxpayers to self-assess as to whether they operate as a personal services business meaning that they do not need to go through an onerous and burdensome third party determination.

Further and most significantly, the APSI regime includes a ‘results test’ which is satisfied where the work is to produce a result, and you provide the tools and equipment necessary (if any) to produce the result, and you are liable for the cost of rectifying any defective work.

The ‘results test’ reflects long standing common laws principles and reflects the practical difference between independent contractors who are running businesses and those who are disguised employees.

If an individual or entity does not satisfy the 'results test', and they earn less than 80 per cent of their income from a single source during the income year, then they may still self-assess against other tests, which broadly requires an assessment of whether or not the individual or entity had:

- two or more unrelated clients who were obtained as a result of making offers or invitations to the public at large or to a section of the public (unrelated clients test);
- separate business premises (business premises test); or
- an employee who performed at least 20 per cent of the principal work by value of the business (employment test).

It is HIA's considered view that the rules relating to the alienation of personal services income (APSI) which are contained in Part 2-42 of the Income Tax Assessment Act (1997) (the ITAA 1997)) are working well and should not be changed.

44. What are the most significant drivers of tax law compliance activities and costs for small businesses?

The residential building industry is one of the most highly taxed and regulated sectors of the Australian economy.

A key and specific driver of compliance activities in the residential construction industry are the contractor reporting obligations established under the Taxation Administration Amendment Regulation 2012 (No 1)). These regulations require businesses in the building and construction industry to prepare and lodge an annual report detailing the names, details and payments made to all contractors they have engaged.

These measures were originally hidden as a budget line item in the 2011 Commonwealth budget and were never subject to meaningful consultation with industry. They are intended to deal with the alleged failure of some (sub) contractors in the industry to properly account for or report income but in effect the regulatory measures are entirely focused on builders and other businesses that pay subcontractors, with those businesses required to obtain and collect data on behalf of the ATO.

These regulations unnecessarily add to the burdens and risks of operating a small business in the residential building industry and impose considerable additional administrative and accounting red tape and costs onto principal contractors and builders. If these regulations were abolished, there would be an automatic improvement in compliance costs and red tape for businesses in the residential construction industry.

In a 2013 survey, more than 75% of HIA members surveyed stated that their red tape and compliance costs have increased as a result of the Regulations reporting requirements with an average increase of $1,621.23. Further HIA members indicated they spent an additional 17.8 hours during the year completing the paperwork required.

A further driver of compliance costs in the industry are the uncertainties and complexities involved in managing and complying with differing definitions of 'contractor' and 'employee'. At a federal level, industrial relations, taxation, and superannuation laws and regulations all use differing definitions. A clear single definition of contractor along the lines of the rules relating to the alienation of personal services income (APSI) which are contained in Part 2-42 of the Income Tax Assessment Act (1997) (the ITAA 1997) would provide certainty to businesses, eliminate unnecessary costs and allow people to choose their preferred method of business.

At a Commonwealth tax level, there are differing treatments of contractor and employee. For PAYG (Pay as you go) withholding purposes, employers rely on the 'common law'. The personal services income provisions of Division 84 of the Income Tax Assessment Act 1997 codifies elements of the common law enabling personal services businesses that satisfy the 'results test' to qualify for business deductions.

The superannuation laws, are much more complex and confusing requiring businesses to be familiar with the Superannuation Guarantee Ruling which extends the definition of an employee to a contractor when:

- the contractor is remunerated wholly or principally for their labour and skills;
- the contractor must personally perform the work, the subject of the contract, with no ability to delegate; and,
- is not paid to achieve a result.

The 'results test' set out in the APSI provisions should be adopted as an appropriate single national objective test of who should be treated as a trade contractor for the purposes of all relevant Commonwealth, including taxation legislation.

46. What other mechanisms (such as a single lower tax rate, improved technology deployment or other non-tax mechanisms) could assist small businesses to engage with the tax system while decreasing compliance and complexity costs?

HIA supports mechanisms that ease compliance burdens and reduce costs such as simplifying and streamlining payroll and reporting systems.

However, the current proposals to mandate digital engagement with the ATO 'digital by default' and introduce 'one touch reporting' under the guise of red tape reduction need to be carefully considered. HIA would be concerned that any new arrangements introduced by the ATO that are packaged as reducing red tape will actually increase compliance costs and force small businesses to introduce new systems that they would not have otherwise required, purely to engage online.

Under Single Touch Payroll (STP), employers would be required to electronically report payroll and superannuation information to the Australian Tax Office (ATO) when employees are paid, using standard business reporting-enabled software. Significantly, STP will potentially require payment of PAYG and superannuation guarantee obligations as and when employees are paid.

In relation to digital engagement or technological improvements, it is a matter for each individual business, as is the decision whether to embrace the changes or not - accordingly it should be an 'opt in' system.

47. Are the current tax arrangements for the NFP sector appropriate? Why or why not?

HIA broadly supports the existing tax arrangements for the Not For Profit (NFP) sector. These entities serve a broad range of community, altruistic and philanthropic purposes, and deliver vital services and benefits to communities throughout Australia. The benefits to society which flow from the activities of this sector, and mutual purpose being served by such groups, justify the current level of exemption from various taxes.

Fringe Benefits Tax (FBT) concessions are an important factor in attracting staff to the NFP and wider charitable sector, where it helps to offset the lower salaries that such groups are able to provide. If this FBT exemption was not provided, charities would tend to spend more on staff salaries to maintain the value of existing salary packages, and therefore have less money to spend on their proper charitable objects.

NFPs and charities rely heavily on volunteers and those who donate their time and goods, and generally speaking run very low cost, efficient operations. If tax concessions were reduced, and

NFP organisations were to reduce their activities to a corresponding extent, an additional social welfare burden would be incurred by governments, which might in the long run significantly exceed the cost of these existing concessions. If considered in that light, charitable tax concessions in particular are really the Commonwealth's most effective form of social welfare spending.

HIA also doubts whether there really is significant income tax revenue foregone, as stated in the discussion paper. As NFPs do not pay dividends, and have no shareholders, investors or share price to worry about, the only incentive they have to generate a surplus is the need to finance growth and accumulate reserves to ensure they remain viable as organisations. If such surpluses were taxed annually as profit, NFPs would simply ensure that no taxable surpluses were generated and all income was spent on current projects as it was received. This would of course be likely to lead to more business failures among such entities and loss of services for the community.

There is however one area that HIA would like to highlight, where the public benefits referred to above may need re-examination. Entities registered under industrial laws such as trade unions and industrial associations of employers do not seem to meet the criteria of benefit to the community generally. Rather they are beneficial, if at all, to only particular sectors of the community, in as much as they are designed to improve the industrial bargaining capacity of particular economic interests by collectivisation. As such, their automatic exemption from income tax liability would not seem to be justified on community benefit grounds.

HIA considers that rather than such industrial organisations having automatic exemption by virtue of registration under an industrial law, they should be required to demonstrate that they fall into one of the other categories in the Act (such as development of the industrial resources of Australia) or that their purpose is one otherwise beneficial to the whole community. If necessary, new and appropriate criteria could be developed, but there should be no presumption, as there is now, that industrial registration is a guarantee that the organisation is beneficial to the community as a whole.

48. To what extent do the tax arrangements for the NFP sector raise particular concerns about competitive advantage compared to the tax arrangements for for-profit organisations?

It is misleading to compare NFPs with For Profit organisations merely from a narrow taxation point of view. While both may be supplying goods and services to the public, the two types of commercial entities perform very different functions in Australian society. For Profit organisations go into business and take risks in a competitive marketplace to generate benefits for their shareholders. It would not be possible to attract the necessary capital from private sources to, for example, develop a mineral deposit, if all profits were to be spent on altruistic and public purposes rather than those who are risking their capital on the success of the venture.

Competitive neutrality is an important economic efficiency consideration, but there are many commercial areas where the absence of competitive neutrality co-exists with marketplace choice. For example, co-operatives compete with private companies in retailing. Industry superannuation funds compete with publicly listed insurance companies. Private schools compete with public schools, and private hospitals compete with public hospitals to the benefit of both.

Given that the benefits of any surpluses generated by NFPs must by law flow back exclusively to its altruistic or public beneficial objects, there seems little merit in raising concerns about possibly competitive disadvantage to For Profit businesses, all of whose profits flow to private shareholders. In theory, it would be better for Australia for a business to be a NFP and apply all of its profits directly for the public benefit, rather than be a FP and apply only 30% of its profits for the public benefit, collected through the tax system.

50. What, if any, changes could be made to the current tax arrangements for the NFP sector that would enable the sector to deliver benefits to the Australian community more efficiently or effectively?

As stated previously, HIA considers the current taxation arrangements appropriate.

51. To what extent are the tax settings (that is, the rate, base and administration) for the GST appropriate? What changes, if any, could be made to these settings to make a better tax system to deliver taxes that are lower, simpler, fairer?

A broad-based consumption tax, which is an indirect tax, is one of the most efficient measures available to increase government revenue simply because, by and large, it is difficult for people to avoid paying it. Independent research conducted for HIA by Independent Economics[23] confirms the efficiency of a GST relative to all other taxes.

Efficiency is not, however, the same as equity. GST is a regressive tax because it applies to all households at an equal rate, meaning that lower income households spend a higher proportion of their income paying the consumption tax. It is, however, possible to 'compensate' for the increased GST. For example, Independent Economics' research demonstrates that it is possible to provide a cut to personal income tax as part of a 'reform' measure which lifts the rate of the GST.

Increasing the rate of GST from 10 per cent to 15 per cent (equivalent to the New Zealand rate) would lift the consumption tax revenue from $56 billion (2013-14) to approximately $82 billion. Broadening the base of GST to an OECD average of 55 per cent of the consumption of all goods and services (GST is currently paid on just 47 per cent of all goods and services) at the same time as increasing the rate to 15 per cent would lift the consumption tax revenue to approximately $96 billion.

A problem in raising the rate of GST is that it is levied on the majority of inputs into new housing and changing the rate would significantly disadvantage new housing costs (compared to existing housing prices), new housing supply and housing affordability. This is already the case given that the current GST is applied only to new housing.

As a hypothetical example, if the GST was raised to 15 per cent with no adjustment to the treatment of new housing, then the additional GST payable on a new home worth $500,000 immediately jumps by $23,000. The price of a nearby established dwelling doesn't (immediately) move at all. The outcome for new housing could be catastrophic and would risk sending the Australian economy into recession. The sharp drop in new housing construction following the introduction of the GST in 2000 nearly tipped Australia into recession.

If GST is to contribute to the tax reform outcomes, it is vital that all new housing inputs (materials and services) are GST exempt. Alternatively, a zero GST rate should apply to new housing inputs (i.e. a differential rate) or provision of a GST compensation facility for new homes.

Under a GST exempt scheme, GST would be payable on the inputs used in building a new home, however the GST would not be applied to the final home (value). Moving a step further, if GST on new housing was 'zero-rated' then the new housing sector should be completely removed from the GST net – it would not be payable on the inputs into new home construction as well as the final value of the 'product'.

Consequently HIA would be opposed to increasing the rate of GST if new housing continues to be disadvantaged.

[23] *Economic Impacts of Negative Gearing of Residential Property,* Independent Economics, June 2014

52. What are the relative priorities for state and local tax reform and why? In considering reform opportunities for particular state taxes, what are the broader considerations that need to be taken into account to balance equity, efficiency and transitional costs?

There is no doubt that reform of Commonwealth taxes cannot be considered in isolation, and that changes at the Commonwealth level must take into account possible state responses, as was the case with respect to the Mining Tax which potentially encouraged states to increase their own royalties on minerals at the expense of Commonwealth tax collections. Ideally, there should be intergovernmental agreements preceding any changes to federal taxes, as was the case with the GST in 2000.

State taxes have evolved over time under the twin constraints of Constitutional validity and administrative convenience. The taxation of land is a good example. HIA agrees that Stamp Duty on land transfers is a volatile, inequitable and inefficient tax which reduces housing affordability. It could be replaced with broad-based community taxes which distribute the tax burden more equitably across all land owners and do not discourage natural turnover of land. However, HIA recognises that reform is very difficult for states without some assistance, possibly by way of trade-off, from the commonwealth.

The state and territory governments received an estimated $9 billion in stamp duty from residential property transactions in the last financial year – almost 25 per cent of their revenue collection – yet it is the most inefficient of all taxes. The Independent Economics research confirms that stamp duty on property conveyances is the most inefficient tax in Australia's taxation system. The other two highly inefficient taxes are company tax and insurance taxes. Year on year stamp duty tax revenue can vary considerably, rendering a state budget in significant positive or negative variance depending on property market cycles. For example, the recent escalation in residential property transactions in New South Wales has placed its budget (and economy) atop the state/territory ladder. However, an unexpected downward cycle will have an equally but negative impact on a state/territory budget.

Stamp duty can add more than $50,000 to the cost of a new home, and while HIA has lobbied continuously for its removal on new residential property transactions, it would be naïve to assume its removal would not require new, additional or alternative revenue sources to offset the $11 billion currently received by the states/territories.

All of HIA's independent research, spanning the period September 2011 through to April 2015, finds that there are very limited alternatives to replacing stamp duty. The two alternatives readily identified by a considerable body of research are a broad-based land tax or an increase in the GST rate – the latter being detrimental to new housing unless it is exempt or zero rated for GST. Similarly the imposition of a broad-based land tax raised questions of fairness and efficiency as well as the requirement for long term transitional mechanisms.

Replacing stamp duty with a broad-based community wide consumption tax would provide a considerably more efficient approach to taxation. (Like stamp duty, removing payroll tax would necessitate an offset revenue source). Such a progression could also offer a fairer mechanism for general revenue raising. As a reform measure, a broad-based consumption tax would improve Australian living standards and could increase Australia's rate of productivity growth.

A transitional process, and a distinct policy framework addressing this component of taxation reform, would necessarily be a pre-requisite to any move towards a broad-based consumption tax replacing the most inefficient tax in Australia's taxation system, namely stamp duty on property conveyances. A consumption tax that retained the current unfavourable differential tax treatment of new housing inherent in the GST would retain an indeed magnify the existing unfairness, distortions and economic inefficiencies.

Appendix I – HIA Economics research and forecasting

Economic publications

HIA State and National Forecast (Quarterly)
HIA Housing Australia's Future (Annual)
HIA Population and Residential Building Hotspots (Annual)
HIA- CBA Affordability (Quarterly)
HIA New Home Sales (Monthly)
HIA Trades Report (Quarterly)
HIA Renovations Roundup (Quarterly)
HIA – Cordell Construction 100 (Annually)
HIA - GWA Kitchen and Bathroom Report 2014/15 (Annually)
HIA Housing Scorecard Report (Bi-Annual)
HIA Stamp Duty Watch (Quarterly)
HIA – CoreLogic RP Data Residential Land Report (Quarterly)
HIA-AIG Performance of Construction Index (Monthly)

Commissioned research

Taxation of the Housing Sector, The Centre for International Economics (2011)
Taxation generated from the housing sector: an extension, The CIE (2013)
Construction and the wider economy: A general equilibrium analysis, The CIE (2012)
Economic Impacts of Negative Gearing of Residential Property, Independent Economics (2014)
Tax Reform and Housing, Independent Economics (2015)

Discussion papers

The Changing Composition of Australia's New Housing Mix - March 2015
Residential Construction – Looking Towards 2015 - December 2014
The Profile for Residential Building Approvals by Type and Geography - November 2014
Observations of Australia's Rental Market - October 2013
Residential Property Prices in Sydney: Some Observations - October 2013
Housing Activity during Business Cycles - August 2013

Research notes

Putting Some Perspective on Dwelling Prices - April 2015
A Portrait of Australian Home Prices - October 2014
Can We Have Confidence In Consumer Sentiment Indicators? - July 2014
Renovations Out of the Blocks - June 2014
A Modest Tightening of the Fiscal Belt - May 2014
Housing: Paving the Road to Recovery? – April 2014
First Home Buyers: The Big Picture – April 2014
New Home Commencements, Australia - February 2015
New Home Commencement, State and Territories - February 2015
Monetary Policy and Mortgage Interest rates - July 2014
Decline of the Aussie Dollar: where to from here? - July 2013

APPENDIX II – Examples of alternate funding models for infrastructure

Any form of bond financing for residential infrastructure (at any level of government, or by the private sector) has the benefit of providing a way to spread payment across the life of the asset. This enables the burden of payment to be equitably shared by the existing residents and the residents who will obtain the benefit of the infrastructure in the future.

Commonwealth Infrastructure Bonds
The issuing of federal government bonds to fund the residential infrastructure requirements of selected new residential developments, or to fund a proportion of the residential infrastructure required for all new residential developments, would help ensure that projects proceed and that new home buyers are not burdened with excessive charges.

State and local governments would be required to offset the reduced cost of loan raisings by lowering the level of development charges applying to new residential development, including in-fill development.

While the bonds in question would offer inducements, such as preferential taxation treatment which incur a cost to the government, the additional offering required to meet infrastructure needs would represent a very small percentage of total bond issuance. Such a bond program would be attractive to institutional and self-managed superannuation funds.

Bond interest and capital repayments are financed primarily through charges on the infrastructure's users, which would be regulated objectively, with any increases linked to transparent metric such as the CPI. The range of eligible projects for support by the issuing of bonds could be aligned with the various capital city strategic plans.

Local Government Infrastructure Bonds
For those familiar with the option of bond financing for residential infrastructure in Australia, consideration inevitably includes a mention of the municipal bond funding model used in the US and discussion around whether a similar model could be applied in Australia.

By way of background, the municipal bond funding model operating in the US enables local governments to raise long term debt to fund investment in long life infrastructure by issuing what are called 'muni-bonds' in public capital markets . This enables local government to fund investment in their local infrastructure to meet the needs of the community today and into the future.

Muni-bonds are attractive to investors as the interest income they receive is exempt from federal and most state taxes. Furthermore, local governments typically have lower rates of default compared with private sector issuers. The fact that investors do not pay tax on the income they receive from muni-bonds provides local governments with a competitive advantage in capital markets. The tax-exempt status means muni-bond issuers only need to pay an interest rate that is comparable with the after tax rate of return that an investor would receive if they invested in the bonds of private sector issuers (assuming the same credit rating of both issuers). This means muni-bond issuers can borrow funds at low interest rates compared with private sector borrowers.

Local governments in Australia maintain very low levels of debt because they do not have the capacity to internally generate the amount of revenue required to service large amounts of debt. Charging property rates is effectively the only method of taxation available to local governments and the rates are based on land values. Furthermore, increasing the amount levied can be restricted by higher levels of government (e.g. rate pegging in NSW). Rate revenue makes up around 38% of council revenue with the remainder primarily funded by grants from State and Federal Government and user charges and fees.

If a muni-bond style funding arrangement was to work in Australia at a local government level there would need to be significant reform to local government funding and it would need to be cost effective for the issuers.

State Government Infrastructure Bonds

A muni-bond system could work at state government level in Australia. There to be sufficient demand for muni-bond style securities from institutional investors and from Australia's expanding superannuation industry, so demand would not be a problem. There would need to be an up-skilling of knowledge in the industry and familiarisation with tax-exempt securities. However, Australian muni-bonds could trade within the existing debt market which adds to the attractiveness of the proposal.

Muni-bond funding for infrastructure in residential developments in Australia would have to be conducted through a general obligation-style bond (out of general revenue), as opposed to a revenue bond (linked to the revenue generated by a specific government project). In other words interest liability would need to be funded by the general revenue of the issuing jurisdiction as residential infrastructure such as local roads and drainage does not generate a revenue stream to fund interest payments.

Tax Increment Financing (TIF)

Tax Increment Financing (TIF) is the most widely used urban renewal funding and delivery model utilised in North America. TIF is what is called a 'value capture' model whereby a portion of the increase in the value of property that is created in an urban renewal area is used to repay the cost of investing in public infrastructure up-front. TIF is a financing model that could be applied to the Australian context in relation to, for example, the urban development financing challenges facing Sydney's existing suburbs.

The TIF model as it is applied in the US temporarily diverts increases in tax revenue attributable to a TIF project (referred to as the 'tax increment') to pay for the infrastructure improvement of that specific project. The property tax revenue increase is used to repay government-issued bonds or privately secured loans which have been used to pay for the infrastructure up-front. Bond holders and investors receive a stable and long term investment (often incorporating favourable tax treatment) and the cost to communities of upgraded infrastructure is spread over a long period of time, generally 25 to 30 years.

A PriceWaterHouseCoopers (PWC) study of the applications of the TIF model in Australia, conducted in 2008, concluded that there were no insurmountable risks or barriers to implementing TIF in Australia. Actively encouraging the use of TIF in Australia for purposes that include the provision of residential infrastructure would need to occur outside of Infrastructure Australia. COAG is one possible option for focus.

Appendix III – HIA Policy on taxation and tax on housing

1. HIA advocates for a restructuring of the GST so that (effectively) new housing construction is exempt.

2. HIA is opposed to any increase to the GST rate unless new house construction is exempt.

3. HIA advocates that the application of GST to new housing construction and existing housing is similar.

4. HIA advocates for the removal of inefficient and inequitable taxes such as stamp duty and payroll tax on new housing construction.

5. HIA advocates the replacement of stamp duty applied to new housing construction and payroll taxes with broad based community taxes.

6. HIA advocates that in any substitution of stamp duty with other taxes, a transitional arrangement apply so as not to disadvantage those who have already paid stamp duty.

APPENDIX IV - Types of taxes

Some taxes are explicit; others may be hidden or ambiguous.

- Explicit taxes include income taxes (personal or company), payroll tax, stamp duty, GST, land taxes, betterment taxes, fuel excises and import duties on inputs such as glass. These taxes may be levied directly on the building , as stamp duty and GST are, or as taxes on labour, capital and intermediate inputs going into the sector. There may also be negative explicit taxes in the form of first home owner grants for instance. Council rates also add to the holding costs of developers and, like all taxes, add to the final cost of a home and land package or an apartment.

- Ambiguous taxes include developer charges imposed by state governments and local councils ostensibly for the provision of infrastructure or to ensure standards are met, but if they are excessive, ineffective or contribute to general revenue they may be construed as additional taxes (this includes where charges are retained to meet future expenditures, used only remotely or not at all for infrastructure, or are not connected with the land on which they are imposed).

- Hidden taxes arise from regulations that are forced on the industry which impose costs or delays but which deliver little in terms of economic benefit and may relate to excessive compliance to standards including environmental (energy efficiency) standards, occupational health and safety requirements, levies (such as long service levies, training levies, fire levies on insurances and others), imposed over-engineering, building restrictions and slow release of land by government authorities.