How tax system egged on property speculation

By Alan Kohler
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Five years ago Treasurer Peter Costello told Australians: "Work for a living and we'll tax you at close to 50 cents in the dollar; speculate and we'll only take 25 cents.

"Not only that but, as a special deal - while stocks last - we'll pay half your speculating costs."

Naturally a million Australians have started speculating on real estate. When the money ran out they borrowed more, much more. Prices doubled, so did debt.

As Professor Cameron Rider of the Melbourne Law School put it to a recent Productivity Commission public hearing into the problem: "Everyone was exuberantly rational."

Macquarie Bank's Rory Robertson, however, describes the halving of the capital gains tax rate in 1999 as "the elephant in the living room".

To quote last week's report on first home buyers by the Productivity Commission: "Like many participants [in its inquiry], the commission has concluded that these general taxation arrangements [capital gains tax, negative gearing, capital works deductions and depreciation provisions] have lent impetus to the recent surge in investment in rental housing and consequent house price increases."

To quote Costello in response to that report: "There is no conclusive evidence that the taxation system has had a significant effect on house prices."

To quote Blind Freddie: "Yeah, right."

As that gentleman well knows, the effective halving of capital gains tax in 1999, combined with negative gearing and deductibility of depreciation and capital works, clearly has had a huge effect on the property market, and was also a huge mistake.

In financial 2002-03, $12.6 billion in rental income was declared and $13.2 billion claimed in deductions. In other words, the nation was negatively geared to the tune of $600 million. This was spread among 1.3 million Australians, 15 per cent of all taxpayers and 220,000 more than the year before. Real estate investment has become a national obsession.

The net carrying cost of their property investment/speculation is roughly zero, after deducting depreciation and improvements. And while those things are tax-deductible in full, only half of the resultant capital gain is taxable at the end. In addition, interest rates had been falling and hard selling was brought to mortgages by the magic of trailing commissions.

No wonder there has been a rise in values, leading to yesterday's crisis summit on affordability.

The winners of the boom are those who already own real estate and those with enough income to support a loan, or enough blarney and front to get a low doc loan. The losers are the renters because, despite what you might have expected, vacancy rates and rents have not fallen much despite the apparent increase in supply of rental properties.

Even on its own terms, cutting capital gains tax by half in September 1999 was an egregious mistake.

The Ralph Committee recommended it in order "to improve international competitiveness while promoting investment in innovative and high growth companies likely to produce significant capital gains" (to quote last week's PC report).

Actually, I couldn't find that exact quote in the 1999 Ralph report, but I did find this one: "The widespread privatisation of major public sector enterprises has greatly increased the number of Australian households owning shares. A less harsh CGT regime which encourages taxpayers to invest in such assets will help entrench and build upon these changes."

Pick a reason, innovation or privatisation; each was a crock. In 1999 "innovative and high growth companies" were booming on the stockmarket and getting more capital than they knew what to do with. Privatisations, as the Ralph report said, were also marching off the shelves.

The cut in the CGT in 1999 was designed to encourage what was already going on. They needed no encouragement. In fact, when the stockmarket boom ended in 2000, the investment searchlight swung totally towards property.

The CGT discount was designed to promote share investment and, theoretically, it equally assists shares and property, but real estate investors are actually better able to take advantage of it because of depreciation and capital works deductions.

For that reason, Cameron Rider and Miranda Stewart of the Melbourne Law School (quoted extensively by the Productivity Commission in its report) recommend that the CGT concession be removed from gains flowing from those things, that is, that depreciation and capital works tax deductions be deducted from the cost base.

But that's about it for practical answers to the problem of low housing affordability caused by the boom caused by tax distortions and low interest rates. Yesterday's summit also called on governments to focus on increasing supply of housing, which is worth doing as well.

But there are two things worth remembering in this debate: if there was enough of a reversal of the housing boom to produce a recession it would be the poor renters who would suffer most because they would probably cop the brunt of the increase in unemployment; and secondly, this is not a good time to be getting into home ownership - prices are falling, it's a good time to rent for a while.

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