

Master Builders Australia

Submission on Financial System Inquiry's Interim Report

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1 Introduction

- 1.1 Master Builders Australia is the nation's peak building and construction industry association which was federated on a national basis in 1890. Master Builders Australia's members are the Master Builder state and territory Associations. Over 124 years the movement has grown to over 32,000 businesses nationwide, including the top 100 construction companies. Master Builders is the only industry association that represents all three sectors, residential, commercial and engineering construction.
- 1.2 The building and construction industry is a major driver of the Australian economy and makes a major contribution to the generation of wealth and the welfare of the community, particularly through the provision of shelter. At the same time, the wellbeing of the building and construction industry is closely linked to the general state of the domestic economy.

2 Background

- 2.1 In April 2014, Master Builders Australia provided a submission to the Financial Systems Inquiry. In July, the Inquiry subsequently released a detailed Interim Report and called for supplementary submissions.
- 2.2 In this follow-up submission, Master Builders makes additional comments in relation to some observations the Inquiry made in its Interim Report. Master Builders, in particular, makes arguments against the Inquiry pressing to change or abolish certain tax policies including negative gearing.

3 Master Builders Australia's Comments

- 3.1 A number of observations and a range of policy options were included in the Inquiry's Interim Report. Master Builders Australia supports further investigation into the following policy options:
 - RMBs initiative – the merits or otherwise of the proposal to allow residential mortgage backed securities to be treated as a high quality liquid asset for the purpose of the liquidity coverage ratio (page xix)

- SME data base – a proposal to facilitate development of a small-and medium-sized enterprise finance database to reduce information asymmetries between lenders and borrowers (page xxi)

3.2 In relation to housing and the financial system, the Inquiry makes a number of observations about negative gearing, capital gains tax and the tax exempt status of the family home, including that:

“Certain tax and regulatory settings distort household’s saving decisions towards housing, for both owner-occupiers and investors. Tax incentives also encourage investors to use more leverage than otherwise might be the case.” (page xxii)

“The housing market has become a significant source of risk for the financial system and the economy. (page A2-2 in noting the effect of negative gearing and capital gains tax)

3.3 The Inquiry points to higher household debt and an increase in leveraged and speculative investment in housing (interim report pages 2-53 to 2-57), concluding that:

“. . . the exposure of the financial system to the housing market has clearly increased over time and, in the opinion of the Inquiry, the systemic risk associated with this trend should be further considered.”

3.4 In relation to the Inquiry’s observations on this issue, Master Builders Australia notes that the increase in household debt as a ratio of household disposable income (from 0.8 to 1.5) occurred as a one-off response (albeit over a number of years) to a structural shift in the Australian economy. The shift involved a move from high inflation, high interest rates to low inflation, low interest rates that in turn facilitated the ability of households to increase debt given the capacity to service a larger mortgage based on the same income.

3.5 The fact that households are now more highly geared means there is increased sensitivity to interest rate movements that, in turn, heightens financial system risk. But the degree this represents an economy wide risk needs to be examined further including, critically, a better understanding of the purpose of the debt as well as debt/equity ratios by household income cohort.

3.6 In order to reduce financial system risk, no one would suggest the introduction of policies that would see Australia revert back to a high inflation economy to achieve a reversal of the process outlined above leading to lower household debt and a reduction in exposure and risk. Master Builders does not agree that these risks are best managed, as suggested in the Interim Report, by changes to certain tax policies such as the tax exempt status of home ownership, negative gearing and capital gains tax.

3.7 Master Builders Australia would heavily caution against a knee-jerk reaction based on the simple assumption that changing tax policies will reduce financial system risk. Better alternative, targeted policy instruments would have less negative unintended consequences, as the Inquiry alludes to:

“where there is compelling evidence for Government intervention, the Inquiry considers the intervention should seek to best balance efficiency, stability and fairness. Inevitably, policy decisions facing the Government require some trade-offs. (page 1-2)

3.8 On this issue, Master Builders Australia strongly supports the Inquiry’s statement that :

“It is not this Inquiry’s role to make recommendations on tax issues; however, the Inquiry will provide its observations to the Government’s forthcoming Tax White Paper.” (page 1-15)

3.9 Master Builders Australia believes the pros and cons of tax policies like owner occupier exemptions, capital gains tax (CGT) and negative gearing should be considered in the widest possible context; tax policy must not be considered through the prism of the financial system only. Master Builders would like to emphasise that less than five years ago, *Australia’s Future Tax System Review* (Henry Tax Review) provided an exhaustive examination of these taxes and as noted, the Government proposes a Tax White Paper process to unfold over time.

3.10 In terms of specific taxes, the Inquiry argues that the tax treatment of investor housing, in particular, tends to encourage leveraged and speculative investment in housing (page 2-53). This, in turn, adds to concern about the impact for the financial system of a sharp and prolonged fall in house prices:

“Since the Wallis Inquiry, household leverage has almost doubled. This has been accompanied by a significant increase in housing prices relative to income over the past decade. Higher household indebtedness and the greater proportion of mortgages on bank

balance sheets mean that an extreme event in the housing market would have significant implications for financial stability and economic growth. (page 1-14)

- 3.11 In order to encourage longer-time horizon investment, discourage speculative investments as well as reducing the CGT burden, Master Builders Australia’s tax policy calls for the introduction of a reducing stepped rate of capital gains. Specifically, Master Builders advocates for assets held for less than 1 year to have 100 per cent of CGT subject to tax; 1 to 2 years have 50 per cent of CGT subject to tax (25 per cent for small business with an underlying active asset); 2 to 5 years have 25 per cent of CGT subject to tax; 5 to 10 years have 10 per cent of CGT subject to tax; and more than 10 years have zero per cent subject to tax (that is, CGT free).

Capital Gains Tax: Reducing Stepped Rate

Time Asset Held	Proportion of Capital Gains Subject to Tax
Less than 1 year	100%
1-2 years	50% (25% for small business with underlying active asset)
2-5 years	25%
5-10 years	10%
More than 10 years	0% (i.e. tax free)

Source: Master Builders Australia

- 3.12 The Inquiry noted another aspect of the tax and transfer system providing favourable treatment to housing; that returns on owner-occupied housing are exempt from tax, making housing a very attractive vehicle for saving (page 2-52). Again, this issue needs to be considered in a broader context. The Interim Report does not canvass other policy changes that need to occur should the tax exempt status be removed. In terms of tax equity, the mortgage on the family home must then become deductible, as well as other related costs such as maintenance.
- 3.13 Master Builders has been a longstanding advocate for the continuation of the tax exempt status of the family home. Decent, affordable housing for Australians has been a goal of all Commonwealth Governments since Federation. The importance of striving towards this goal cannot be underestimated. As well as providing shelter, secure housing helps people to cope with economic, social and health issues. There is no empirical evidence to support the proposition that the tax exempt status of home ownership undermines the equity or efficiency of the tax system. Housing also has

distinct benefits that are often overlooked, including increased wealth and employment, and many social benefits including increased stability, and social capital.

- 3.14 The Inquiry notes that investors can reduce their tax liabilities by deducting borrowing costs and other related expenses against total income at the individual's full marginal tax rate (page 2-53). Once again, as important as financial system stability is, the issue needs to be considered in broad context.
- 3.15 Master Builders Australia believes there is a strong case for retention of 'negative gearing' provisions in Australian tax policy. Preservation of negative gearing provides certainty to investors in Australia's housing stock and is a vital element ensuring supply of more affordable residential housing for lower income earners and for those who elect to rent as a lifestyle choice.
- 3.16 Without an effective negative gearing arrangement, the supply of rental properties would be lower and/or the rents charged for available rental properties would be higher. Similarly, absent negative gearing there would likely be substantial additional fiscal pressure on federal, State/Territory and local governments to directly provide public rental housing (thus taking on a greater hands-on role as landlord) and/or provide additional financial assistance to meet the higher (non-subsidised) housing costs carried by socially disadvantaged members of society.
- 3.17 There is no proof to substantiate the proposition that the house price 'bubble' in the early 2000s was caused by the combination of capital gains tax changes introduced in 1999, and negative gearing. Master Builders rejects any suggestion that the appropriate policy solution is to subject housing to even more taxation - through either a reduced CGT concession or via changes to the negative gearing rules.
- 3.18 As the Productivity Commission noted: "Ostensibly 'quick fixes' suggested by many participants – such as limiting negative gearing or removing the CGT discount for housing – could detract from rather than promote more efficient investment." (Productivity Commission, First Home Ownership Inquiry, p. XXV, 2004) Importantly, *Australia's Future Tax System Review* (the Henry Review), in categorically stating that the current taxation treatment of housing

is not the major source of supply constraints in the Australian housing market, made the point very strongly that any reforms designed to change the tax treatment of investor housing should only be considered once the housing supply issue has been resolved.

- 3.19 Master Builders strongly supports retention of the current negative gearing provisions. In the main, most investors are 'mums and dads' who provide the bulk of investor/rental housing and are therefore the major source of affordable housing in Australia. Any changes would only create a housing affordability crisis, as was the case when negative gearing was disallowed in the 1980s.

4 Conclusion

- 4.1 In this follow-up submission, Master Builders Australia makes additional comments in relation to some observations the Financial System Inquiry made in its Interim Report. In particular, this submission makes arguments against the Inquiry pressing to change or abolish certain tax policies.
- 4.2 Master Builders Australia does not agree that financial system risk is best managed, as suggested in the report, by changes to certain tax policies such as the tax exempt status of home ownership, negative gearing and capital gains.
- 4.3 Master Builders Australia would heavily caution against a knee-jerk reaction based on the simple assumption that changing tax policies will reduce financial system risk. Better alternative, targeted policy instruments would have less negative unintended consequences
- 4.4 The pros and cons of tax policies like owner occupier exemptions, capital gains tax and negative gearing should be considered in the widest possible context; tax policy must not be considered through the prism of the financial system only.
- 4.5 As the Productivity Commission noted: "Ostensibly 'quick fixes' – such as limiting negative gearing or removing the CGT discount for housing – could detract from rather than promote more efficient investment." (Productivity Commission, First Home Ownership Inquiry, p. XXV, 2004)

- 4.6 Importantly, *Australia's Future Tax System Review* (the Henry Review), in categorically stating that the current taxation treatment of housing is not the major source of supply constraints in the Australian housing market, made the point very strongly that any reforms designed to change the tax treatment of investor housing should only be considered once the housing supply issue has been resolved.
- 4.7 Master Builders would like to emphasise that the Henry Review provided an exhaustive examination of these taxes less than five years ago with the Government's Tax White Paper process set to provide another opportunity for a wide ranging review.
