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Committee Secretary
Standing Committee on Economics
PO Box 6021
Parliament House
Canberra ACT 2600

Dear Sir or Madam

Re: Inquiry into Tax Deductibility

The Housing Industry Association (HIA) welcomes the Commonwealth Government's ongoing commitment to the reform of the Australian tax system and is grateful for the opportunity to contribute to this inquiry.

The 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, low/medium-density housing, high-rise apartment buildings and building product manufacturing.

HIA believes that well executed tax reform which aims to remove the unwanted distortionary impacts of inefficient taxes will deliver substantial productivity improvements and enhance all of our living standards.

HIA is of the view that the ability to deduct expenses incurred in the process of generating taxable income is a fundamental tenet of Australia's tax system for both individuals and companies. The terms of reference for this inquiry, which cover tax deductibility as it applies to the personal and company tax systems, provides for a very wide scope. With this in mind, HIA's response focuses specifically on a number of elements that relate to housing and the residential building industry.

We address two elements with regard to the personal tax system: firstly, deduction of expenses incurred in earning employment income; and secondly, the deductibility of expenses related to investment income. With regard to the company tax system we address the deductibility of interest expenses.

Personal tax system

Employment related deductions

Australia's current tax system provides individuals with the ability to reduce their assessable income by amounts equivalent to their expenses they incurred in earning income. Deductibility of employment related expenses is common to the tax systems in many developed economies throughout the world, although the specifics relating to allowable deductions vary quite widely.

In the two jurisdictions mentioned in the terms of reference, the United Kingdom and New Zealand, the allowable deductions are quite restrictive in comparison to the Australian system. One of the strengths of the Australian system is its recognition that some expenses relate to goods and services that are partially employment related and partially for personal use. The current system enables expenses to be deducted in proportion to their use in employment. However, this also causes a degree of complexity which adds to the administrative and record keeping requirements. There may be scope to simplify this system with a view to reducing the cost to government of administering individual tax collection activity, however it is not a substitute for more material tax reform to remove inefficient taxes and improve national productivity.

The terms of reference note a focus on 'broadening the tax base' which in this context implies narrowing the scope of allowable deductions. The extent to which deductibility influences an individual's expenditure behaviour is unknown. A reduction or removal of deductibility may see individuals elect to incur fewer employment related expenses, which may see a partial transfer of expenditure to businesses or businesses may experience a reduction in productivity as they no longer benefit from individual's personal expenditure on items used in their employment.

There are specific deductions where a removal or reduction in deductibility is likely to distort consumption in a way that is detrimental. The most notable is the deductibility of employment related self-education expenses. The deductibility of employment related self-education expenses currently provides individuals with an incentive, though a tax transfer, to undertake further training. This transfer amounts to a public investment in building the productive capacity of the nation's workforce. Whether the ability to deduct education expenses from income earned is the most efficient form of incentive is beyond the scope of this submission. However, disallowing deductions for employment related self-education expenses without an appropriate compensatory incentive risks impeding labour productivity improvements.

Investment related deductions

The personal taxation system enables expenses incurred in earning investment income to be deducted from an individual's assessable income. Any change to the tax system which restricts an individual's ability to deduct investment expenses from their assessable income has the potential to change the allocation of investors' capital. With residential property being a widely held asset class amongst individual investors, any such changes are likely to have a significant impact on the housing sector and the rental market.

In some instances investors may incur investment expenses that exceed the income derived from the investment in a particular period resulting in a net loss from the investment. Within the scope of residential property investment, it is relatively common for investors to incur net losses during the early phases of the investment holding period with the expectation that a combination of capital appreciation and rental inflation over time will see positive returns over a long investment horizon that exceed the cash flow losses realised earlier in the holding period.

Commentary relating to property investment and taxation often speculates about the role that this element of the tax system plays in Australia's housing market, with particular regard to housing affordability.

In 2014 HIA commissioned Independent Economics (IE) to investigate the effects of negative gearing on residential property. To assess the effects of residential negative gearing, an alternative policy for taxation of rental property income was used 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 (copy attached) 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 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.

When considering targeted changes to existing tax arrangements, or assessing options for broader reform, including through the Taxation White Paper process, it is important to focus on reducing current distortions to Australia's taxation system (of which stamp duty is the primary example)and prevent any new or additional distortions.

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.

While beyond the scope of this inquiry, 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.

Company tax system

Many businesses within the residential building industry and supporting supply chain have debt as part of their capital structure. Any change to the tax system which limits the capacity of businesses to deduct interest costs incurred in deriving business income will represent an increase in the cost of capital. An increase in the cost of capital would force a reduction in the supply of new housing.

This is particularly important for building product manufacturers when assessing the feasibility of capital investments to boost manufacturing output capacity or to undertake plant upgrades.

A higher cost of capital will mean businesses require a higher return on capital deployed in processes which go into producing new dwellings. This will manifest as an increase in the price of new homes purchased by consumers. Furthermore, under a higher cost structure fewer new dwellings are likely to be produced at all price points. This represents an increased risk that the quantity of new housing in Australia will fail to meet the housing demands of a growing population.

Should you wish to discuss the issues raised above, please contact Graham Wolfe, Chief Executive - Industry Policy & Media on 02 6245 1300 or at g.wolfe@hia.com.au.

Yours sincerely
HOUSING INDUSTRY ASSOCIATION LIMITED

Shane Goodwin
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