Graeme A Beal
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30 April 2009

AFTS Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Secretary,

Submission Relating to Australia's Future Tax System

Attached is a submission relating to the present review into Australia's Future Tax System.

The submission relates to:

The Retirement Income System and

The general Tax System.

Yours faithfully,

Graeme A Beal.

THE TAX POLICY WHICH WRECKED THE GLOBAL ECONOMY

The perverse effects of tax and welfare policies which caused unsustainable house price inflation in Australia, UK and US

1. EXECUTIVE SUMMARY

Even before rising defaults on US sub-prime mortgages in mid-2007 morphed inexorably into the global financial crisis (GFC), what had happened in housing markets around the world during the past 20 years was being intensely scrutinised by many economists. There appears to be a consensus that the immediate cause of the GFC was too many people in America buying houses that they could not afford, aided and abetted by financial institutions determined to lend them the money to do it. What the experts don't agree on is why this same process was happening in several Western countries, more or less simultaneously, and why it went on for so long.

Until about 1980 all real estate booms were considered local or regional. Alan Greenspan is on record as saying he didn't believe it was even possible for America to have an America-wide housing boom. However, in a September 2007 "Meet the Press" interview he admitted there had indeed been a global housing boom for which there must be some unknown global explanation. That begs the question…what caused the global housing boom that has lead to the inevitable bust which is now unfolding?

The central proposition of this submission is that Western governments inadvertently created the conditions for a synchronous boom in housing and household borrowing by adopting essentially the same politically popular and apparently permanent tax policies applying to owner-occupied housing.

An allied exacerbating factor which has gone unremarked by economists is that, for the first time in human history, governments have the ability to tax every significant legal wealth-producing activity of their citizens and enforce a high level of compliance. (They can now also tax many illegal activities as well!). Thanks to widespread computerisation tax gatherers can enforce compliance by mandating third party reporting and conducting data matching. These enhanced capabilities are regularly telegraphed via media articles and are widely understood.

In this context, if governments then choose, for political purposes, to completely and permanently exempt from taxation only one potential means of wealth creation it is inevitable that the activity which produces that tax-free wealth will attract much more than its normal share of resources and effort. When these exemptions are left in place for 10 or 20 years, without countervailing regulation, asset price misalignments of huge and damaging proportions are a foregone conclusion.

To put the problem in the present day context, the tax foregone because of the exemption becomes in effect a permanent "stimulus package" tightly targeted at one market sector…the owner-occupied housing sector. Furthermore, because house buying is a highly leveraged activity, the final effect of the "stimulus package" is similarly highly leveraged.

During the last 20 years governments in Australia, the United Kingdom, America, Ireland, Spain and other countries have all taxed everything else except capital gains from owner-occupied housing. The completely rational response of citizens to make the most of these exemptions has produced concurrent sustained housing and borrowing booms in each of these countries, which to everyone's misfortune, have collapsed almost simultaneously, leading to the GFC.

The US was the latest and largest economy to put such exemptions in place. The increased demand for housing, the attendant increased demand for mortgage finance and the innovative responses from financial institutions trying to maximise profit by satisfying that enhanced borrowing demand have been well documented as being the genesis of the GFC.

Housing is very important to people. To use an old expression "it gets them where they live". People die for their houses…almost 200 did during the recent Victorian bushfires. People get enormous status and ego satisfaction from owning bigger and better housing than their peers…a sort of "edifice complex". Repeatedly trading up to bigger and better housing was the only rational way to maximise benefit from the government "stimulus packages" provided by the CGT exemption. Selecting something so perfectly aligned with human vanity as the only major activity to permanently exempt from tax is certain to lead to excesses and produce perverse results over time.

This is Adam Smith Economics 1.01. The Scottish moral philosopher's "Wealth of Nations", published in 1776, repeats three themes over and over. These are, (i) people are naturally disposed to advance their fortune by the best method available to them at the time, (ii) people are naturally attracted to activities which involve the least payment of tax and (iii) government policies often have unintentioned consequences.

During March this year the Bank of England reduced the UK cash rate to 0.5%. It hasn't been that low since Adam Smith was a boy. Perhaps that should be taken as a sign that it's time to temporarily eschew long equations using most of the Greek alphabet and instead apply some Smithian pragmatic behavioural economics to modify tax policy to eliminate, or greatly reduce, the unwarranted stimulus for owner-occupied housing. If deemed necessary from time to time owner-occupied housing can be stimulated with measures which are timely, targeted and temporary and not politically popular, perverse and permanent.

This submission examines in detail the tax changes which were made in Australia, the UK and the US, and the sustained changes in house prices and associated debt accumulation which followed them and ultimately lead to widespread wealth destruction and livelihood disruption around the world.

The evidence connecting the tax policies with the booms in house prices in each of the three markets studied is largely circumstantial, as it is for the connection between human activity and climate change. Because of that naysayers can claim they are both fairy stories without scientific proof and therefore not sufficient reason for politically unpopular action. If no action is taken to eliminate the unwarranted government stimulus for owner-occupied housing the whole sorry cycle of the last 20 years will be certain to repeat itself and leave another generation wondering what went wrong. Furthermore the sustained artificial elevation of house prices engendered by these policies has many long lasting adverse social and economic effects. However I realise that convincing an elected government to take unpopular decisions today to avert a problem in 10 or 20 years time is a "hard sell". But like climate change, intuition tells us it should be addressed.

1.1 Specific Recommendations

1. The exemption from the assets test should be either removed completely or at least capped in a manner which ties it to national average weekly earnings. My specific suggestion is to cap it at 156 times average adult fulltime weekly earnings for both singles and married couple owner-occupiers and to revise the cap annually according to that formula. Currently the cap would be $189,820 based on the ABS figure for November 2008[1]. This is less than the average median price of a house but is more than the $124,500 value of a house imputed by the difference between the allowable assets for age pension entitlement for home owners and non-home owners. Any excess of an age pension applicant's home value over the exempt amount would be included in their total assets for purposes of determining pension entitlement.

Irrespective of whether the exemption is abolished or capped this change will necessitate the Federal government having access to an up-to-date database of individual home values similar to, and perhaps integrated with, systems used by the states for land tax and rating purposes. The internet now abounds with sites offering instant online estimates of individual house values so that capability is building. None of this is beyond the abilities of a highly computerised bureaucracy. A side benefit is that the regularly updated information on house values, which aggregate to Australia's largest single asset, will assist the government and the central bank in managing the economy.

Major adjustments to pension rates and thresholds will be required to adapt the pension system to new levels of pensioner assets and to prevent disadvantaging the truly needy in our society. The total cost of age pensions to the budget may stay about the same but the distribution will be vastly different.

Announcement of this measure should be made as soon as possible if something similar is not already included in the May 2009 Budget.

2. The CGT exemption which has been in place since 1985 should be completely abolished for gains made on owner-occupied housing bought after the announcement date. This also should be as soon as possible.

The purpose of removal of this exemption is to confirm the fundamental equivalence of all forms of income for tax purposes and to cease the unwarranted tax treatment of owner-occupied housing as a "sacred cow" which can never be slaughtered. Its purpose is not to raise tax revenue but to prevent, or at least minimise, future housing price booms. In the absence of undue government stimulation for the owner-occupied housing sector such a tax should not produce much revenue.

Because the main purpose of the removal of the exemption is to produce a more level playing field for asset allocation decisions it does not matter particularly how a CGT is applied to owner-occupied housing so long as it is similar to that applying to other investments likely to be considered by households. Because I don't consider tax should be paid on inflationary gains I personally favour indexation, despite its complication, rather than the present simpler 50% discount on long term gains.

Capital losses on housing should only be deductible from housing gains.

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[1] Source: ABS 6302.0 Table3

Another less effective but more popular alternative would be to apply the US pre-Taxpayer Relief Act 1997 (TRA97) regime of conditional roll-over relief and a one-off capped CGT exemption at some future event. The evidence is that this regime kept US house prices in line with inflation for a considerable time span.

3. Any government stimulus for owner-occupied housing should concentrate more on increasing the supply of low-cost land and housing, rather than trying to restart the house price boom from present lofty price levels by cash injections. Efforts should concentrate on returning house prices to a sustainable equilibrium with average earnings, rents and construction costs as quickly as possible without endangering lenders. Any measures which can reduce the reliance of state revenues on land and real estate transaction taxes, which in Australia are some of the highest in the world,[2] will help to increase home ownership.

4. The Australian government should use whatever influence it can bring to bear to convince the UK and US to similarly modify their tax systems to eliminate the undue stimulus given by their generous CGT exemptions to investment in owner-occupied housing. However Australia should modify its tax system even if the UK and the US do not. There is no good reason for our tax system to be "competitive" with that of other countries in respect of stimulus for owner-occupied housing. Owner-occupied housing is sold to very few foreigners!

2. THE TAX EXEMPTIONS AND THEIR EFFECT ON HOUSING MARKETS.

The following section describes the tax changes of the three countries, and their effects on their respective housing markets in the order in which they were implemented: Australia, UK and US.

2.1 Australia

2.1a *Tax Changes*

Australia was the first of the three countries in this study to put a potentially damaging exemption for owner-occupied housing in place but was the last to enact a capital gains tax.

The Hawke Labor government introduced the CGT in September 1985 primarily to recapture tax revenue lost to various tax minimisation schemes designed to convert taxable income to tax-free capital gains. Prior to 19 September 1985 virtually all capital gains were completely tax-free to investors who were not full-time traders in capital goods. Following the 1985 legislation almost all capital gains realised on purchases made after that date, after adjustment for inflation, were taxed as if they were the top slice of ordinary income. However, capital gain from the sale of owner-occupied housing, irrespective of amount, frequency or lifetime total, was made the only significant exemption and has remained completely tax-free to the present. One reason given was the purely political consideration that it was considered politically unpalatable to "tax the family home". Another was that it would encourage home ownership, often referred to as the "great Australian dream".

This was equivalent to government conferring on the owner-occupied housing sector an exclusive "stimulus package" equal to the tax foregone.

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[2] Source: International Comparison of Australia's Taxes April 2006 Warburton and Hendy

As if exclusive CGT exemption for this asset class wasn't stimulus enough, the Hawke government's Social Security Act of July 1991 exempted owner-occupied housing of any value from the assets test for age pension entitlement. This second exemption absolutely confirmed for people that government was effectively encouraging them to acquire the biggest and best principal residence that borrowed money could buy to use as an untouchable store of value in their retirement.

To take maximum advantage of the two exemptions people had to buy a succession of bigger and better homes to live in. This activity was so closely aligned with natural human vanity that it was virtually guaranteed to lead to excess. It did, but somewhat surprisingly, it took 20 years in Australia. If the exemption is left in place it will do it all over again.

In order to clearly recognise the causal connection between the two exemptions put in place by Hawke, and the resulting unprecedented 20 year run-up in Australian house prices it is useful to visualise the economic situation during the 1980's and beyond from the perspective of an investor experienced in identifying the best use for any surplus funds.

The blanket exemption of capital gains from owner-occupied housing from CGT meant there was no apparent change in their absolute tax treatment. These gains had been exempt prior to 19 September 1985 and they remained exempt afterwards. The vast majority of people without significant investments, apart from their home, would simply not have immediately recognised the huge shift in relative tax treatment conferred by the CGT exemption *vis à vis* almost all other asset classes. It would, however, have been instantly recognised by sophisticated investors paying high rates of tax. In effect a huge government tax saving had been held out to those with the wit and resources to recognise and take advantage of the changed tax situation. It is important to note that for 1985/86, the year CGT was introduced, the top personal tax rate in Australia was 60% for taxable incomes over $35,788. Tax savings were top of mind for these people.

Most investors with significant surplus funds in 1985 would have had them invested in the stock market. It was the middle of the famous "greed is good" bull market which had been rising strongly since 1982. On the day CGT became effective the All Ordinaries Index closed at 943.2. During the next two years it would more than double again, finally peaking at 2305.4 on 21 September 1987. That's a capital appreciation of 56.4% per year for stocks compared to minus 4.4% per year for Australian house prices over the same period according to the ABS Existing House Price Index[3]. With investors preoccupied with such mouth-watering returns from shares it's no surprise that no one rushed to exploit the new tax savings to be had from owner-occupied housing.

Another important point was that, unlike the housing exemptions which the UK and US governments would later put in place, the Australian exemption did not change the tax status of any existing capital gains from housing. Both the UK and US exemptions produced generous "windfall" effects for many owners. The Australian CGT exemption did not as it only applied to gains yet to be accrued on home purchases made after 19 September 1985.

[3] Source: ABS 6416.0 House Price Indexes: Eight Capital Cities
Table 10. Established House Prices, Index Numbers, Pre September Quarter 2005 Methodology.

These two reasons explain why there was virtually no discernable reaction in the Australian housing market immediately following the CGT exemptions. However, things were about to change.

Stock markets around the world went into free fall in October 1987. By 11 November 1987 the All Ordinaries Index had fallen 50.1% to 1151.0. By then thousands of Australian share investors would have taken their last tax-free capital gains out of the stock market, and were considering what to do next. Many had already faced the unpleasant reality of paying CGT at rates up to 60% for the very first time.

For an experienced investor, paying the top tax rate, and surveying his forward investment alternatives at that time, both income and real capital profits from investing in equities, fixed interest securities and rental real estate would be taxed at 49%. On the other hand, capital profits from actively traded owner-occupied housing would be completely tax-free. If that wasn't enough stimulus, owner-occupied housing could be readily and relatively inexpensively geared to increase the tax-free rate of return on equity about fivefold or more compared to alternative non-geared investments. Canny operators would also have known that one big advantage of direct investment in real estate, not available with passive investments, is the possibility to control and accelerate capital appreciation by selective property improvements. Add to this superior wealth-building potential the status and ego satisfaction to be derived from living in progressively bigger and better located houses and the government's CGT exemption provided an absolutely compelling reason for switched-on investors to maximise returns from investing in owner-occupied housing. The only sad note was that this bonanza was limited to only one property per taxpayer. But there was nothing in the policy to stop that one property from being a $20 million house. While perhaps not their main investment game, this was low-hanging fruit which was too good to pass up.

One only has to review past listings of so-called "prestige" or "executive" homes for sale after short but extremely profitable tenures to realise this was a game rich people have played with monotonous regularity. However there is ample evidence in the house price and lending data that the completely rational initial response by investors to the CGT exemption on owner-occupied housing started an unprecedented widespread boom in Australian house prices and borrowing which eventually imperilled the financial system of this country.

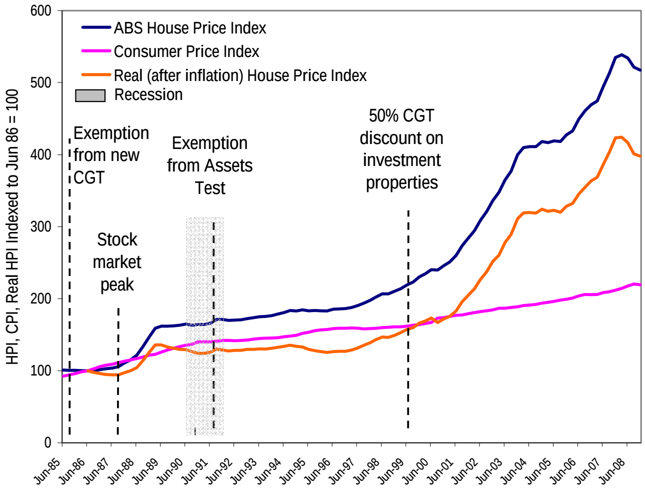
How would you go about maximising the benefit from these exemptions? Because the CGT exemption only applied to one principal residence of the taxpayer there were only a few simple rules to follow in order to maximise the return. Firstly, buy up big. Ten percent appreciation on a $5 million house is a tax free $500,000 and occurs in the same time as a tax free $50,000 appreciation on a $500,000 house. Secondly, buy with only capital gain in mind. That generally means buying high quality established property in naturally sought-after locations, or property which can be enhanced quickly by selective, cost effective improvements. As we will be living in the house, and only for a short time, any considerations of potential rental yield can be ignored. Thirdly, use maximum possible leverage. This not only makes it possible to buy bigger but also gears up the rate of return on the equity we are trying to compound. Fourthly, turn them over often. Having to move often is a bit of a bore but frequent selling is the only way to compound our tax free capital gain as many times as possible before the tax rules change or the market tops out.

If people weren't smart enough to work this out for themselves there was eventually an army of financial advisors, real estate brokers and mortgage brokers, all paid on commission, to convince them to stretch a little further because any capital gains were going to be tax-free.

2.1b *The Boom in Prices*

The results of a sufficient number of people following this formula are entirely predictable. They are increased competition and higher prices for high quality properties, increased demand for ever larger mortgages and greatly increased high end housing turnover. Increased momentum attracts others who extrapolate present trends into the indefinite future and decide to jump aboard. Inevitably this feverish activity, concerned only with fast capital appreciation, and completely unconcerned with rental income potential, quickly increased house prices away from fundamental relationships to average incomes, rents and construction costs. This started as an entirely rational response by experienced investors to the exemptions provided by government in 1985 and 1991. However, as in most booms, what the early people do wisely the latecomers do foolishly and a boom becomes a bubble.

CHART 1
Australian Nominal and Real House Prices
Jun 1985 to Dec 2008



Sources: RBA, ABS

Chart 1 show the huge run-up in nominal and real established house prices in Australia and its relation to the 1985 and 1991 exemptions. Table 1 shows the growth rates in real established house prices before and after the 1987 stock market peak.

Table 1: Australian Real House Prices before and after 1987 Stock Market Peak

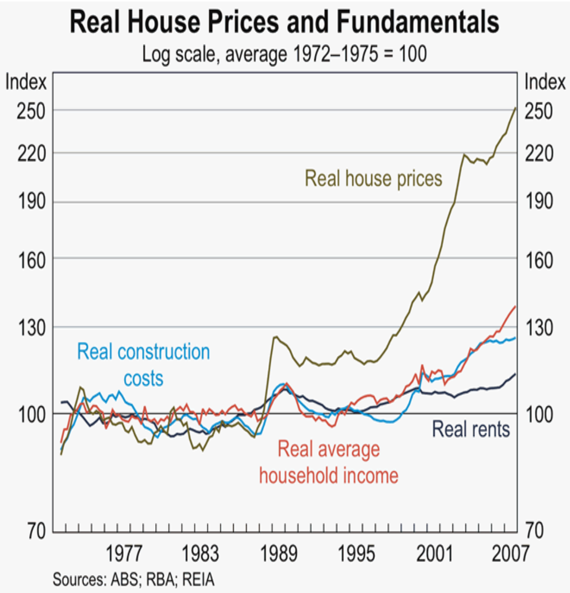
1970 to 1Q-2008

Yearly data 1970 to 1987, Quarterly data 2Q-1986 onwards.

Period Yrs.	From	To	Relativity to Stock Market Peak	Annualised Real Rate of Change
17.00	1970	1987	Before (long term)	+ 1.37%
1.25	2Q-86	3Q-87	Immediately before	- 4.38%
Stock market peaked 21 September 1987				
1.50	3Q-87	1Q-89	Immediately after	+24.41%
20.50	3Q-87	1Q-08	After to peak of housing market	+ 5.02%
The above 20.5 year period includes the following three periods.				
1.50	3Q-87	1Q-89	Immediately after	+24.41%
7.00	1Q-89	1Q-96	During and following recession	- 1.56%
12.00	1Q-96	1Q-08	Run-up to housing market peak	+ 6.80%
Sources: ABS Housing Price Index, Consumer Price Index. Abelson & Chung, 2004				

However, the extent of the huge misalignment, relative to fundamentals, which has occurred in the Australian housing market since the introduction of the two exemptions is best illustrated in Chart 2 reproduced from Dr Anthony Richard's paper, "Some Observations on the Cost of Housing in Australia"[4] in the April 2008 Reserve Bank Bulletin.

Chart 2



Dr Richard's chart indicates that real house prices at the end of 2007 were around 75% overvalued relative to average incomes, around 125% overvalued relative to rents and around 100% overvalued relative to construction costs. This major market misalignment is unprecedented and has all occurred since 1987. This is in marked contrast to the prior 15 years between 1972 and 1987, when more people regarded housing primarily as shelter rather than a "can't miss" investment opportunity.

[4] Dr Anthony Richards, Head of Economic Analysis, RBA.

During this earlier period there was a relatively stable relationship between house prices and incomes, rents and construction costs despite some major disturbances in the economy during that period.

American researcher and author, Robert Schiller[5], has noted that peaks in house prices tend to follow peaks in stock prices with an average lag of about two years. Analysts could be forgiven for regarding the 50.5% jump in nominal Australian house prices, as measured by the ABS House Price Index, which occurred between the stock market peak in September 1987 and March 1989 as just another manifestation of this pattern even if the magnitude of the rise was quite extraordinary. The previous bull market in Australia ran from 1974 to 1980 and produced about the same percentage rise in share prices as the 80's bull market. It was followed by a modest rise in Australian house prices which did not depart significantly from a traditional relationship to incomes, rents and construction costs. Some other factor is necessary to explain the enormous initial move in house prices away from their traditional relativities to incomes, rents and construction costs which took place between September 1987 and March 1989 and continued for 20 years, moderated only slightly by the early 90's recession. The difference this time was the two exemptions which turned owner-occupied housing into a uniquely privileged asset class.

How much "fiscal stimulus" to the owner-occupied housing sector was finally provided by the 1985 CGT exemption? A precise estimate is complex and requires data which is difficult, if not impossible, to obtain. My "back-of-an-envelope" calculation puts it at $9.35 billion total over the period June 1986 to June 2008 if estimated owner-occupiers' likely realised capital gains had been taxed at rates applying to superannuation gains. The maximum "take" would have been $1.23 billion in 2004 and the maximum tax credit would have been 0.10 billion in 1996, had losses been allowed as deductions. If taxed as normal capital gains the figures would have been $11.6, $1.42 and $0.15 billion respectively. Obviously the total taxes which taxpayers saved by the existence of the CGT exemption are a tiny fraction of the extra taxes which will need to be collected from them to meet the cost of stimulatory measures now required because the CGT exemptions were in place in Australia and elsewhere. For the nation overall it was a lousy deal!

Most of the many studies of housing price trends since 1987 have treated the period as having two unconnected price booms separated by a recession…the first boom running from 1987 to 1989 and the second from about 1997 to early 2008. Accordingly they have looked for and ascribed different causes to each.

My central proposition is that the post-1985 government policy of taxing everything else except unlimited capital gains on owner-occupied housing and the post-1991 policy of exempting principal residences of any value from the assets test for the age pension amounted to a significant, permanent "stimulus package" specifically targeted at the owner-occupied housing market and were the primary drivers of one long housing price boom which commenced in September 1987 and which finally peaked because it simply ran out of "greater fools" in March 2008.

2.1c *The Borrowing Boom*

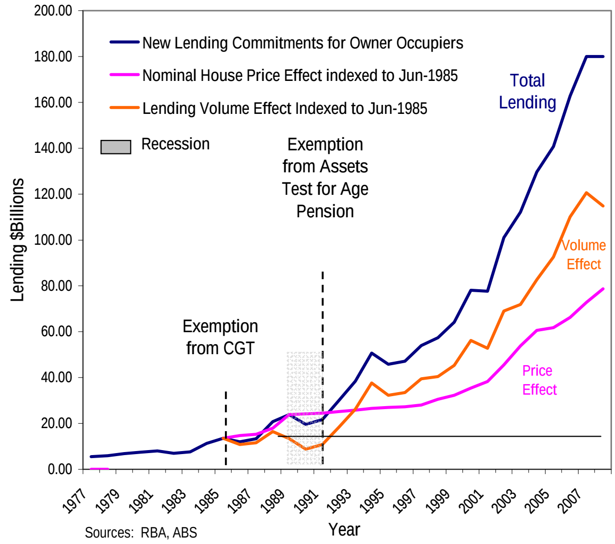
The run-up in house prices had not long become established before it ran into "the recession we had to have" which produced negative GDP growth from June 1990 to September 1991. Unemployment of 10%, mortgage rates of 17.5% and tighter credit

[5] Robert J Shiller, Professor of Economics, Yale University, "Irrational Exuberance" 2005

steadied the rise in house prices until approximately 1996. However, lending data, (which should more appropriately be thought of as borrowing data because no one lends money unless it's been applied for), tell a somewhat different story. Borrowing for owner-occupied housing briefly receded between July 1988 and December 1990. It then took off strongly from July 1991 and this coincided exactly with the Hawke government exemption of owner-occupied housing of any value from the assets test for age pension entitlement.

Chart 3 shows the growth in total borrowing by owner-occupiers related to the exemptions and the early 90's recession. It also shows the relative contributions of price effect and volume effect to total borrowing.

CHART 3
New Lending for Owner-occupiers Decomposed into
Volume and Price

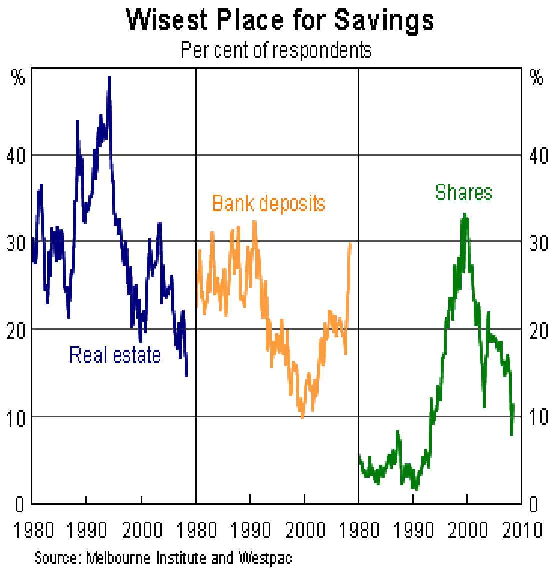


It appears that large numbers of people, perhaps attuned by the 1990/91 economic downturn to the potential of teasing out holes in the public purse, immediately recognised that the exemption from the assets test presented a government approved mechanism for them to quarantine a potentially large amount of wealth in a form which would not affect their entitlement to the age pension. It meant that a retired couple could live in a home of any value…$250,000 or $25million, it didn't matter…and if they chose to live frugally enough they could collect a full age pension for the rest of their lives. Think of the pension as a "$400,000 LAST Homeowner's Grant". Of course, if living that frugally was a bit of a bore you could settle for a smaller $200,000 Last Home Owner's Grant by keeping more of your own spending money handy.

The circumstantial evidence from the borrowing data is that this exemption was the catalyst which lit and maintained a fire under the Australian housing market for the next 17 years. The earlier CGT exemption meant that there would be no leakage of homeowner's capital to taxation along the way.

This hypothesis is entirely consistent with surveys of public sentiment illustrated in Chart 4. These show that during the late 1980's the percentage of respondents reporting real estate to be the wisest place for savings increased suddenly from about 22% to about 44%, coinciding closely with the CGT exemption and the 1987 stock market decline. There was a further steep increase from about 33% to nearly 50% closely following the exemption from the assets test. The next closest approach to unanimity in nearly 30 years of surveys was a 33% vote for shares just prior to the dot.com bust. That would have been a bad call! In the mid 1990's investment in housing was unquestionably the "barbecue stopper *du jour*".

Chart 4[6]



I also used an RBA time series of total loans approved for owner-occupied housing[7] for the period 1977 to 2008 to quantify the "excess" demand for housing, and associated debt, generated by these two exemptions. Using RBA and ABS data I calculated the annual growth rate in aggregate owner-occupied housing debt which exceeded the sum of annual growth rates in population and the CPI. The result is an indicative measure of the amount of housing debt borrowers were willing to incur to buy housing in excess of that needed to keep pace with population growth and inflation or, in other words, to buy bigger and better housing for themselves. The results are illuminating.

During the period from June 1977 to June 1987 inclusive, the ten years immediately preceding the start of the housing boom, "excess" housing debt actually decreased by an average of 1.02% per year, (9.15% average lending growth minus 8.80% average inflation minus 1.37% average population growth equals minus 1.02%). By contrast, during the 20 years from 1987 to 2007 inclusive the "excess" debt growth averaged 9.19% per year, (13.90% minus 3.42% minus 1.29% equals 9.19%). This change represents a dramatic shift in the public's propensity to borrow for housing. I also calculated the "excess" debt growth for the seven year period 1990 to 1996 during which housing prices and construction costs actually fell slightly according to Chart 3. If high "excess" debt growth continued during this period it would have to be attributed to some demand factor other than the prospect of immediate house price appreciation. Paradoxically, the "excess" debt growth for this period averaged 10.81% per year, slightly higher than the long term post-CGT exemption average.

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[6] Source: RBA Bulletin Aug 2008 Article by Dr Philip Lowe, Asst. Governor (Financial Services) RBA
[7] RBA Bulletin Table D06

This can be construed as an indication that many prospective home buyers, rather than being discouraged by the prolonged period of flat house prices, were sticking to a long term plan engendered by the exemptions and actually exploited the flat period as a buying opportunity.

The only other period of relatively stable house prices was during 2004 and 2005, and that period exhibited an even higher average annual excess debt growth of 14.06% showing that, if anything, the borrowing trend was accelerating, probably facilitated by more aggressive competition among lenders at that time.

The dramatic, and apparently permanent, rise in “excess” debt figures which began two years after CGT introduction add weight to the proposition that the CGT and assets test exemptions are the main causes of the seismic shift which occurred in the Australian housing market in the direction of higher house prices and borrowing during the past 21 years.

The initial relative advantage of actively trading owner-occupied housing has been eroded over time by subsequent tax changes. Between 1985/86 and 1990/91 the top tax rate was progressively reduced from 60% to 47%. From 1987/88 dividend imputation improved the relative attractiveness of dividend-paying equity investments. In 1999 the Howard government reduced CGT on long term gains by 50%, effectively reducing the top CGT rate to 23.5%. In 2007/08 superannuation payouts of any amount were made completely tax-free, increasing the relative attractiveness of superannuation as an investment. Today, despite all these changes, capital gains derived from owner-occupied housing still have a 23.5% tax advantage, on an unleveraged basis, over most alternative investments outside of superannuation.

2.1d *Other Effects*

The fact that that the housing boom was primarily driven by high end buyers seeking fast, tax-free capital appreciation from trading existing homes rather than first home buyers seeking project homes is confirmed by the huge difference in price appreciation in established houses, which includes the land component, compared to that for project homes, which includes construction costs only. During the period from September 1987 to December 2007 the ABS Existing Home Index increased by 388.7% while the corresponding Project Home Index increased by only 174.6%, less than half the established home increase. The boom certainly was not driven by increases in construction costs.

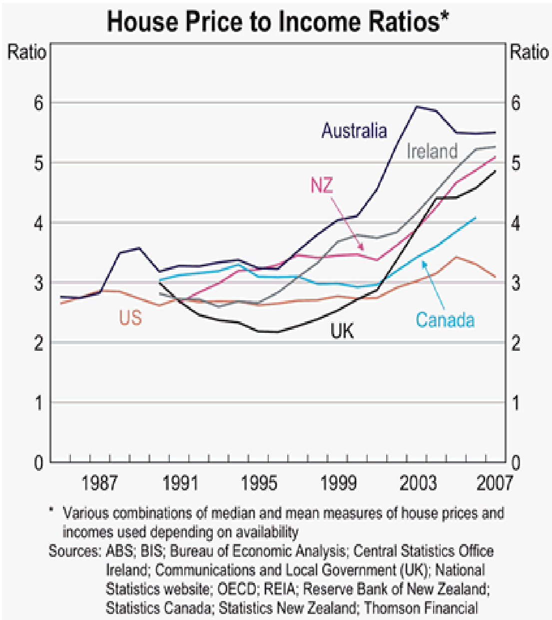
In a normally functioning market, undistorted by massive government stimulation, it would be normal for developers and builders to quickly exploit the potential profit gap which opened up between house prices and construction costs. Increased supply of new houses normally could be expected to place a cap on rising house prices as happened in the US housing market. It did not happen in Australia because state and local governments were quick to front-end load infrastructure costs into land costs.

Also the uncapped CGT exemption kept on providing a far more effective incentive for high-end owners to upgrade than for low-end intending owners to enter the market. Financial institutions understandably preferred lending large mortgages to affluent, credit-worthy applicants on the security of good quality, sought-after properties than making smaller, riskier loans to untested first time borrowers[8]. This

[8] See “An Update on Household Finances” Ric Battelino, Deputy Governor, RBA Bulletin November 2008.

factor also explains why mortgage defaults, so far, are lower in Australia than in the US or UK, despite Australian households finishing up with a larger average debt to income ratio and a higher house price to income ratio than either of those two countries. Chart 5[9] shows that Australia's house price to income ratio was extremely high by international standards.

CHART 5



In order to realise an immediate benefit from the CGT exemption you had to have a home to sell. Who was in the best position to derive the most immediate benefit from the CGT exemption? They were middle to high income earners in secure jobs providing discretionary income and high credit scores, and who already had tradeable equity in expensive, well-located houses. For renters and people saving for their first home any benefit from the exemption was deferred so far into the future that it would have provided no immediate benefit and negligible incentive to change behaviour. It was a highly regressive tax policy which helped high end home owners prosper at the expense of eventually pricing intending first home owners out of the market.

Another indicator that the boom was primarily driven by existing home owners upgrading in order to maximise their benefit from the CGT exemption is the important point that Mr Ric Battallino makes in his November 2008 RBA Bulletin article[10]. This is that "at the end of the (house price) boom, the home ownership rate in Australia was no different to that at the start; in both cases about 70%". Dr Richards in his May 2008 paper found "home ownership among 25-39 year olds – typically the age when people first enter home ownership - has fallen from around 65% in 1986 to 58% in 2006. Abstracting from shifts in age structure of the population, the average home ownership rate has fallen by around 4% since 1986". If increasing home

[9] See "Some Observations on the Cost of Housing in Australia" Dr Anthony Richards, Head of Economic Analysis Department, RBA Bulletin April 2008.
[10] RBA Bulletin Nov 2008 "An Update on Household Finances" Ric Battelino, Deputy Governor, RBA

ownership was one of the Hawke government's reasons for implementing the CGT exemption it failed miserably on that score.

2.2 The United Kingdom

In the UK capital gains tax was first introduced by the Labour government of Harold Wilson in 1965. As in Australia it was primarily an anti-avoidance measure to circumvent schemes aimed at converting ordinary taxable income to tax-free capital gains. However, at the time the UK was in an economic slump and the raising of additional revenue was probably a consideration.

In 1988 the Thatcher government allowed re-basing of asset values for CGT purposes to values as at 31 March 1982 and set in place a set of extremely generous CGT exemptions for owner-occupied housing at the same time. The re-basing provided the option of exempting from tax all gains which had accrued prior to 31 March 1982. The six year gap between the base date and the effective date of the exemption meant that immediately following the announcement owner-occupiers with several years of capital gains could realise "windfall" gains free of CGT. For virtually all other investments available to individuals all realised capital gains from any source which totalled more than an annual exempt allowance (£9,600 per taxpayer for 2008/9) were taxed as if they were the top slice of normal income. However, under the Private Residence Relief provisions, capital gains of any amount from sale of owner-occupied housing were made completely exempt from CGT as long as all of the following conditions applied:

- It was your only home for the whole period you owned it (ignoring the last three years you owned it).
- You used it as your home and nothing else all the time you owned it.
- For the whole period you owned it you didn't let out any of it, and didn't have more than one lodger.
- The land area does not exceed 0.5 hectare.
- You bought it, and made any improvements to it, to use as your home rather than to make a gain.

It appears from the official assessors' manual that, in practice, the curious last condition is satisfied if you did not convert the house to flats and did not convert the title from leasehold to freehold.

The final three years of the period of ownership always qualify for CGT exemption regardless of how you use the property as long as the house has been your main residence for some part of that period. This generous provision allows an exemption of three year's CGT on sale of a second property, such as a London apartment used only during the week or a holiday house in Spain, providing it is nominated for a short period, say for one week, as your principal residence. This potentially valuable three year exemption comes at the cost of foregoing only one week's CGT exemption on your real principal home and the trouble of making the appropriate elections in a timely fashion[11].

[11] See http://www.taxationweb.co.uk/tax-articles/general/where-do-you-live-cgt-main-residence-relief-on-more-than-one-home.html

As an added bonus, awarded by a “grandfather” provision, complete exemption of CGT of any amount is also available on sale of a residence, acquired before 5 April 1988, which has been provided rent-free for a dependent relative.

In 1988 the top marginal rate of CGT was 60% which provided plenty of incentive for high income taxpayers to commence aggressively exploiting the housing exemptions. For the period 1988/89 through 2007/08 the top marginal CGT rate was 40%. In 2007/8 the 40% rate applied to taxable income over £34,600. From April 2008 CGT was reduced to 18%, somewhat reducing, but certainly not eliminating, the incentive to aggressively trade owner-occupied housing in the future.

There appears to be no limit on the amount of the Private Residence Relief, the frequency with which it can be claimed or the total number of times it can be claimed.

In the UK some home owners were in a position to immediately reap windfall gains from the new exemptions and this is reflected in house price indices.

I used an index produced by the Nationwide Building Society[12] of nominal prices for standardised single family dwellings commencing in 1Q 1952. I converted growth rates in nominal prices to real growth rates using the UK Retail Price Index (RPI)[13]. Table 2 illustrates the change in the rate of growth of house prices which occurred around the date of the CGT exemptions.

Table 2: UK Real House Prices before and after April 1988 CGT Exemptions

4Q-1952 to 3Q-2007

Quarterly data

Period Yrs.	From	To	Relativity to Start Date of Exemptions	Annualised Real Rate of Change
35.25	4Q-52	1Q-88	Before (long term)	+ 2.56%
1.50	3Q-86	1Q-88	Immediately before	+ 7.43%
New CGT exemptions effective for sales after 6 April 1988				
1.50	1Q-88	3Q-89	Immediately after	+18.34%
19.50	1Q-88	3Q-07	After to peak of housing market	+ 3.91%
The above 19.5 year period includes the following three periods.				
1.50	1Q-88	3Q-89	Immediately after	+18.34%
6.50	3Q-89	1Q-96	During and following recession	- 7.18%
11.50	1Q-96	3Q-07	Run-up to housing market peak	+ 9.01%

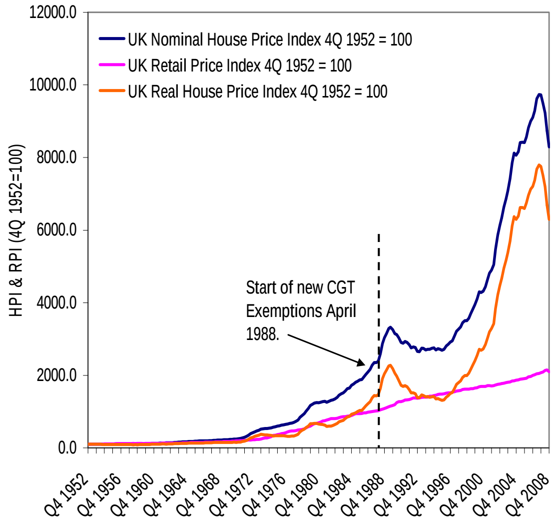
Sources: Nationwide All houses Index, UK Office for National Statistics Retail Price Index

In the UK house prices finally peaked in 3Q 2007. During the 35.25 years prior to the CGT exemptions real price growth averaged 2.56% compared to 3.91% for the 19.50 years following them. This seemingly small difference causes house prices to double

[12] Nationwide Building Society, All Houses Index
[13] UK Office for National Statistics, Retail Price Index, All Items

in 27.42 years before, compared to only 18.07 years after, the exemptions. This difference would be significant to anyone paying off a mortgage.

CHART 6
UK Nominal and Real house Prices
4Q-1952 to 4Q-2008



Source: Nationwide Building Society. UK Office for National Statistics

Chart 6 shows UK nominal and real house prices for the period 4Q 1952 to 4Q 2008 in relation to the effective date of the 1988 CGT exemptions.

2.3 The United States

In the US capital gains were first taxed in 1913, initially at a rate of 7%. From then until 1951 many different CGT rates applied at various times to all gains from all assets, with the tax rate generally depending on the holding period for the asset. In 1951 roll-over relief was first introduced for gains made on sale of owner-occupied housing and this allowed deferral of CGT provided a house of equal or greater value was purchased within two years either side of the sale. In 1981 the "age 55" rule was introduced which provided a once-off mandatory CGT exemption of $125,000 following the first sale of an owner-occupied home by a person 55 years of age or more. In 1981 the maximum CGT rate was also reduced from 28% to 20%. The roll-over relief, the "age 55" exemption and the 20% rate remained unchanged until the Clinton administration enacted the Taxpayer Relief Act of 1997 (TRA97).

TRA97 abolished both the roll-over relief and "age 55" rules and replaced them with a US$250,000 CGT exemption for single taxpayers ($500,000 for couples filing jointly) applying to gains from any housing which had been owned and lived in for periods totalling two years out of a five year period ending on the day of sale. The exemption could be taken once every two years and there was no limit on how many times it could be taken. It could also apply to a second house subject to ownership, residence and exemption frequency tests being met. In 1997 the maximum CGT rate applying to real estate assets held for longer than one year was 20%. In 2001 a new top marginal rate of 18% was introduced for assets held for at least five years. In 2003 this was reduced to 15% but this is scheduled to revert to 18% in 2010.

The exemptions of TRA97 made a huge difference to the tax treatment of owner-occupied housing in the biggest single asset market, by value, in the world. At the stroke of a pen it replaced a once-in-a-lifetime $125,000 CGT exemption (for singles and jointly filing couples, $62,500 each for married independently filing couples), which could only be taken after reaching age 55, with a two yearly $500,000 exemption (for jointly filing couples) from tax rates of 20%. The number of times the exemption can be taken is limited only by the enthusiasm and house picking skill of the home owner and by how long it takes the housing market to produce capital gains worth taking. By 1997, the examples of the Australian and UK markets showed that the more people who joined the game the faster this occurred.

How much more generous were the Clinton exemptions? If a comparison is made between a once-in-a-lifetime exemption on turning 55, of $125,000 total for jointly filing couples, and a potential exemption of $500,000 every two years the post-TRA97 exemption is potentially 95 times more "stimulating" than the pre-TRA97 exemption**.** My expectation is that many high earners took it as a personal challenge to see if they could achieve $500,000 of tax-free capital gains every two years.

Because the TRA97 exemptions radically changed the tax status of existing unrealised capital gains they could be taken advantage of immediately by owners with substantial accrued gains. They were! TRA97 set a previously lack-lustre US housing market on fire. The fire was deliberately lit. Just why is uncertain. Some commentators have postulated that the Clinton administration was concerned that the previous roll-over provision had been "locking in" owners and inhibiting geographic flexibility of the workforce. It may have been done to re-invigorate a chronically flat housing market or to encourage greater home ownership or just to align the US tax treatment more closely with the UK system. Whatever the reason it is almost certain that the Clinton administration seriously underestimated the likely response to the changes.

The rules to be followed to obtain the greatest return from the new exemption were virtually identical to those which were already working for so many in the UK and Australian housing markets. Because the US exemption was capped it was obviously smart to realise capital gains at or about the level of the cap. Once the boom became established this would have encouraged faster turnover in properties. High earners with good credit ratings could also augment their gains by simultaneously owning more than one home and taking care to comply with the ownership and residence requirements to claim as much exemption as often as possible under the rules.

As was the situation in the UK and Australia, virtually every legal, wealth building activity open to the citizenry was subject to taxation except that the profits from actively trading your own residences were completely free of tax up to a very generous cap.

The US housing boom which immediately followed TRA97 ultimately peaked in July 2006 and the inevitable bust which followed took another year to morph into the start of the global financial crisis presently unfolding around the world.

I used the S&P Case Shiller Composite 10 City House Price Index (SPCS-10)[14] to track the changes in US house prices since 1Q 1987. This is a composite monthly index of nominal house prices in Boston, Chicago, Denver, Las Vegas, Los Angeles, Miami, New York, San Diego, San Francisco and Washington DC from January

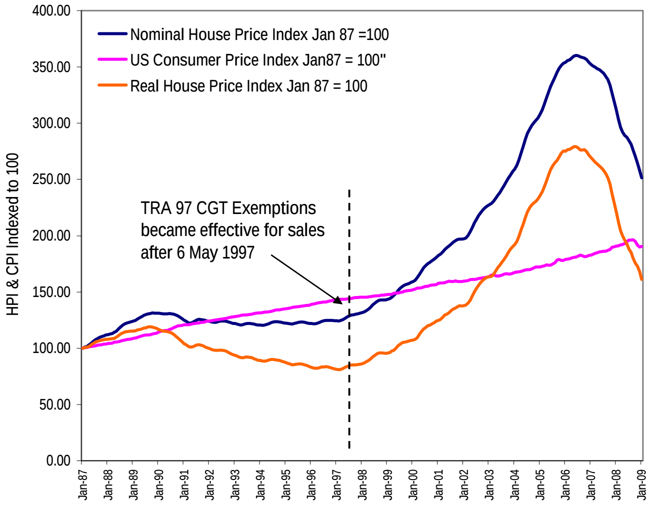
[14] Source: S&P

1987. It uses repeat sales methodology to capture the true price appreciation of constant quality homes. The nominal house prices have been converted to after inflation prices using the US Consumer Price Index.

CHART 7 illustrate the dramatic growth in both nominal and real US house prices which occurred immediately following TRA97.

TABLE 3 shows the change in real house prices around the introduction of the new CGT exemptions.

CHART 7
US Nominal and Real House Prices
Jan 1987 to Jan 2009



Source: S&P Case Shiller Composite 10 City Index, US Department of Labor

These massive change in consumer sentiment towards owner occupied housing coincided precisely with the TRA97 exemptions.

How much were the TRA97 exemptions worth to US owner occupiers? I estimated that during the nine years between the May 1997 introduction of the TRA97 exemption and May 2006, two months before the housing market peak, the total capital value of US owner-occupied housing appreciated from US$5.746 trillion to US$16.350 trillion. Neglecting the carry-forward of any pre-TRA97 gains which would have been significant but unknowable, the total potential new capital gain was therefore US$10.604 trillion,. Had the normally realised percentage of this been taxed at long term applicable CGT rates the total tax take for nine years would have amounted to approximately US$321 billion, growing from a minimum of US$4.5 billion in 1998 to a maximum of US$77.3 billion in 2006. These estimated effective stimulus figures would be much larger if they included post-TRA97realisation of gains accrued pre TRA97.

Table 3: US Real House Prices before and after May 1997 CGT Exemptions

Monthly Data Jan 1987 to Jul 2006

Period Yrs.	From	To	Relativity to Start of New CGT Exemptions	Annualised Real Rate of Change

10.25	Jan-87	Apr-97	Before (long term)	- 1.40%
1.50	Oct-85	Apr-97	Immediately before	- 1.51%
New CGT exemptions effective for sales after 6 May 1997				
1.50	Apr-97	Oct-98	Immediately after	+7.56%
9.25	Apr-97	Jul-06	After to peak of housing market	+ 8.36%
Following the July 2006 housing peak house prices have fallen as follows:				
2.42	Jul-06	Dec-08	Decline from peak of housing market	-13.57%

Sources: S&P Case Shiller Composite 10 House Price Index, US Dept. of Labour Consumer Price Index.

As is the case with the Australian situation, the effective "fiscal stimulus" of US$321 billion allowed to home owners was enough to generate a financial crisis but pales into insignificance when compared with the several trillion dollars taxpayers will need to contribute to fix the problem caused by a completely rational response by home owners to the stimulus. It was definitely not a good deal except for the few prescient people who sold their big houses tax-free at the top of the market, have been renting ever since and are only now looking to buy back into a market awash with genuine housing bargains.

While precise comparisons are difficult an online comparison of like-for-like houses for sale in the US and Australia shows that American houses are currently priced at about 50% of the price of corresponding Australian houses.

3. DISCUSSION

For the 2002 tax year, in what appears a measure aimed at cutting tax department workload, the UK government enacted an exemption which meant that private companies with taxable income of less than £10,000 paid no income tax. The measure had to be abolished in 2005 because by then thousands of small sole traders had incorporated themselves to benefit from the tax break.

There was not much doubt that it was the tax exemption which had stimulated the sole traders to take on the extra expense and complication of operating as companies.

Tax incentives work! Sometimes a perfectly rational response to them produces unintended consequences.

Between 1985 and1997 Australia, the UK and the US governments successively amended their tax systems to provide incentives for citizens to buy their own homes. Perversely, it turned out that the perfectly rational way to maximise benefit from the tax break in each country was for existing home owners to repeatedly trade their homes for bigger and better ones using progressively more borrowed money to do so.

These tax incentives also worked! That's exactly what existing home owner did.

In each of these countries a sustained boom in house prices commenced almost immediately following the tax changes and did not stop until high default rates on sub-prime mortgages in the US triggered major paralysis of global credit markets which ultimately produced the present financial crisis seriously affecting the global economy.

Once again there is little doubt that the introduction of the tax exemptions exclusively applying to owner-occupied housing initiated the housing and borrowing booms which caused the credit market collapse which led to the GFC.

I consider that the evidence is overwhelming that the CGT exemptions for owner-occupied housing in Australia, the UK and US initiated the global financial crisis. The present GFC would probably not have occurred had these exemptions not been in place.

Other commentators have suggested other common factors as possible reasons for the unprecedented amplitude, duration and synchronicity of the housing booms in the three counties. These included steadily increasing incomes, low inflation and low interest rates. The strongest argument that these were merely favourable environmental factors is the fact that, although these factors were undoubtedly present in the US in the mid 90's there was absolutely no evidence of a housing boom in that country until the TRA97 exemptions were enacted, nine years after the Australian and UK booms started. The US housing boom only started immediately after TRA97 was in place.

So what's wrong with governments encouraging people to buy bigger and better homes via a capital gains tax exemption?

1. The main problem is that if enough large countries do it simultaneously and for long enough it produces a global financial crisis of unprecedented scale.

2. It is not necessary. There is absolutely no good reason for permanent "fiscal stimulus" for owner-occupied housing. In Australia it probably came about because the Hawke government was badly advised, was following the 1975 example of Ireland, or just lacked the political courage to include housing gains in the new CGT. It certainly did not encourage an increase in home ownership in Australia. As previously noted, Dr Richards claims the resulting house price boom actually produced a 4% reduction in home ownership.

People with the resources to do so need no encouragement from government to exercise their "edifice complex" by buying the biggest and best house they can afford, if that is their inclination. People of more modest means are assisted most effectively into home ownership if house prices remain within a sustained stable relationship with earnings, rents and construction costs and transactions are made as frictionless as possible. Right now, by any objective fundamental or comparative investment criteria, Australian houses are significantly overpriced. Most people instinctively know that and are staying out of the market unless stimulated by temporary cash grants to enter it.

3. Owner-occupied housing is a poor choice of asset class to artificially stimulate. Owner-occupied houses are completely unproductive assets which, by definition, produce no income for the owner or for the nation. They can't be sold to foreign countries to produce revenue.

Despite the saving and investment elements sometimes attributed to them owner-occupied houses are essentially consumption goods, albeit, long-lived ones. Like bananas, they are best bought when they are cheapest. To renters the house they rent is unquestionably a pure consumption item and rent paid is a cost to their revenue which must come from some productive activity. For home buyers their tenure is usually more secure but their house payments still have to come from the revenue of some productive activity. In both cases it is income set aside for immediate consumption rather than re-investment in a productive activity. In the long run the indestructible land component of owned housing makes it a fairly reliable store of value, wherein lies its only dubious claim to be an investment.

Housing construction provides only a small amount of employment in proportion to the capital permanently alienated from other uses by housing. Residential land and dwellings alienate 43.5 % of the nation's capital but require only about 5% of national wages and salaries for dwelling construction. Many other industries provide greater labour intensity.

Government "fiscal stimulus" via a permanent CGT exemption for owner-occupied housing will encourage the sinking of ever larger amounts of capital into non-productive assets. Capital sunk into owner-occupied housing is unavailable for other productive investments which have the potential to increase the revenue of individuals and the nation.

It makes much more sense to permanently stimulate share ownership by retaining dividend imputation indefinitely than to continue exemptions which encourage the trading of non-productive owner-occupied housing.

4. The permanent CGT and asset test exemptions on owner-occupied housing produced major asset price misalignment in only one asset class which could not be remedied with the blunt instrument of monetary policy without collateral damage to productive sectors of the economy which were operating in a sustainable manner.

Chart 2 indicates that at the end of 2007 Australian house prices were overvalued by 75% to 125% depending on which fundamental factor you measured them against. This means that the largest single asset on Australia's national balance sheet… residential dwellings and the land they stand on…which represented 54.4% of Australia's national net worth and 66.2% of aggregate household net worth[15] was around 100% overvalued. A rapid correction of house prices to fair value, assuming no overshooting on the downside which usually occurs, would reduce Australia's net worth by 27.2% and the household sector's net worth by 33.1%. It is fortunate that we do not sell many houses to foreigners!

Much more importantly for the economy generally, the housing overvaluation means that assets securing residential loans representing 37.8% of total bank assets, 61.9% of credit union assets and 67.7% of building society assets were also around 100% overvalued[16]. A sudden return of house prices to fair value obviously carries the risk of completely wiping out the share capital of many of these lending organisations.

During the latter years of Australia's 20 year house price and borrowing boom it was evident from its many pronouncements on the subject that the RBA was deeply concerned that the misalignments building up were not going to end well. Their 2003 annual conference on "Asset Prices and Monetary Policy" was devoted entirely to the issue. They obviously needed a scalpel to operate on residential mortgage rates in isolation rather than the broadaxe of monetary policy which was their only weapon, apart from moral suasion.

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[15] ABS 5204.0 Australian System of National Accounts 2007/2008

[16] RBA Bulletin Tables B2, B7 and B7.

It is obviously in the national interest to eliminate tax exemptions exclusively applying to one asset class which can potentially create asynchronous price misalignments in the economy which conventional monetary policy cannot selectively address.

5. Stimulating individuals via permanent exemptions to upgrade their housing also means stimulating them to assume more debt. The history of booms shows that what the frontrunners do wisely, many latecomers do foolishly. If high LVR debt is secured by overpriced property both the borrowers and lenders are made more vulnerable to economic shocks.

The gearing ratios for house purchase are often greater than those used in futures trading. Leaving in place government encouragement for people to upgrade their housing once house prices reached the lofty heights of 2003 was, for some inexperienced buyers, equivalent to encouraging small children to play on the expressway and could only end in misery and disillusionment.

6. The CGT exemption is regressive in that it potentially provides far greater benefit to the already well-off. Baby boomers approaching retirement have priced their adult children out of the housing market. It is poetic justice that many of those boomers are complaining that their adult children are still living with them!

A concomitant result, especially of the assets test exemption, is that indebtedness has moved up the age profile by approximately one quintile[17]. Older debtors have less time to recover from shocks like the GFC and risk becoming a greater cost to the social security budget than if the exemption had not existed.

7. The government is going to need every last tax dollar it can possibly collect for the next few years.

4. HOW SHOULD GOVERNMENT POLICY BE CHANGED?

If it is accepted that CGT exemptions in Australia, UK and the US were primarily responsible for, or even just made a significant contribution to, the present GFC it follows that changes should be made in all three countries to prevent a repetition. Possible changes include modifying tax policy to eliminate the present privileged status of owner-occupied housing, giving additional powers to central banks to allow selective control of residential mortgage rates or modifying bank regulatory powers to allow selective control of mortgage lending. Of these three alternatives modifying tax policy is the most logical because it treats the problem at its source and minimises government intervention in market activities.

Of course the Australian government only has direct control over its own domestic policies but should use what influence it can bring to bear to convince other countries to consider similar changes to their tax policies.

There are two ways of producing a level playing field for asset allocation in this situation. One is to leave gains from housing free of CGT as at present but to eliminate all other capital gains taxes. This would be destructive of revenue by the foregoing of CGT now collected and the certain proliferation of new schemes to

[17] RBA Bulletin Oct 2007 "Some Observations on Financial Trends", Ric Battelino, Deputy Governor, RBA.

convert ordinary income to capital gains. The remaining and best option is to eliminate the tax-free status of owner-occupied housing.

In Australia the 1991 exemption of owner-occupied housing of any value from the assets test is not strictly a tax measure but certainly has implications for how tax revenue is re-distributed. Borrowing data show that this exemption greatly reinforced the stimulus effect of the earlier CGT exemption. It is highly regressive and allows access to the age pension by people who plainly don't need it but understandably don't want to pass up the opportunity to "get some of their taxes back", which I suggest is the other "great Australian dream".

4.1 Specific Recommendations

1 The exemption from the assets test should be either removed completely or at least capped in a manner which ties it to national average earnings. My specific suggestion is to cap it at 156 times average weekly earnings and revise the cap annually according to that formula. Currently the cap would be $189,820 based on the ABS figure for November 2008. This is less than the average median price of a house but is more than the $124,500 value of a house imputed by the difference between the allowable assets for age pension entitlement for home owners and non-home owners.

Whether this exemption is removed completely or capped this change will necessitate the Federal government having access to an up-to-date database of house values similar to, and perhaps integrated with, systems used by the states for land tax and rating purposes. The internet now abounds with sites offering online estimates of individual house values so that capability is building. None of this is beyond the abilities of a highly computerised bureaucracy. A side benefit is that the regularly updated information on house values, which aggregate to Australia's largest single asset, will assist the government and the central bank in managing the economy.

Major adjustments to pension rates and thresholds will be required to adapt the pension system to new levels of pensioner assets and to prevent disadvantaging the truly needy in our society. The total cost of age pensions to the budget may stay about the same but the distribution will be vastly different with the elimination of one element of blatant middle class welfare.

Announcement of this measure should be made as soon as possible if something similar is not already included in the May 2009 Budget.

2. The CGT exemption which has been in place since 1985 should also be completely abolished for gains made on owner-occupied housing bought after the announcement date. This also should be as soon as possible.

The purpose of removal of this exemption is to confirm the fundamental equivalence of all forms of income for tax purposes and to cease the unwarranted tax treatment of owner-occupied housing as a "sacred cow" which cannot be slaughtered. Its purpose is not to raise tax revenue but to prevent, or at least minimise, future housing price booms. In a properly operating housing market it should not produce much revenue at all.

Because the main purpose of the removal of the exemption is to produce a more level playing field for asset allocation decisions it does not matter particularly how a CGT is applied to owner-occupied housing so long as it is similar to that applying to other investments likely to be considered by households. Because I don't consider tax should be paid on inflationary gains I personally favour indexation, despite its complication, rather than the present simpler 50% discount on long term gains.

Capital losses on housing should only be deductible from housing gains.

Another less effective but more popular possibility would be to apply the US pre-TRA97 regime of conditional roll-over relief and a one-off capped CGT exemption at some future event. The evidence is that this regime kept US house prices in line with inflation for a considerable time span.

The political fallout from abolishing these longstanding exemptions is probably overstated. If it is explained correctly most voters would be willing to accept the trade-off between the benefits from the exemptions and a greatly reduced possibility of a repeat of the painful GFC.

If John Howard's government could get itself re-elected in 1998 promising a GST another government could surely do the same while promising freedom from a GFC.

Also fears of a house price collapse are probably overdone. A US study by Case and Shiller (1988) showed that house prices are notoriously "sticky" downwards, even in a country where house keys can often be "jingle mailed" back to the bank to terminate the mortgage, which is not the case in Australia.

Graeme A Beal

[removed for privacy reasons]

April 2009