MASTER BUILDERS
AUSTRALIA

Submission to

The Treasury

on

Australia's Future Tax System

October 2008

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building australia

1 Introduction

1.1 This submission is made by Master Builders Australia Inc (Master Builders).

1.2 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 nine Master Builder State and Territory Associations.

1.3 Over the past 118 years the Association has grown to over 31,000 businesses nationwide, including the top 100 construction companies. Master Builders is the only industry body that represents all three building and construction sectors: residential, commercial, and engineering.

2 Review of Australia's Future Tax System

2.1 Master Builders welcomes the Rudd Government's decision to undertake a major review of Australia's Future Tax System. Long-term reform of Australia's tax and welfare systems is a key way to secure the economic foundations for the future in order to maximise our potential to create wealth, spread opportunity and encourage productivity.

2.2 The Review should play a vital role in modernising Australia's economy to meet the economic, social and environmental challenges of the 21st century. Meeting future challenges like climate change, the ageing population, new technologies and rapid globalisation, will require a tax system that is as fair, efficient and globally competitive as possible and the Review must help achieve those goals.

2.3 The Review should be a comprehensive examination of the tax system and complement other key Government reforms such as the Carbon Pollution Reduction Scheme and modernising the Federation through the Council of Australian Governments processes.

2.4 Master Builders believes that the priority of the Review should be to help boost Australia's productive capacity, and build prosperity in an increasingly competitive global environment.

2.5 Australia's tax system needs to be internationally competitive; streamlined, simplified and harmonised; and one which encourages hard-work and rewards workforce participation by removing complex disincentives.

2.6 Master Builders understands that the review will encompass Australian Government and State taxes, except the rate and base of the GST, and will make recommendations to create a tax structure to deal with challenges of the 21st century by considering a number of factors including:

- The balance of taxes on work, investment and consumption and the role for environmental taxes;
- Further enhancements to the tax and transfer system facing individuals, families and retirees;
- The taxation of savings, assets and investments, including the role and structure of company taxation;
- The taxation of consumption and property (including housing) and other State taxes;
- Simplifying the tax system, including the interactions between federal, State and local government taxes; and
- Interrelationships between the elements of the tax system, as well as the proposed emission trading system.

2.7 The Review Panel, which is expected to provide a final report to the Treasurer by the end of 2009, is to also ensure appropriate incentives for:

- Workforce participation and skill formation;
- Individuals to save and provide for their future, including access to affordable housing;
- Investment and the promotion of efficient resource allocation to enhance productivity and international competitiveness; and

- Reducing tax system complexity and compliance costs.

2.8 Master Builders Submission seeks to limit its comments to matters of significance to the building and construction industry and to matters of access to affordable housing.

3 Overview of the Building and Construction Industry

3.1 The building and construction industry is a major driver of the Australian economy and makes an essential 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 prosperity of the domestic economy.

3.2 According to the ABS, the value of work done by the building and construction industry was a record $135 billion in 2007-08, an increase of 11.9 per cent on the previous year. Residential building work done was $43 billion (excluding $20 billion of smaller renovations work), non-residential building $31.2 billion and engineering construction $60.9 billion. In 2007/08, year average employment in the construction industry grew by 3.6 per cent to reach 976,500 (average of four quarters to August 2008), or more than 9 per cent of the total Australian workforce.

3.3 A measure of the challenge ahead can be seen in Master Builders 10 year estimates for the building and construction industry. The cumulative construction task over the next decade should see $1.7 trillion of work done in chain volume (or constant price) terms assuming that Australia will fare relatively well against the global financial crisis and does not experience a deep and prolonged recession. For the residential building sector this will involve more than $800 billion of work done over the same period, and for the non-residential building and construction sectors, including engineering construction, a figure close to $900 billion. The number of jobs in the industry is expected to increase by more than 200,000 to around 1.2 million employees over the same time period.

3.4 As noted, Australia faces significant economic, social and environmental challenges in the 21st century. The current global financial crisis highlights the critical importance of an integrated and multi-faceted policy response including fair and efficient tax and transfer systems.

3.5 Taxation policy has a key structural reform role to play in meeting the challenges and securing Australia's future prosperity and in protecting the living standards of Australians including the importance of home ownership.

4 Tax and the Building and Construction Industry

4.1 The building and construction industry is one of the most widely taxed industry sectors. It suffers a taxation burden, direct and indirect, at all levels of government – federal, State and local. These tax burdens unduly work against achieving optimum economic and social objectives.

4.2 The high tax burden distorts investment decisions, discourages economic efficient turnover, reduces employment opportunities and adds to the cost of compliance. The high tax burden also decreases housing affordability, increases housing stress and places a greater burden on governments for housing assistance.

4.3 Master Builders therefore welcomes the opportunity that the current tax review offers and makes the following observations and recommendations for reform of the tax system.

Simplifying business tax compliance

4.4 Raising revenue to fund government outlays must be done as administratively efficiently as possible. The inefficient collection and administration of taxes distorts economic decision making and simply adds an unnecessary cost burden to the building and construction industry that should be removed.

4.5 The increasing complexity and volume of Australia's tax law represents an ongoing burden for Australian builders. Resources devoted to compliance with an unnecessarily complex tax system could be used more productively. Master Builders therefore supports measures that result in the minimisation by all levels of government of these costs.

4.6 Master Builders is also particularly concerned that complexity and its resulting compliance burden falls disproportionately on small business which cannot take advantage of economies of scale. This unfairly disadvantages small businesses relative to large.

Federalism, inefficient State taxes and housing affordability

4.7 Master Builders is a strong advocate for the complete removal of the taxes listed in the Intergovernmental Agreement of 1998. The 'listed' taxes included business taxes such as those on leases, hire purchase, mortgages and commercial conveyances. The agreement called for these taxes to be removed by 2005.

4.8 The current situation is that the States have agreed on a timetable for the abolition of all but one of the taxes. The States have not agreed to remove stamp duty on business conveyances of real property and Master Builders believes that the review of the tax system is an opportunity to revisit some 'unfinished business'. Firstly Master Builders advocates that the Government require an undertaking from the States to abolish stamp duty on business conveyances of real property.

4.9 In addition, although the States have agreed to the abolition of other 'listed' taxes, the timetable stretches in some cases out to 2012, way past the 2005 date established under ANTS. The Government should negotiate with the States to bring forward the timetable for abolition in respect of these taxes.

4.10 In an overarching sense, Master Builders believes the current review of Australia's tax system presents an ideal opportunity to develop a blueprint for reform of Australia's Federalism model in order to achieve a more efficient taxation regime. In this context, Master Builders notes growing evidence of deterioration in State Government budgets and is concerned that the States should play their role in exercising fiscal discipline. Review recommendations need to be far-reaching and practical and should encapsulate the removal of inefficient taxes and charges, particularly stamp duties on residential property transactions and should not be unduly influenced by the status of State and territory budgets.

4.11 Notwithstanding this, it is regrettably acknowledged the States will in the short term still rely on a range of narrowly based, highly distorting taxes for their revenue collection. Master Builders calls on the Government to examine the potential for State governments to remove the heavy reliance on inefficient taxes such as stamp duties. In themselves these taxes represent large impositions on the business community as a result of the distortion of decision making and direct increases in costs, as well as high compliance costs and reduced overall economic efficiency.

4.12 The rationale for removal of these taxes is that they generally fail badly on the tests of efficiency, simplicity, equity and low compliance and that, as transactional taxes, they impede economic activity. This applies particularly so to stamp duties. These taxes fall disproportionately upon the building and construction industry.

4.13 Stamp duties are an inefficient tax which add directly to the price of houses and other buildings but also make it more difficult for first home buyers to raise sufficient deposit and/or finance to pay both stamp duty and provide the initial equity in purchase of the house. These impacts are reduced to the extent that individual State and territory governments provide first home buyer exemptions. While stamp duty may in some cases only be a small fraction of the total price of a house, it can be a significant proportion of the initial funding (particularly in major capital cities) needed to enter into home ownership.

4.14 Residential stamp duty is an inefficient tax which not only affects housing affordability but also makes it more difficult for people looking to realise their housing preferences, particularly first home buyers and baby-boomer ‘empty nesters’ looking to downsize. Stamp duties also act as a serious impediment for more elderly people looking to realise their housing preferences in retirement. Stamp duties, as a transaction tax, are inefficient and other things being equal would tend to reduce the turnover of housing resulting in less than optimum use of the current housing stock.

4.15 In this context, it is important to note that the effectiveness of eliminating (or at least substantially lowering) stamp duty would be reduced if the supply of land is not improved. There would be the potential for lower prices and increased demand to simply translate into higher prices for owners and tenants. Given the inter relationships between demand and supply, it is critical that governments work to address the core structural problem affecting housing affordability, namely supply-side constraints. This is where enhanced cooperative arrangements between the Commonwealth, State governments and local government are the key to solving the housing affordability problem.

4.16 Master Builders recommends that the cumulative influence of GST be removed. In particular, GST imposed on stamp duty is unacceptable. It cannot have been the intention of the Commonwealth Government that tax reform would result in situations where tax on tax on tax could arise. For example, on a warranty insurance premium for domestic builders, GST is first applied to the premium, followed by an additional 10 per cent stamp duty. A broker's fee is calculated, which in turn has GST added to it. Master Builders' view is that the stamp duty should be calculated on the GST excluded premium price. A further example of this inequity is the fire service levy in NSW, Victoria and Tasmania, used to fund metropolitan and country fire services. GST applies to the levy, and then stamp duty on the GST inclusive price is charged by State governments. Administration of these levies is costly and time consuming, and far from best practice in tax administration or efficiency terms.

5 Housing and Tax: Improving Access to Affordable Housing

5.1 Housing is an essential part of Australia's way of life. High standards of housing have always been a high priority for Australians, most of whom seek home ownership. Master Builders therefore advocates the following tax reforms relating to housing as priority areas for action.

First Home Owners Grant

5.2 Notwithstanding the recent decision to provide a short term increase in payments until 30 June 2009 to first home buyers as part of the Government's economic stimulus package introduced in response to the global credit crisis, Master Builders submits there is a strong case to permanently raise and then index compensation payments under the current First Home Owners Grant Scheme (FHOG).

5.3 The original and underlying policy principle of the FHOG was to ensure that first home buyers were not financially disadvantaged by the increase in the cost of new homes as a result of the introduction of the GST. The then Government, in releasing 'Tax Reform – Not a New Tax, a New Tax System' (ANTS) in August 1998, recognised the importance of the housing sector in the Australian economy and, in particular, the impact that the GST would have on first home buyers. The explicit policy objective was to compensate first time buyers of new homes.

5.4 The GST compensation policy was premised on an assumption that the GST would raise the prices of new homes by about 4.7 per cent and the fact that existing home owners would benefit from a rise in the value of their homes (sales of existing homes are GST exempt).

5.5 In the period since the introduction of the GST on 1 July 2000, a number of events have occurred that have diminished the value of the $7,000 compensation package. Master Builders submits there is a strong case to index the compensation payment under the current FHOG Scheme to maintain the intended policy objectives stated in ANTS and to bring the grant into line with other areas of spending which are indexed annually to maintain their real value.

5.6 Failure to index the grant would invalidate the initial policy objectives of compensating for the impact of the GST on first time new home buyers so that intergenerational equity is maintained.

5.7 Indexing of the FHOG is also self-funding and should involve no net cost to the Budget. Essentially, as the prices of houses increase and, assuming no change in profit margins or labour input ratios, the amount of GST raised in the process of building the house should also increase by the same amount. The indexing of the Grant is therefore funded by higher GST receipts.

5.8 Master Builders also advocates that a higher grant be applied to those purchasing new homes rather than to those purchasing established homes. It is the purchase of new homes which directly adds to activity in the housing area and which also brings advantages in terms of the significant flow-on or multiplier effects to upstream and downstream industries.

The tax exempt status of the family home

5.9 Shelter is a basic human need and is increasingly recognised as a fundamental right. Affordable, quality housing remains essential to Australia's quality of life and it is important to pursue policies which will ensure the effective delivery of such housing to all Australians.

5.10 Decent, affordable housing for all 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.

5.11 Home ownership is an integral part of Australia's social and economic fabric. It has contributed much to the social harmony and stability which has fostered improved socio-economic outcomes. These benefits include greater incentives for civic involvement, security of tenure that increases community participation and minimises disruption to social networks, reduced incidences of socially disruptive behaviour and reduced welfare dependency. This is why the role of home ownership as a public good has always been recognised by all governments.

5.12 Widespread falls in home ownership will ultimately result in a decline in the quality of life of the Australian community.

5.13 There is no empirical evidence to support the proposition by some that the tax exempt status of home ownership undermines the equity or efficiency of the tax system. Master Builders therefore strongly advocates the continuation of the tax exempt status of the family home and rejects calls by some for it to become taxable.

Retention of current negative gearing provisions

5.14 There are no specific aspects of the current tax arrangements that provide a bias towards investment in property relative to other investments or other asset classes. Indeed, the ability to offset losses from one activity against income or profits from another is part of the normal operation of the Australian tax system.

5.15 Existing tax arrangements for investors do not explicitly discriminate in favour of investment in housing. It is also not correct to assert, as some have done, that rental housing investment is unique in the manner and extent to which it can be geared.

5.16 The current tax arrangements remain broadly neutral between private investment by individuals in rental housing, equities, and in commercial property. In each case, investors can benefit either directly or indirectly from negative gearing, depreciation and capital works deductions, and the CGT discount.

5.17 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 can only create a housing affordability crisis as was the case when negative gearing was disallowed in the late 1980s.

5.18 The removal of the negative gearing provisions can only work against the broader objectives of the current Government's housing affordability policy initiatives, including more rental stock for low income and disadvantaged groups in the community.

5.19 Master Builders does not believe that it is tax policies like negative gearing that have led to Australia's worsening in housing affordability. Demand for housing has certainly been strong in the past decade or so, but rather than negative gearing which has been in place for many decades, the most important change and driving force has been strong income and population growth encouraged by low inflation and interest rates.

5.20 (Any) policy driven measures in the tax system have been factored in over the decades and should not be seen as being responsible for the worsening in housing affordability we have seen in recent time.

5.21 Master Builders has been arguing that the core of the housing affordability problem lies on the supply side. Ideally, a flexible supply response would always adapt to fluctuations in demand with stable price growth the result. Master Builders believes State and local government policies in relation to land release, infrastructure taxes and charges and development assessments have, increasingly, become a supply side constraint that has fuelled higher prices and worsening housing affordability. Master Builders calls on the Government to consider alternative fiscal arrangements with State governments to deliver permanent relief from developer charges.

5.22 Of course, the situation can go the other way, that is, excess supply leading to weak or even negative price growth as is being experienced (painfully) in the United States. However, given Australia's circumstances, this is not a likely scenario.

5.23 Removal of negative gearing would almost certainly not lead to any instant improvement in housing affordability. On the contrary, it would risk investment in Australia's rental market that mums and dads (essentially) do by making a loss on an investment, they hope will one day attract capital gain.

Capital Gains Tax

5.24 A capital gains tax (CGT) is applied to the increase in asset value when an asset is sold.

5.25 While the Australian Government substantially reduced CGT with reforms in 1999, many other countries have since implemented CGT changes to attract greater investment. From an international perspective, Australia's CGT system is no longer competitive and is limiting investment and innovation. Alternative CGT approaches were canvassed by the 1999 Ralph Review of Business Taxation but not accepted by the Government on the grounds of revenue neutrality.

5.26 Master Builders recommends that the Australian Government should introduce a stepped rate capital gains tax to significantly reduce the burden of tax on capital gains and encourage increased investment. A possible stepped rate schedule is reproduced in the table below.

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)

5.27 Some commentators argued that the 1999 capital gains tax changes caused asset price bubbles, particularly in the housing market. These commentators argue that a bubble in house prices in 2003 and 2004 was caused by the combination of CGT and negative gearing and that an appropriate policy solution was to subject housing to even more taxation through either a reduced CGT concession or a reduction in negative gearing. There is no proof to substantiate this proposition.

5.28 Master Builders does not support this proposition.

5.29 The strong increase in housing prices in 2003 and 2004 was driven by a number of factors, and is very difficult to isolate the cause of each one. Master Builders believes price increases would have been much smaller if planning controls and land release from state and local governments had been more effective.

5.30 House prices in most regions have moderated and in some cases fallen, reflecting the cyclical element as well as location-specific nature of the asset. There would also be some problems limiting the CGT concession, (or negative gearing) as the Productivity Commission has noted:

> "O*stensibly '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)

5.31 In addition, around 70 per cent of the housing stock is owner-occupied and not subject to CGT at all. The imposition of CGT on owner-occupied housing is not being proposed by commentators, so an increase in CGT for investment housing would merely increase the tax discrepancy between investor and owner-occupied housing. It is not clear that this will have any effect on the total demand for housing although it will increase the tax on rental property.

5.32 Finally, housing also has distinct benefits that are often overlooked. As noted in paragraphs 5.9-5.13, housing provides many benefits including increased wealth and employment, and many social benefits including increased stability, social capital, maintenance, education and health.

6 Broader Tax Reform – Personal and Corporate Taxation

6.1 Master Builders advocates for the Government to pursue further fundamental taxation reform in order to reduce the tax burden and to remain globally competitive. As well as the introduction of a reducing rate of capital gains tax discussed earlier, Master Builders strongly supports:

- Further reductions in personal tax rates,
- Further reductions to the company tax rate, and
- Moves to gradually reduce the top marginal rate of personal tax to the same level as the corporate tax rate.

6.2 Reform of the company tax regime in 2001 enhanced Australia's attractiveness as a regional business headquarters and ensured that Australia enjoyed a period of greater competitiveness. The reduction in the rate of company tax from 36 to 30 per cent meant that Australia was more globally competitive.

6.3 However, many other countries have been reducing their company tax rates in recent years and the research shows that Australia is once again slipping in terms of international competitiveness.

6.4 Master Builders therefore recommends further reductions in the company tax rate at a rate that maintains Australia's global tax competitiveness.

6.5 Master Builders recommends the Government should commensurately aim to reduce the top personal income tax rate down to be more closely aligned to the corporate tax rate. Such a policy approach will largely remove the current ambiguity that is created by independent contractors who seek to take advantage of the 30 per cent company tax rate. Such an approach will also improve tax compliance obligations.

7 Conclusion

7.1 The building and construction industry is one of the most widely taxed industry sectors and Master Builders has long advocated for fundamental reform to reduce personal and business tax burdens. The tax burden unduly works against achieving optimum economic and social objectives, distorts investment decisions, reduces employment opportunities and adds to the cost of compliance. This high tax burden also decreases housing affordability, increases housing stress and places a greater burden on governments for housing assistance.

7.2 Master Builders strongly supports the retention of a number of existing taxes relating to housing, including the First Home Owners Grant, the tax exempt status of the family home, and retention of current negative gearing provisions.

7.3 In order to significantly reduce the burden of tax on capital gains and encourage increased investment, Master Builders advocates the introduction of a stepped rate capital gains tax whereby the percentage of gains subject to the tax reduces the longer an asset is held.

7.4 Master Builders believes the current review presents an ideal opportunity to develop a blueprint for reform of Australia’s Federalism model to achieve a more efficient taxation regime. Master Builders notes growing evidence of deterioration in State government budgets and is concerned that the States should play their role in exercising fiscal discipline. Review recommendations need to be far-reaching and practical and should encapsulate the removal of inefficient taxes and charges, particularly stamp duties on residential property transactions and should not be unduly influenced by the status of State and territory budgets.

7.5 Master Builders advocates for the Government to pursue further fundamental taxation reform in order to reduce the tax burden and to remain globally competitive. Reform should include further reductions in personal tax rates; further reductions to the company tax rate; and moves to gradually reduce the top marginal rate of personal tax to the same level as the corporate tax rate.