CGT main residence exemption

Why removing the tax concession for homes over $2 million is good for the budget, the economy and fairness

Policy Brief

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Summary

The largest tax concession in Australia is the capital gains tax (CGT) exemption for the main residence. Last year it cost the budget $46 billion and is predicted to cost the budget $189 billion over the next four years. Each year the cost of the CGT exemption on for the main residence costs the federal budget more than Defence, Education or Medicare.

Modelling commissioned by The Australia Institute from NATSEM shows low income households (those in the bottom 30%) get almost no benefit from this tax break. Almost 90% of the benefit goes to the top half of income earners while the bottom half get only 11%. High income households (those in the top 20%) get more than half of the benefit (55%).

With the government looking for budget savings that do not disproportionately impact low income households, it is appropriate to look at this very large tax concession.

The government could raise revenue in an equitable way by limiting the CGT exemption to houses worth less than $2 million. This would mean that houses worth less than $2 million would still be exempt from CGT while houses worth $2 million or more would be subject to CGT.

Limiting the tax break to houses worth less than $2 million would raise almost $12 billion over 4 years. 56% of the additional tax revenue would come from the top 10% of income earners.

Reducing the concession is likely to have a positive economic impact by reducing distortions in the economy. At present the exemption encourages over capitalisation in main residences since any increase in their value is tax free. This has the effect of pushing up the value of housing and therefore making that housing less affordable. It also reduces investment in other areas.

Capital gain is less productive for the economy than other forms of income. Earning an income from a capital gain does not require the production of something but instead means holding an asset while its value increases. So from an economics perspective this is a less useful form of income.

Restricting the main residence exemption to houses worth less than $2 million would reduce this distortion, raise billions of dollars and do so from high income households.

Introduction

In the lead up to last year's September tax reform summit, Australia's Prime Minster Malcolm Turnbull declared 'everything was on the table'.[1] This is an invitation to look at areas of the tax system that have previously been overlooked. In particular it is an opportunity to take a fresh look at areas previously considered 'off the table'.

The Prime Minister underscored the need for tax changes to be considered 'fair'. Without that, Mr Turnbull believed, there would be no support for the reform and it would likely fail.

Many recent attempts to reduce the budget deficit have disproportionately impacted low income households since they are the main beneficiaries of government spending.[2] If Mr Turnbull's stated goal of fairness is to be achieved, the government's next measures should reduce the budget deficit in ways that don't impact on low income households.

Over time Australia's tax system has become increasingly complex. The current tax reform debate is an opportunity to look at some of the existing exemptions from tax, also known as tax concessions, to consider if they are still working in Australia's best interest and to see if more revenue can be generated in an equitable way by scaling back some of these concessions.

The largest tax concession is the capital gains tax (CGT) exemption for main residences. This tax concession is even larger than superannuation tax concessions. It will cost the budget $46 billion in 2015-16.[3] It is appropriate to look at such a large tax concession to make sure that it is delivering good value for money for the Australian people.

[1] Keany et al. (2015) *Reform summit: Everything on the table at meeting of industry leaders, Malcolm Turnbull says*

[2] NATSEM (2014) *NATSEM Budget 2014-15 Analysis*

[3] Commonwealth of Australia (2015c) *Tax Expenditure Statement 2014*

The overlooked budget solution

The government's budget in 2014 attempted to reduce the deficit almost entirely through spending cuts. It was comprehensively rejected by both the public and the Parliament. While governments should always be on the lookout for ways to do things more efficiently and make savings, the size of the current budget deficit cannot be addressed only with spending cuts.

The government must also look to revenue measures if it wants to effectively reduce the budget deficit. One type of revenue measure that is often overlooked is tax concessions. A tax concession occurs when the government allows a group of taxpayers to pay less tax than the rest of the public. An example of this is superannuation tax concessions.

Complexity of taxation means we tend to focus on those things we understand. People regularly get paid and so regularly pay income tax. They regularly buy things and so regularly pay GST. But most people don't regularly pay CGT. This leads to a situation where CGT is not well understood and this contributes to low levels of scrutiny.

CGT is paid when someone makes a capital gain. A capital gain is when an asset is sold for more than it was bought for. For example if someone buys an investment property for $300,000 and then 10 years later sells it for $400,000 then they will have made a capital gain of $100,000. This capital gain would be added to their income and they would pay tax on that income.

There are a number of tax concessions that apply to CGT. One is the CGT discount which halves the capital gain before tax is paid. So in our investment property example above the capital gain of $100,000 would be reduced to $50,000. This $50,000 would then be added to their income and they would pay tax on it while the other $50,000 would be tax free. The CGT discount applies to all capital gains as long as the asset was owned for at least one year.

The other tax concession applied to capital gains is the main residence exemption. This means that any capital gains on a person's main residence is exempt from CGT. So in our example above if the house that was bought was for the owner to live in as their main residence rather than as an investment property then the whole $100,000 capital gain would be exempt from CGT.

The incentive of Capital Gains Tax

Economics focuses itself on creating the right incentives to encourage people to produce. A basic assumption of economics is that more production leads to more consumption which increases wellbeing. The incentives to encourage people to produce by, for example, working or setting up and running a business are at the heart of economics.

Earning an income from capital gains does not require the production of something but instead means holding an asset while its value increases. So from an economics perspective this is a less useful form of income. That is not to say that earning income from capital gains should necessarily be discouraged but rather it should not be encouraged in the same way as income from profits or wages.

Earning an income from your labour means you are producing something. Risking your money in investment means you are producing something. Earning interest on savings means you are effectively lending the money to someone who is investing it and producing something. Earning an income from capital gains is far less productive.

Despite this we have a situation in the Australian tax system where capital gains from assets other than someone's primary residence are taxed at half the rate as income from other sources. That is, someone earning $100,000 from wages or from running a successful business is taxed twice as much as someone earning $100,000 from selling assets for more than they had bought them. Further capital gains from the primary residence are entirely tax free.

Excessive interest in capital gains in a particular market can distort that market. It can create bubbles where assets are overvalued as people buy assets because they are continuing to rise in price rather than because of their underlying value.

By taxing capital gains more lightly, Australia is encouraging people to focus on earning an income from capital gains rather than from more productive ways. This can lead to problems if there is an over-emphasis on income from capital gains in the economy. A focus on capital gains in a market can lead to asset bubbles and crashes that can be damaging to both individuals and the economy.

Distribution of CGT exemption on main residence distribution

The government could reduce the deficit by reducing tax concessions, and the largest tax concession is the capital gains tax exemption for people's main residence. According to Treasury this exemption will cost the budget $46 billion in 2015-16, and is expected to cost the budget $188.5 billion over the forward estimates.[4]

This is a significant cost to the budget. A cost to the budget of $46 billion a year is more than the federal government spends on Defence ($26.3 billion), Education ($31.9 billion) or Medicare ($21.1 billion).[5]

The tax concession that has gained the most attention has been superannuation tax concessions, mainly because of their size and the fact that they overwhelmingly benefit high income earners. While the size of superannuation tax concessions is large, an even bigger tax concession is the CGT main residence exemption.

The focus of this paper is on the CGT main residence exemption. Modelling for this exemption has been commissioned from the National Centre for Social and Economic Modelling (NATSEM). Using their economic model, the Static Incomes Model (STINMOD) an analysis has been done of who benefits from the CGT main residence exemption.[6]

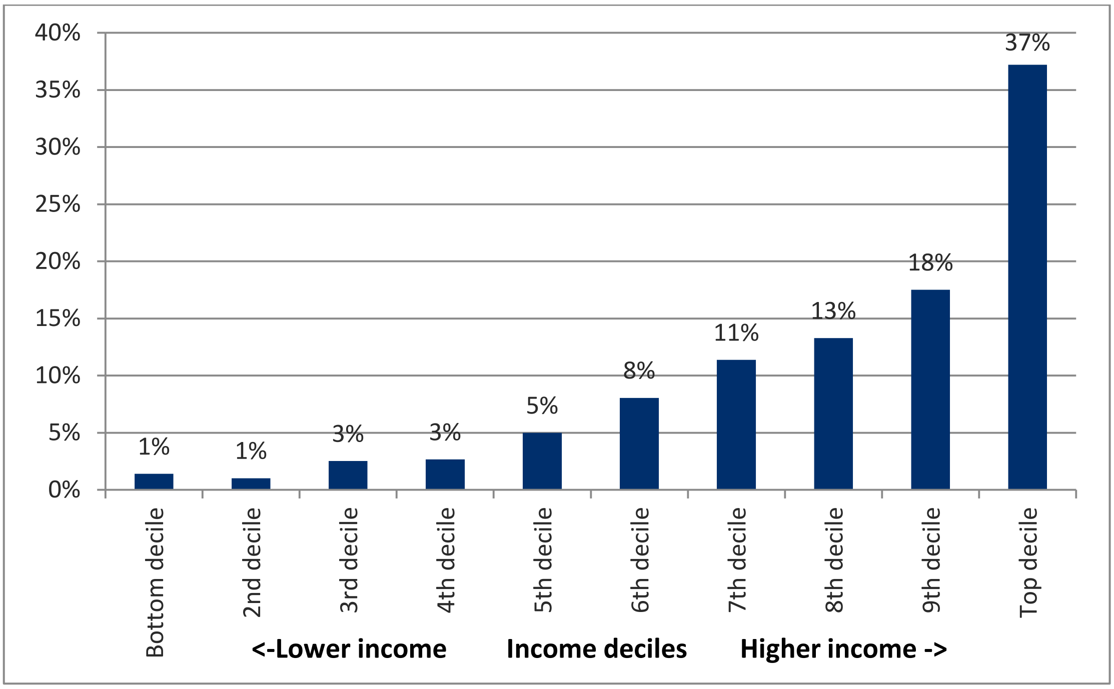
The distribution by income decile is shown in figure 1

Figure 1 – Distribution of GCT main residence exemption by income decile

[4] Commonwealth of Australia (2015a) *Budget 2015-16*

[5] Commonwealth of Australia (2015b) *Budget 2015-16*

[6] A description of STINMOD can be found in Appendix 1



Source: NATSEM Modelling

The benefits of exempting the main residence from CGT flows mainly to high income households with more than half of the benefit flowing to the top 20 per cent of households. With low income households (those in the bottom 30 per cent) only getting 5 per cent of the benefit. In fact half of all households only get 13 per cent of the benefit.

According to Treasury the size of the main residence exemption is $46 billion in 2015-16. This means that the exemption to the top 10 per cent of households was worth $17.1 billion. It was worth $25.1 billion to the top 20 per cent while the bottom 30 per cent only got $2.3 billion.

Those missing out on the benefit of this tax concession mainly include households who rent. These are disproportionately lower income households. Among those who own their own home or are paying it off, more of the benefit flows to those who own higher value houses as these usually rise faster, in dollar terms, than lower value houses.

The rapid growth in house prices is making it increasingly difficult for low income households to buy their own home. This will have the effect of further concentrating the benefit of the main residence exemption into the hands of high income households over time.

The inequitable distribution of the main residence exemption is very similar to the distribution of the benefit of superannuation tax concessions. A previous Australia

Institute report found that the top 20 per cent of households by income earned 60 per cent of the benefit of superannuation tax concessions (compared to 55 per cent for the main residence exemption).[7] The bottom 50 per cent got 11 per cent (compared to 13 per cent for the main residence exemption).

This means that the same concerns about the inequality of superannuation tax concessions also apply to the main residence exemption. Malcolm Turnbull has specifically highlighted the need for tax changes to be fair. This would seem to strengthen the case for a change to the CGT main residence exemption.

[7] Grudnoff (2015a) *A super waste of money: Redesigning super tax concessions*

Proposed reform

The reason that the main residence has been exempted from CGT seems largely political.[8] While it is likely that any attempt to remove the exemption would be politically difficult it is important to understand that there is not a strong economic case for this concession.

The exemption is likely to lead to a distortion of investment decisions such as an over investment in main residences and less investment in other assets that are subject to the capital gains tax. The exemption could have the effect of pushing up house prices and so removing it might help stabilise property prices, particularly when combined with the removal of the CGT discount which I have previously advocated.[9]

There is also not a strong case to keep the exemption on equity grounds since the majority of the benefits currently flow to high income households, with very little benefit flowing to low income households. But policy reform is made by politicians so any reform needs to consider what is popular as well as making the economic and equity case.

One policy option that would raise revenue, while being less politically contentious, would be to restrict the exemption to those selling houses worth less than $2 million. Under this policy those selling a house worth $2 million dollars or more would pay capital gains tax but those selling a house worth less than $2 million would remain exempt.

This has the advantage of raising revenue only from those who can most afford it while maintaining the exemption for the vast majority of householders. Last year, less than one per cent of owner-occupied house sales were for $2 million or more.

Modelling done by NATSEM using STINMOD shows that if the CGT exemption for primary residence was restricted to houses worth less than $2 million then an additional $2.9 billion dollars would be raised in 2015-16 and an extra $11.8 billion over the next four years.[10]

[8] Int'l Business Publications (2015) *Australia Tax Guide Volume 1 Strategic Information and Business Taxes* p84

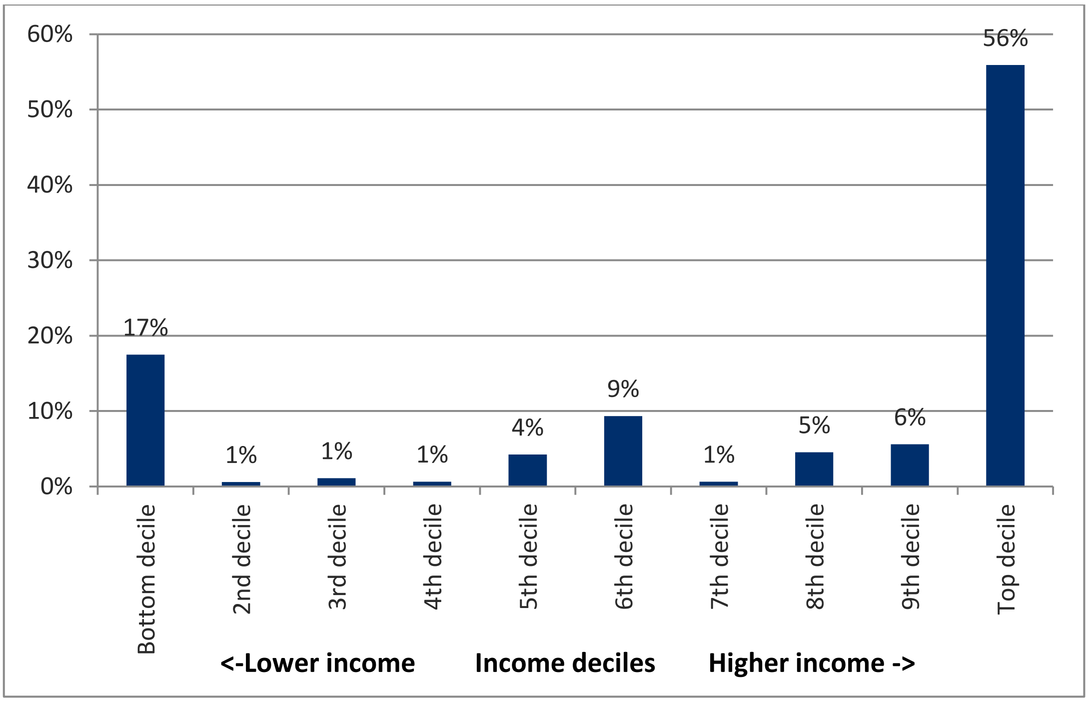
[9] Grudnoff (2015b) *Top Gears: How negative gearing and the capital gains tax discount benefit drive up house prices*

[10] The result for the forward estimates is calculated by assuming the result for 2015-16 grows at the same rate as the CGT main residence according to the Tax Expenditure Statement over the next four years. As higher priced property tend to grow in value faster than average this is expected to be an underestimate of the actual total.

This does assume that the CGT discount is not applied to main residences worth $2 million or more. This reform should ideally be made at the same time the CGT discount is abolished.[11]

62 per cent of the additional revenue is raised from high income households with 56 per cent coming from the top 10 per cent of households. The breakdown of the extra revenue gained is shown in Figure 2 below.

Figure 2 – Distribution by decile of revenue raised if GCT main residence exemption was restricted to houses under $2 million



Source: NATSEM Modelling

It is not surprising that more than half of the additional revenue comes from the top 10 per cent of households. It is likely that these households own the vast majority of houses that are worth $2 million or more. What is interesting is that there is a small but significant percentage of the revenue that comes from the bottom 10 per cent of households.

This small group of households are predominately older with about two thirds of them over 60 years of age. These households are mainly retired and are asset rich but income poor. A significant number of these households are paying the additional tax from their estates when the house changes hands after their death.

[11] For more information on abolishing the CGT discount, its effects and impacts see Grudnoff (2015b)

A minority of these households are in the bottom 10 per cent temporarily because the business they run has made a loss. There are also a number of households that are effective at reducing their taxable income and as a consequence appear to be low income but are quite wealthy.

As noted above the number of houses sold each year that are worth $2 million or more is quite small (less than one per cent). This means that from year to year there is some variability in how much extra revenue is collected from each decile. This helps explain the variability among the deciles. What the distribution highlights is that the majority of the extra revenue will come, as would be expected, from the highest income households.

Conclusion

The Prime minister has announced that everything is on the table and that changes to the tax system must be fair. Removing the CGT exemption for main residences worth $2 million or more will raise significant amounts of revenue from those who can most afford it.

Tax concessions can be justified on economic or equity grounds. There seems to be no such justification for the CGT exemption for main residences worth $2 million or more. This policy change will impact on less than one per cent of home sales while still raising $11.8 billion over the next four years.

If the government is serious about reducing the budget deficit in a fair and equitable way then changes to the CGT main residence exemption should be seriously considered.

Appendix 1

STINMOD, or the Static Income Model, is a microsimulation economic model developed by the NATSEM, which is used to simulate the effects of changes to policy on Australian household incomes. The model allows for detailed assessment of changes to differing levels of specificity, ranging from a population, to a cohort, to a group of individuals, to a household, to individuals.

The model is static as it does not assess its dependent variables across more than one period. This means it does not take into consideration behavioural change, and instead gives 'day after' impacts of a change to the government's system of tax and transfers. In other words, the model's primary focus is on the initial change, rather than change on change.

The model's database is based on data from the Australian Bureau of Statistics, in particular the Household Income and Expenditure Survey and other related catalogues. STINMOD categorises its base files into demographic, income and household composition, which allows the modeller to simulate multivariate impacts of policy change. The model is regularly updated for income and population changes, and the parameter datasets of income source are adjusted with policy changes.

The model simulates the adjusted household income in response to exogenous changes, or shocks, in both entitlement and liability, which produces outputs that give indications to the topline and distributional effects of that change on the population. Because of the microsimulation foundations of the economic model, STINMOD can granulate the results to focus on "cameos", or effects on targeted specific groups, as well as estimating broader effects.

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