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Switching Gears: Addendum II

Why housing prices won't crash

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Introduction

House prices in Australia have grown at an unprecedented rate since 2004. A healthy economy fuelled by a strong mining sector, coupled with sustained low interest rates and a mixture of favourable tax settings have made the property market a desirable investment choice for Australians over the last decade. Consequently, property prices have increased to the point of unaffordability in many major Australian capital cities.

Many first home buyers are locked out of the market, with established investors regularly buying a second, third or fourth investment property in order to offset personal income taxes. In addition, population growth has far outstripped new property construction, leading to a gap between supply and demand that is further fuelling house price growth.

The McKell Institute's *Switching Gears* report into negative gearing, released in June 2015, recommends a discontinuation of negative gearing allowances for existing housing stock, and a grandfathering of current allowances for those who are already negatively geared. Under this proposal, negative gearing would still be allowed for newly constructed properties. These recommendations have since been adopted by the Federal Opposition in its housing affordability platform. Opponents of the changes have argued that under this proposal property prices would fall, thereby ensuring that the overall wealth of the 67 per cent of Australians who own property will decrease.

The McKell Institute has commissioned economic modelling to determine the likely outcomes in the property market if policy settings were left unchanged; and if policy settings were updated to reflect the recommendations originally tabled in *Switching Gears*. This addendum finds that over a 10-year period, house prices will continue to grow under both current settings and the proposed changes.

This report finds that under current arrangements, house prices across Australia's 8 capital cities are forecast to grow at 3.09% per year, while under the proposed changes, house prices are also forecast to grow, albeit at a more modest 2.60 % per year across the same 8 cities.

Modelling House Prices - Methodology

The McKell Institute commissioned independent modelling to predict Australian house prices over the next decade, both with the Federal Opposition's proposed changes, and without any change to the tax mix. The assumptions and findings are detailed as follows:

Capital Gains Tax Discount

The Federal Opposition's proposal is to reduce the capital gains tax discount from 50 per cent to 25 per cent. The effect of this change to the tax mix is difficult to estimate. The reduction in the CGT discount will result in higher tax liabilities on investor owned property which may result in a long term effect that marginally reduces demand for homes with higher expected capital gains (although homeowners are left unaffected). The result will be to moderate future house price growth. Grandfathering the discontinuation of the CGT discount will ensure a smooth transition without any sudden changes to prices.

As such, we estimate a 0.5 per cent reduction in housing price growth per year from the discontinuation of the CGT discount.

Negative Gearing

The Federal Opposition's proposal will see negative gearing abolished for existing homes, but continued for new housing stock and other investments. The long term effect will be that this policy will moderate demand for existing homes and lift demand for new homes. The increased new supply will ensure rents remain stable. Grandfathering existing negatively-geared homes will ensure the housing market remains stable during the transition phase.

For the purpose of this modelling, it is assumed that under the Federal Opposition's proposal new housing supply will grow by 10 per cent per year (ie. If there are 5,000 new dwellings built in one period, the next period would see 5,500 new dwellings built).

The new supply will ease house price growth via the supply channel. We use existing house prices across cities to model the relationship between house prices and people per dwelling (population/number of dwellings). We find that a 1 person increase per dwelling is associated with house prices being 11.58 per cent higher. This is the figure that we use to model future house price growth based on future population growth and dwelling growth.

We use the average population percentage growth in the past 10 years for each state to represent each capital city's future dwelling growth.[i] We use the average dwellings percentage growth in the past 10 years for each state to represent each capital city's future dwelling growth without negative gearing changes.[ii] 10% is added to represent the growth change with the Federal Opposition's proposal.

Below are the population and dwelling growth rates used:

Table 1: ***Population and Dwelling growth based on past 10 year averages***

	Population Growth (% annual)	Dwelling Growth (% annual)	Dwelling Growth Proposed Reforms (% annual)
ACT (Canberra)	1.62%	2.23%	2.45%
NSW (Sydney)	1.28%	1.13%	1.24%
NT (Darwin)	1.69%	2.03%	2.23%
QLD (Brisbane)	1.98%	2.01%	2.22%
SA (Adelaide)	0.97%	1.43%	1.58%
TAS (Hobart)	0.60%	1.12%	1.23%
VIC (Melbourne)	1.73%	1.98%	2.18%
WA (Perth)	2.48%	2.44%	2.69%

In most cities, dwelling growth matches or exceeds population growth. With a 10% boost in dwelling growth from the Federal Opposition's proposal, we could expect a gradual reduction of the person per dwelling ratio for most states. To see the reduction, we forecasted the people per dwelling measure with and without the Federal Opposition's proposal, assuming the above population and dwelling growth rates and the proposal is introduced in 2017. We found that across cities there is a decline of on average -0.04 persons per dwelling in 2026 due to the increased construction. In areas where dwelling growth is low such as Hobart and Sydney the reduction is less than average. In all areas but Sydney, the new proposal will lead to a drop in persons per dwelling by 2026.

We were then able to forecast future house price growth based on the effects of the proposal on persons per dwelling measure, income technology on lending rates and anticipated slower growth due to the cut in the capital gains tax discount.

On average, prices grow by -0.49 per cent per annum less than they otherwise would under the Federal Opposition's proposal. **The increase in housing supply from negative gearing is shown to have a negligible impact of about -0.01 per cent to -0.03 per cent per annum on housing prices particularly when the effect on the persons per dwelling reduction is small.**

House Price Predictions Across Australia

Figure 1: Average Median House Price Growth across the 8 Australian capital cities with and without the proposed reforms (over a 10-year period)

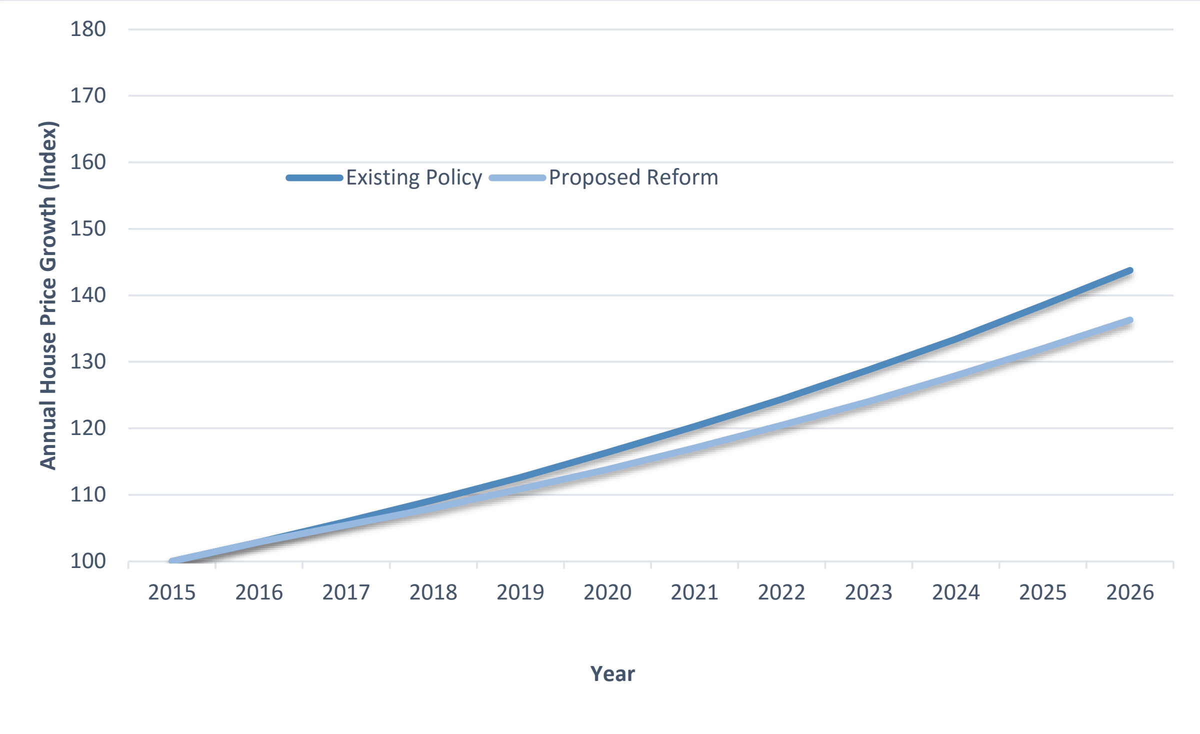


Table 2: *This demonstrates the difference in growth of median house prices across the 8 capital cities. The findings show that under the existing policy, growth will be 3.09% per annum, while under the new policy proposal, growth will slow marginally to 2.60% per annum.*

Forecast Median House Price Growth, 2017-2026 - 8 City Average		
Year	**Business As Usual**	**Proposed Policy**
2017	2.94%	2.39%
2018	3.04%	2.49%
2019	3.14%	2.59%
2020	3.24%	2.69%
2021	3.34%	2.79%
2022	3.44%	2.90%
2023	3.54%	3.00%
2024	3.65%	3.10%
2025	3.75%	3.20%
2026	3.85%	3.30%
Compound Annual Growth Rate	**3.09%**	**2.60%**
Average difference in % growth over 10 year period		**-0.49%**

Table 3: 10-year Compounded Average Growth Rate (CAGR) under current and proposed negative gearing policies

	Existing Policy	Proposed Reforms	Growth Differential
Canberra	3.00%	2.50%	-0.50%
Sydney	3.18%	2.71%	-0.48%
Brisbane	3.13%	2.64%	-0.50%
Melbourne	3.08%	2.59%	-0.50%
Adelaide	3.04%	2.56%	-0.48%
Perth	3.15%	2.64%	-0.51%
Darwin	3.04%	2.53%	-0.51%
Hobart	3.03%	2.56%	-0.47%

Predicting house prices is a hazardous exercise as housing does not always conform to changes in the fundamental economy. We have attempted to forecast house prices with some simple assumptions to understand the impact of the Federal Opposition's proposal.

We find that under the proposal, the reduction in prices due to the CGT discount exceeds that caused by the increase in supply anticipated by only allowing new properties to be negatively geared.

The proposal tabled in Switching Gears and adopted by the Federal Opposition is estimated to achieve a small reduction in housing price *growth* over the next ten years, making housing slightly more affordable. Housing prices will continue to increase under both current policy settings and under the proposed changes across all cities in Australia. The proposed changes, however, will not result in a statistically significant shock to the housing market.

Other factors contributing towards housing market growth

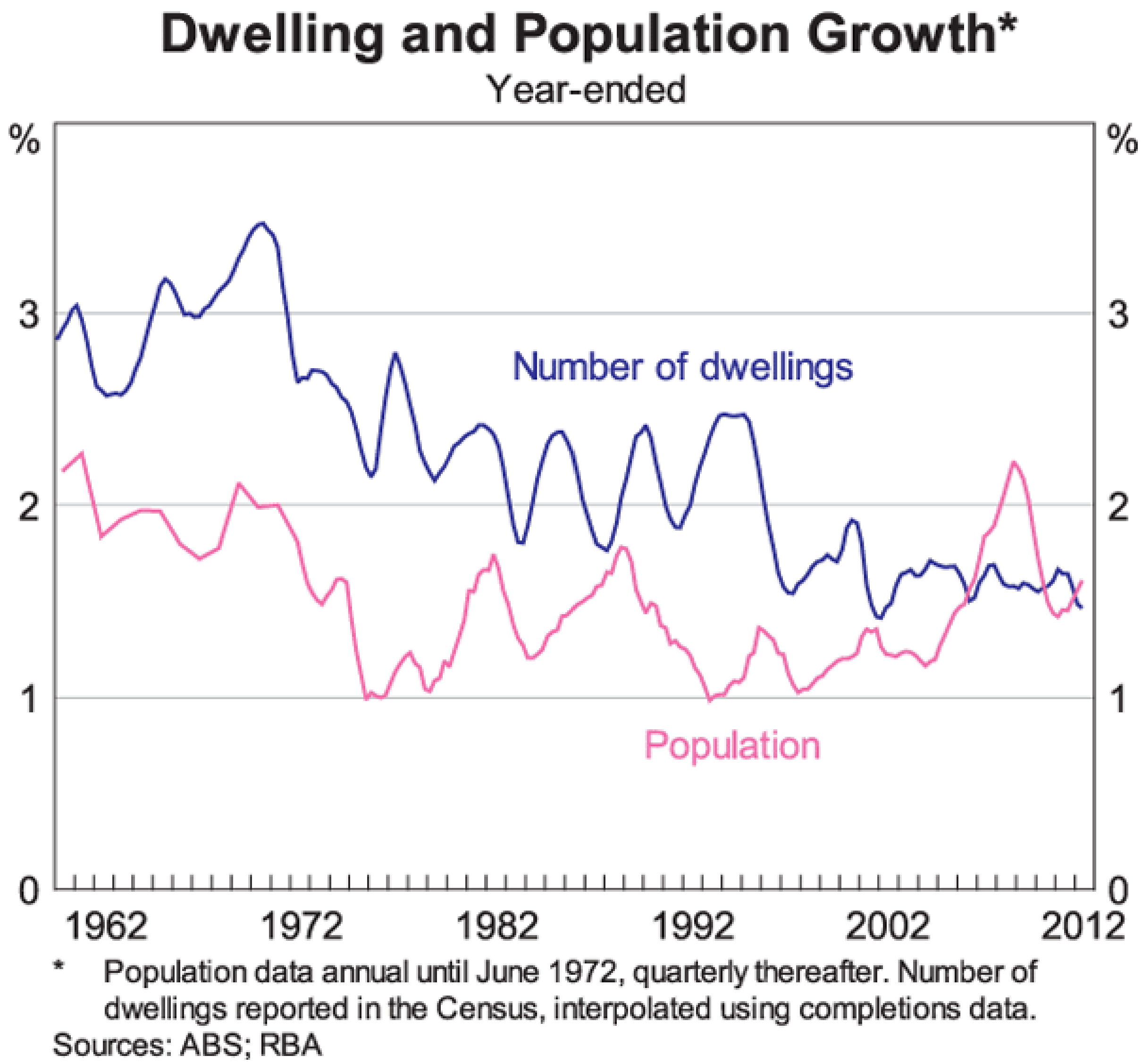
A Shift in Demand from Investors to Owner-Occupiers

The current tax settings inherently benefit older investors at the expense of younger people aiming to buy their first home. The *Re:Think Tax Discussion Paper* released by the Australian Government in March 2015 acknowledged that while tax settings are not the sole drivers of housing investment, the current policy mix does distort investment options towards property.[iii] When these distortions are removed, property investment may seem less of an attractive investment opportunity, thereby removing some investors from the existing housing market. However, rather than crashing the market, this will likely result in more young people being able to invest in their first home, resulting in a demand shift for housing from investors to owner-occupiers.

Demographic factors

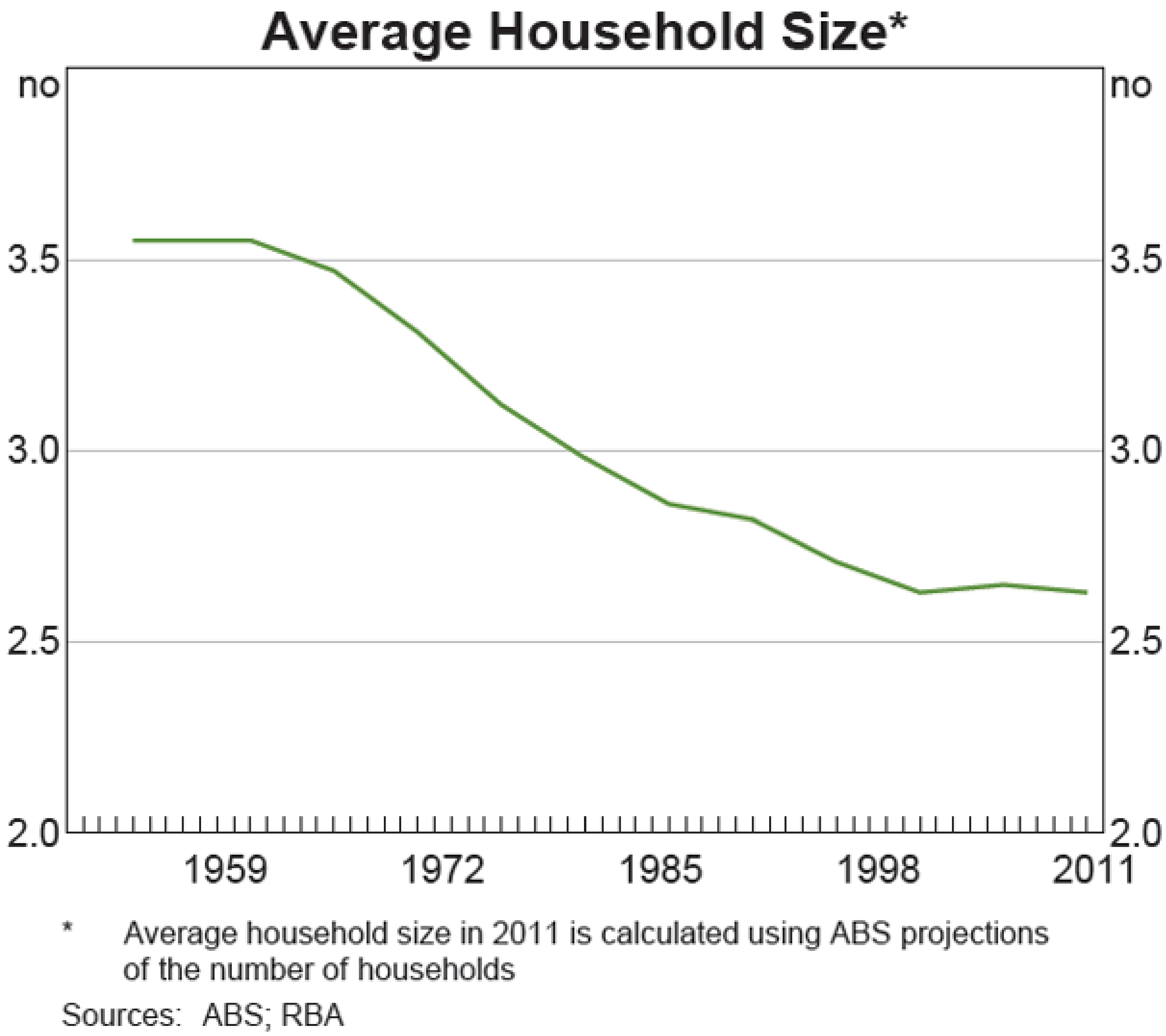
Demand for housing will not subside in coming years due in part to a variety of demographic factors. Rising population growth in recent years has been attributed mainly to high growth in immigration: Australia has one of the highest immigration rates in the developed world.[iv] While population growth has slowed slightly in the previous year, forecasts from the Department of Immigration and Border Protection suggest that Australia's population is still expected to expand at a rate higher than what was recorded between 1990 and 2005.[v]

Annual demand for new housing has increased by about 40 per cent since the mid-2000s, largely due to strong population growth.[vi]



Source: RBA[vii]

Other than population growth, other demographic factors are contributing towards housing demand. The average size of households has fallen in recent years due to a combination of falling fertility rates, an ageing population and rising household incomes.[viii] The effect rising incomes has had on property stock is witnessed in the fact that the "average number of spare bedrooms has increased over the past 20 years for households across all age groups and most household types."[ix] "These forces have resulted in smaller-sized households, on average, that have demanded more housing for a given level of population."[x]



Source: RBA[xi]

An ageing population brings about a higher demand for housing stock due to the preference of many older people to age *in situ* (in place).[xii] Remaining in their own home rather than moving into aged care facilities is the preference of the vast majority of older people, but this preference leads to more 1 and 2 person homes. Planning for this phenomenon has been identified by many government agencies, but as the Baby Boomer generation ages, the demand for housing stock will remain strong.

Income Growth

Rising incomes has been identified by the Reserve Bank of Australia (RBA) as one of the main driving factors behind housing price growth over the longer term.[xiii] When real incomes increase, households appear to be prepared to spend proportionally more on housing.[xiv]

Interest Rates

Low interest rates drive growth in housing demand, thereby leading to higher house prices. Since the mid-1990s, interest rates in Australia have remained low, fuelling the high growth Australian property markets have experienced since this time. Speculators believe that interest rates will remain low for the foreseeable future: the end of the mining boom and low prices for resources puts the Australian economy at risk of recession.[xv] Monetary policy will be used by the RBA to stimulate growth in other parts of the economy while these factors remain.

Peer-to-Peer Lending

Although still a small industry, new fintech and peer-to-peer lenders have been experiencing double-digit growth in the personal lending markets over the past couple of years. "P2P lending is on the rise and will become a real channel for consumers to borrow funds and a viable fixed income product for retail and institutional investors, both domestic and overseas."[xvi] This new industry will contribute toward growth in housing demand as it opens up access to affordable loans to people who cannot save enough for a home loan deposit from a traditional bank.

Foreign Investment and the Exchange Rate

Foreign investment into Australia's real estate market increased threefold in the decade to 2013-14 to a total of $74.6 billion,[xvii] although foreign investment remains a small percentage of overall real estate sales. However, with the Australian dollar becoming comparably weaker over the past few years, Australian property has become an increasingly enticing investment for overseas buyers. The Foreign Investment Review Board will still continue to regulate property investments made by overseas buyers, but investment is made easier when it supports new developments. “While (growth in foreign investment due to a lower Australian dollar is) unlikely to drive property prices higher on its own, it should provide enough extra demand to support prices.”[xviii]

Supply-side factors

Building approvals for new dwellings rose significantly over the past few years to a peak in March 2015, driven by low interest rates and high demand for housing in major capital cities, particularly Sydney and Melbourne.[xix] However, recent ABS data shows that dwelling building approvals have been trending downwards since March last year, indicating that “the supply boost that has acted as a dampener for house prices may have run its course.”[xx]

The Need for A New Policy Mix

"The housing market has become a significant source of risk for the financial system and the economy."[xxi]

In 2014, The *Financial Systems Inquiry* (*Murray Inquiry*) noted that negative gearing and the capital gains tax discount distorts household savings decisions towards the property market.

> *"In the year before the introduction of the (capital gains tax) discount, Australia's 1.3 million landlords made an aggregate taxable profit of $700 million in real terms. By 2012-13, the 2 million landlords reported collective losses of $5.5 billion."*[xxii]

The current tax incentives also contribute to volatility in housing markets.

> *"Negative gearing is most attractive as a tax minimisation strategy when asset prices are rising strongly. So in boom times it further increases investor demand for housing. The opposite is true when prices are stable or falling."*[xxiii]

The current taxation settings encourage speculation in the housing market, leading to what some have argued is a bubble. Although that argument is contentious, removing tax concessions that contribute towards systemic risk is advisable.

Through moderate adjustments to negative gearing policy and the capital gains tax rate, systemic risk within the housing market can be reduced, while maintaining a continual upward growth in housing prices overall. The proposed reforms benefit investors and prospective home buyers by increasing housing stock and maintaining investment returns, while improving housing affordability over the longer-term.

Conclusion

In June 2015, The McKell Institute's *Switching Gears: Reforming Negative Gearing to Solve Our Housing Affordability Crisis* recommended the discontinuation of negative gearing allowances for existing housing stock, and a grandfathering of current allowances for those who are already negatively geared in order to improve housing affordability in Australia. Under these proposals, negative gearing would still be allowed for newly constructed properties, bolstering investment in new property development, and contributing to closing the supply gap.

Subsequently, the core policy recommendations of *Switching Gears* have been endorsed by the Federal Opposition and questions have been raised regarding the long term impacts on house prices that would result from the proposed changes. This addendum addresses these concerns, finding that house prices under both existing policy settings and the proposed changes would continue to increase.

Looking at housing prices over a 10-year period, this analysis has found that under existing arrangements, the average annual increase in housing prices across the eight capital cities would be *3.09%,* whereas under the proposed reforms, house prices across the same eight cities would continue to rise, albeit at a lower rate of *2.60%* per annum.

These findings demonstrate that the proposed changes will have a positive effect on housing affordability, while ensuring current investors in the housing market still see a long-term increase in the value of their existing investments in a de-risked and more stable investment environment. The results disprove certain suggestions that the proposed changes would have a dramatic impact on house prices when introduced in 2017 as proposed by the Federal Opposition.

The modelling conducted for this report further indicates that the Federal Opposition's negative gearing and CGT discount proposals will have a small effect on housing price growth over the long term. The proposal will not result in a shock to the housing market, but slightly lower growth over the next decade, resulting in more affordable housing for all Australians.

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