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Reforming negative gearing to solve our housing affordability crisis – additional research.

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About the Author



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He is currently editor of the Journal of Law and Economics, and is the founding director of the Herbert Smith Freehills Initiative on Law & Economics at UNSW.

He has been a Visiting Professor of Economics at the MIT Department of Economics and Visiting Professor of Law at the University of Chicago Law School.

His research has been featured in press articles in such outlets as: The New York Times, The Financial Times, the New Republic, and the Daily Kos.

Later in 2016, Professor Holden will be returning to Harvard University as a visiting professor.



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Contents

Switching Gears: Additional Research	5
Gross Domestic Product (GDP)	6
<i>Construction</i>	6
<i>Interest Rates</i>	6
Jobs	8
Housing Affordability	9
Conclusion.....	10





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Switching Gears: Additional Research

Since the release of the report “Switching Gears” in June 2015 there has been significant debate about the future of negative gearing in Australia. In fact, elements within both major Australian political parties have suggested a willingness to curtail the ability to negatively gear rental properties in some fashion. In fact, in his valedictory address to Parliament, Former Australian Treasurer Joe Hockey endorsed restricting negative gearing to new housing construction. This is exactly scenario 4 from Switching Gears—indeed the scenario that had the most positive budgetary impact according to the report.

In light of this it seems timely to consider other factors beyond the budgetary impact of scenario 4 from the report. This addendum considers the impact of the proposal on: (i) GDP, (ii) Jobs, and (iii) Housing affordability.

Before proceeding to consider the impact on those areas, recall that under the proposal in scenario 4, all existing negatively geared properties would be “grandfathered”—in the sense that tax deductibility on existing loan balances and structures would continue to be allowed. Properties not currently negatively geared would not be allowed to be, unless those properties constituted “new construction”. The report went into some detail about what might constitute new construction.

The key way in which this has a positive budgetary impact is through the paydown of loans on existing negatively geared properties diminishing the interest shield over time. That is, deductions slowly reduce as the loans are paid off. There are also benefits flowing from the incentives for new construction.





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We now consider the other three key areas in which the proposal could have a positive impact.

Gross Domestic Product (GDP)

There are at least two channels through which the proposal could positively impact GDP. The first is through an increase in residential construction. A second channel is by providing conditions which allow further interest rate cuts.

Construction

By allowing future negative gearing only for new construction, one provides a strong incentive for new construction. The initial report described the potential impact of this as follows:

"The Housing Industry Association estimates that nationwide around 185,000 new homes need to be built each year to meet both population growth and demand for new housing. According to the ABS, the current value of new residential construction is around \$45 billion...a reasonable estimate is that a 10% increase would occur. Were this to occur it would add \$4.5billion to GDP."

A legitimate question is whether this increase in economic activity would "crowd out" economic activity in other sectors. Given the current weakness in demand conditions, and the possibility that Australia is suffering from "secular stagnation"¹, this seems relatively unlikely.

Interest Rates

The Reserve Bank of Australia ("RBA") has shown consistent concern about the impact of cuts to the cash rate on house prices—especially in Sydney and Melbourne. In its February 2016

¹ See, Richard Holden "Big project spending will stir up a stagnant economy," *Australian Financial Review* 20 August 2015.





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announcement the RBA emphasised that subdued house price growth made accommodative monetary policy possible, saying: “Given these conditions, it is appropriate for monetary policy to be accommodative...The pace of growth in dwelling prices has moderated in Melbourne and Sydney over recent months and has remained mostly subdued in other cities.”

Since negative gearing has been seen as fueling house price growth², the proposal to limit negative gearing to new construction should help moderate price growth in circumstance where it might otherwise be considered “frothy”. Combined with the stance of the RBA, this suggests that an additional benefit of the proposal is that it could help provide a path for further cuts to the cash rate by the RBA.

How large this benefit is clearly depends on the relationship between interest rates and economic growth. This is a complicated relationship to estimate since causation runs both ways: interest rates affect growth through stimulating demand and capital formation, but growth affects central bank interest rate policy. A reasonable estimate of the impact of the impact of a 50 basis point rate cut is that it would increase GDP growth by 10 basis points.³ Since the cash rate is currently 2.0% it is possible that, all else equal, removing concerns about housing bubbles could allow the RBA to cut rates by 25-50bps. Using the relationship described above this would translate into an extra 5-10bps of GDP growth, or approximately \$1-\$2 billion of output in the first year, growing from there.

² See, for instance, “Negative gearing is just one culprit in the housing-bubble blame game,” retrieved at <http://www.smh.com.au/business/comment-and-analysis/negative-gearing-just-one-culprit-in-the-housingbubble-blame-game-20150717-giesns.html>

³ <http://amsacta.unibo.it/764/1/276.pdf>



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Jobs

The construction sector impact above suggests one important avenue through which employment could increase as a result of the proposal. Some estimates put the number of people employed in residential construction at around 250,000.⁴ The 10% increase scenario discussed in the original report would lead to 25,000 new jobs, assuming a constant labour share.

The general economic stimulus from the RBA rate cut scenario discussed above would also boost employment. Using what is known as “Okun’s Law”, this could translate into a 0.05% additional reduction in unemployment.

⁴http://www.aigroup.com.au/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/LIVE_CONTENT/Economic%2520Indicators/Construction%2520Survey/2015/Construction%2520industry%2520profile%2520and%2520Outlook.pdf



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Housing Affordability

As the initial report pointed out, the primary cause of housing affordability issues—especially in Sydney and Melbourne—is a lack of housing supply. The key feature of the proposal are the incentives for new housing supply.⁵

It is unlikely that the changes to negative gearing proposed in this report would have a material effect on prices in the near term. Over time it is expected that these reforms would improve housing affordability. As other reports, including the Henry Review, have noted tax settings play a relatively minor role in the price of housing. Other factors such as market fundamentals, zoning and building regulations and interest rates have a more material impact on house prices than tax settings.

How significant a reduction in rents from this increased supply would be ultimately depends on the magnitude of the supply shift and the price elasticity of demand for rental properties. A similar logic applies to owner-occupied properties. Any changes in rents will need to be considered in the context of increased housing affordability and renters becoming owner-occupiers.

Although it is beyond the scope of this exercise to quantify the size of the improvement in housing affordability, it is worth noting that increasing housing is the best policy instrument to use. Other instruments, such as rental subsidies use public funds raised through distortionary taxation and are thus less efficient.

⁵ Edward L. Glaeser & Joseph Gyourko & Raven E. Saks, 2006. "Urban growth and housing supply," Journal of Economic Geography, Oxford University Press, vol. 6(1), pages 71-89.



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Conclusion

Grandfathering properties that are currently negatively geared but allowing negative gearing going forward only for new construction has a number of advantages. It transitions smoothly away from the current system without significant disruption and it provides incentives for increased housing supply. This will lead to increased availability of properties for renters and owner-occupiers. Taken together these produce a significantly positive budgetary impact, increase GDP and jobs, and improve housing affordability.

