THE MCKELL INSTITUTE

Levelling the Playing Field

The Economic Case For Reforming Negative Gearing

By Professor Richard Holden

November 2018

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About the Author

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His research focuses on contract theory, organizational economics, law and economics, and political economy. He has written on topics including: network capital, political districting, the boundary of the firm, incentives in organizations, mechanism design, and voting rules.

Professor Holden has published in top general interest journals such as the Quarterly Journal of Economics, the American Economic Review and the Review of Economic Studies.

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 the MIT Sloan School of Management, Visiting Professor of Economics at the Harvard Economics Department, and Visiting Professor of Law at the University of Chicago Law School.

He is a Fellow of the Econometric Society and a Fellow of the Academy of Social Sciences in Australia. His research has been featured in press articles in The New York Times, The Financial Times, The Economist, the New Republic, and the Daily Kos.

Professor Holden appears regularly as a media commentator, and has published opinion pieces in outlets including The Australian Financial Review, The Australian, The New York Times, and The New Republic. He also writes a weekly column analyzing global economic data called Vital Signs for The Conversation.

Introduction

In June 2015, The McKell Institute released the report Switching *Gears* which outlined 5 options for reforming negative gearing in Australia. These options ranged from “Business as Usual” to immediately abolishing negative gearing.

The most appealing option considered was Option 4 in the report: Grandfather existing negatively geared properties and permitting new negative gearing only for new construction. This subsequently was adopted as the basis on the Australian Labor Party policy for the 2016 election, and they have indicated that they will implement the policy if elected at the next federal election, due in the first half of 2019.

In light of developments in the Australian property market since 2015-16, and the repeated claims from Treasurer Josh Frydenberg[i] and others[ii] that the policy would have severe negative impacts, it is natural to revisit the policy in light of the current state of the Australian property market.

After considering the facts, this report concludes that the policy is still the most appropriate approach to reforming negative gearing. It will level the playing field between owner-occupiers and investors, bolster financial stability, improve the budget bottom line, and encourage new construction.

Key Findings

Finding 1: Economic rationale behind reforming negative gearing to apply to new properties only remains unchanged, despite recent developments in housing market.

Finding 2: Recent reduction in median house prices in some capitals reflects the centrality of variables other than negative gearing in dictating prices. The 23 per cent contraction in credit offered by banks between November 2017 and September 2018, in particular has played an outsized role in the recent downturn in prices.

Finding 3: Property prices continue to grow faster than wages, despite reduction in housing prices in some markets during 2017/18.

Finding 4: Since McKell Institute's 2015 report arguing in favour of restricting negative gearing to new properties only, on most indicators, housing affordability has worsened.

Finding 5: Since 2015 banks have raised interest rates, especially on interest-only loans. This has increased the Commonwealth's tax expenditures on negative gearing by $1.6 billion.

McKell Institute's Previous Work on Negative Gearing

This report continues the McKell Institute's suite of research on negative gearing reform. In 2012, The McKell Institute's maiden report, *Homes For All*, argued strongly in favour negative gearing reform. Of the 40 recommendations tabled in that report, Recommendations 16 and 17 addressed tax concessions for property investments, finding that 'consideration should be given to the phasing out of negative gearing over the long term in relation to existing properties but perhaps retained for new properties to stimulate supply'.

Subsequently, 2015's *Switching Gears* report dived into the detail of negative gearing reform in Australia, tabling five potential options regarding negative gearing, exploring the impact of a business as usual approach, a complete abolition, and more nuanced reform options. The key recommendation from the Switching Gears report was that negative gearing should be restricted to new properties only, with existing investors grandfather as to phase in changes over time.

This option was preferable for numerous reasons. First, it would fact that it would make the 'playing field' of the housing market fairer, enabling more owner-occupiers and first home buyers into the market. Secondly, it would leverage the generous negative gearing tax concessions towards the construction of sorely needed new housing stock, to increase supply – as was argued in McKell's 2012 *Homes For All*. The key recommendation from Switching Gears was mirrored in the Federal Opposition's housing policy, which it took to the 2016 federal election and has committed to implementing if a change of government occurs at the next federal election, due in the first half of 2019.

Two addendums to *Switching Gears* have since been published. In February 2016, *Addendum I* explored the positive impacts the proposed changes to negative gearing would have on GDP growth and job creation. It found that up to 25,000 extra jobs would be created in the wake of reform, with a positive impact on economic growth more broadly. Addendum II, released in May 2016, explored the impact on house price growth under the proposed reforms. It found that house prices would continue to grow after the changes, albeit at a slightly lesser rate.

Three key reasons for why negative gearing reform is even more urgent than in 2015

In June 2015, The McKell Institute released *Switching Gears*, a report which argued in favour of restricting negative gearing to new properties only. Since then, the core components of that policy have been adopted by the Federal Opposition, which has pledged to implement the reform should it form government after the next federal election, due in the first half of 2019. Since *Switching Gears* was released, opponents of the policy have cited changing dynamics in the Australian housing market as justification for not proceeding with the proposal. However, as this report finds, the key justifications for reforming negative gearing are actually stronger than when The McKell Institute's original report was released for three key reasons:

1. **Housing is actually less affordable than in 2015, even in Sydney:** When S*witching Gears* was published in 2015, the median house price in Sydney had soared to $880,000, a major concern for affordability. At the end of 2018, following a sharp drop in prices from the housing boom's peak, the median house price in Sydney is $945,000. So while in 2015, the median Sydney house price was 16.9 times median income, today it is 17.2 times the median income. On most measures housing is less affordable now in Sydney and other capitals – like Melbourne and Canberra – than it was in 2015.
2. **Negative gearing is costing the Australian taxpayer more now than it did in 2015:** Additionally, from a revenue perspective, there is arguably a greater case for reforming negative gearing to improve the Commonwealth budget bottom line now than there was in 2015. Since then, banks have raised interest rates – particularly on interest-only loans. This has had an impact on the Commonwealth's tax expenditure relating to negative gearing by $1.6 billion.
3. **Negative gearing reform would provide a needed boost to new housing construction:** By allowing negative gearing to continue for new construction, the reform plan is likely to boost housing stock. This is needed to keep pace with growing demand. The shift to negative gearing for new construction only may also provide incentives for state and local governments to adopt policies that increase prospects for new construction. A boost to construction would also have a positive economic effect.

Part 1: Recent Developments in the Australian Property Market

In 2015, *Switching Gears* outlined the case for reforming negative gearing in a sensible and targeted way. The reform approach outlined in the 2015 report considered both the existing market trends at the time of writing, and the cyclical nature of Australia's future housing market when prosecuting the case for targeting negative gearing to new properties only while grandfathering negative gearing for existing investors and property owners.

However, opponents of reforming negative gearing have cited emerging trends in Australia's housing market as reasons for the Federal Opposition to abandon its negative gearing policy – a policy that closely resembles that argued for in 2015's *Switching Gears* report. While there have been developments in Australia's housing market since 2015, the core principals and economic logic behind the reform remain unchanged. Indeed, many of the key economic indicators on housing affordability have worsened since 2015. This adds further impetus to readjusting Australia's tax policy so the housing market is open to a broader range of investors and owner-occupiers.

Availability of credit had major impact on prices in late 2018

One of the most important developments in the Australian property market is the tightening of bank credit since November 2017. In the lead up to, and wake of, the interim report from the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* banks cut back on the amount they are willing to lend to individual borrowers.

In November 2017, the banks lent $22.23 billion for housing – the highest figure on record. In September 2018, however, the banks lent $17.09 billion, representing a 23 per cent reduction in the monthly lending from the November 2017 peak *(Figure 1.1).*

There are a number of reasons for this. Banks have reassessed their underwriting standards, as occurs from time to time. In addition, concerns about more aggressive enforcement of the National Consumer Credit Protection Act—including a judgment against Westpac—has led banks to become stricter in assessing the non-mortgage expenses of borrowers. This secular downward shift is likely to have caused a reduction in auction clearance rates and downward price pressure. When taking a long term view of the housing market, however, it is clear the availability of credit has been trending upwards over the past decade (*Figure 1.2*). Despite some volatility in month-by-month lending data, *Figure 1.2* demonstrates a continual upward trajectory of credit availability in the Australian housing market.

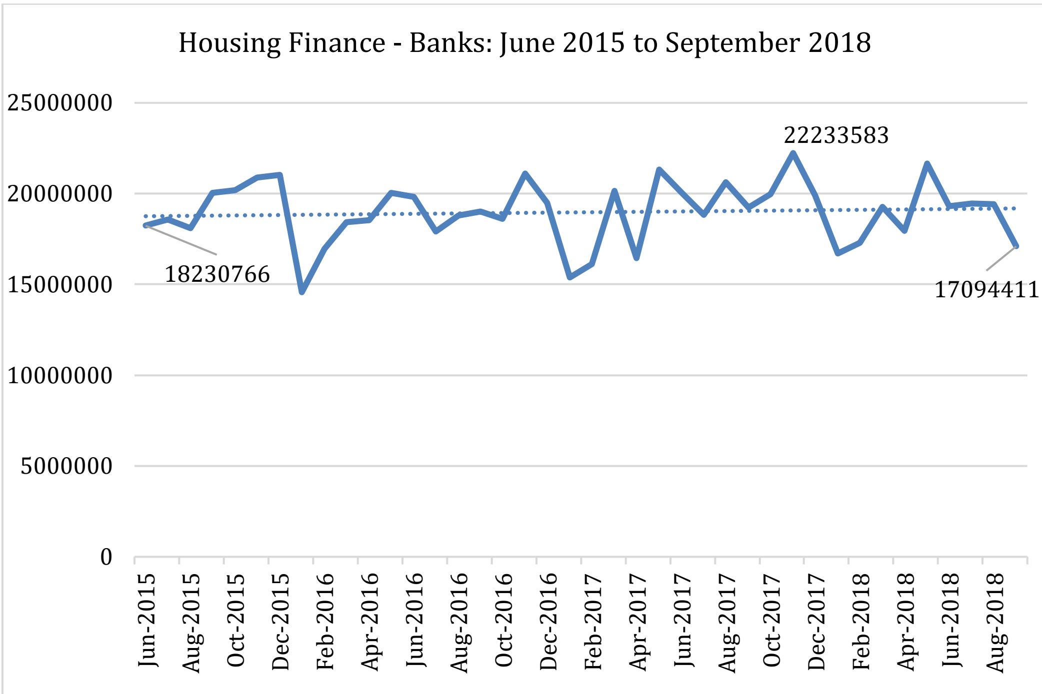

Figure 1.1: Housing Finance Lent by Banks from June 2015 (release of Switching Gears) to September 2018. Source: ABS Cat. 567102

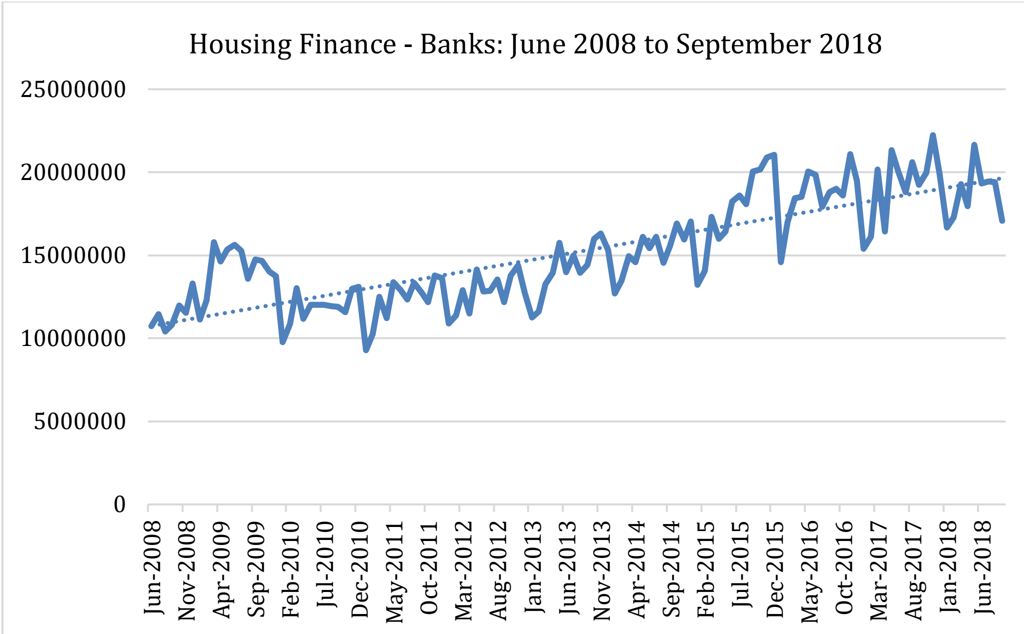

Figure 1.2: Housing Finance Lent by Banks from June 2008 to September 2018. Source: ABS Cat. 567102

Despite price contraction in 2018, unaffordable housing remains the norm

There has been considerable media coverage surrounding the contraction in house prices in 2018, particularly in Australia's largest property market, Sydney. It is undoubtedly the case that prices have 'come off the boil' since their peak in June 2017, when median house prices in Sydney reached $1.075 million, or around 19.5 times median income – an unsustainable and unaffordable level. As of September 2018, prices in Sydney had modestly reduced, with median house prices registering at $945,000. While a notable reduction from the peak in 2017, current median house prices are still 17.2 times median income. When the McKell Institute's *Switching Gears* report was written in 2015, median house prices in Sydney were around $880,000, or 16.9 times median income at that time. So despite the decline in prices during 2018, housing affordability in Australia's largest city is worse than when the McKell Institute first advocated for negative gearing reform in 2015.

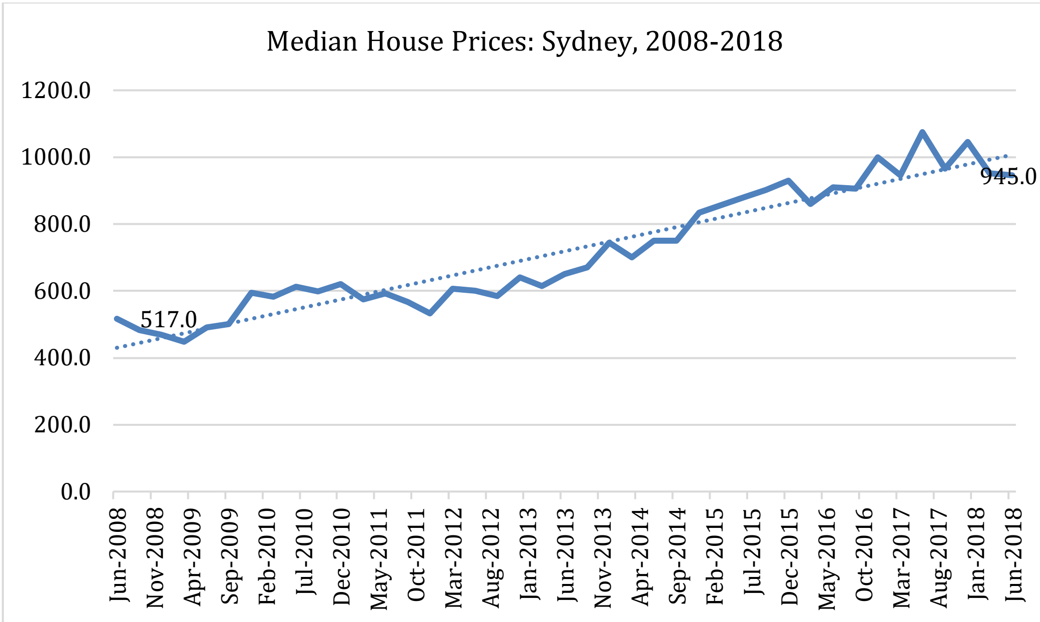

Figure 1.3: 10 year median house price growth in Sydney. Despite the modest drop in median prices in late 2018, house prices in Sydney have nearly doubled in the 10 years to late 2018.

While unaffordable housing might be most acute in Sydney, it is also evident in other major cities in Australia. *Figure 1.4* tracks median house prices in Australia's eight capital cities over the past decade. While there have been some modest contractions in prices in late 2017 and into 2018, houses have continued to grow across the board. This data is relevant to the debates surrounding negative gearing, as opponents of reform have argued that the late 2017/2018 contraction negate the need for negative gearing reform. However, as with any substantive reform, a long-term view needs to be adopted. Despite the recent decline in prices – led by declines in Sydney – house prices continue to trend upward over the longer term. Even in the shorter term, this remains true. Since 2015 when McKell Institute's *Switching Gears* was released, prices have continued to trend upwards in every Australian jurisdiction (see *Figure 1.5*).

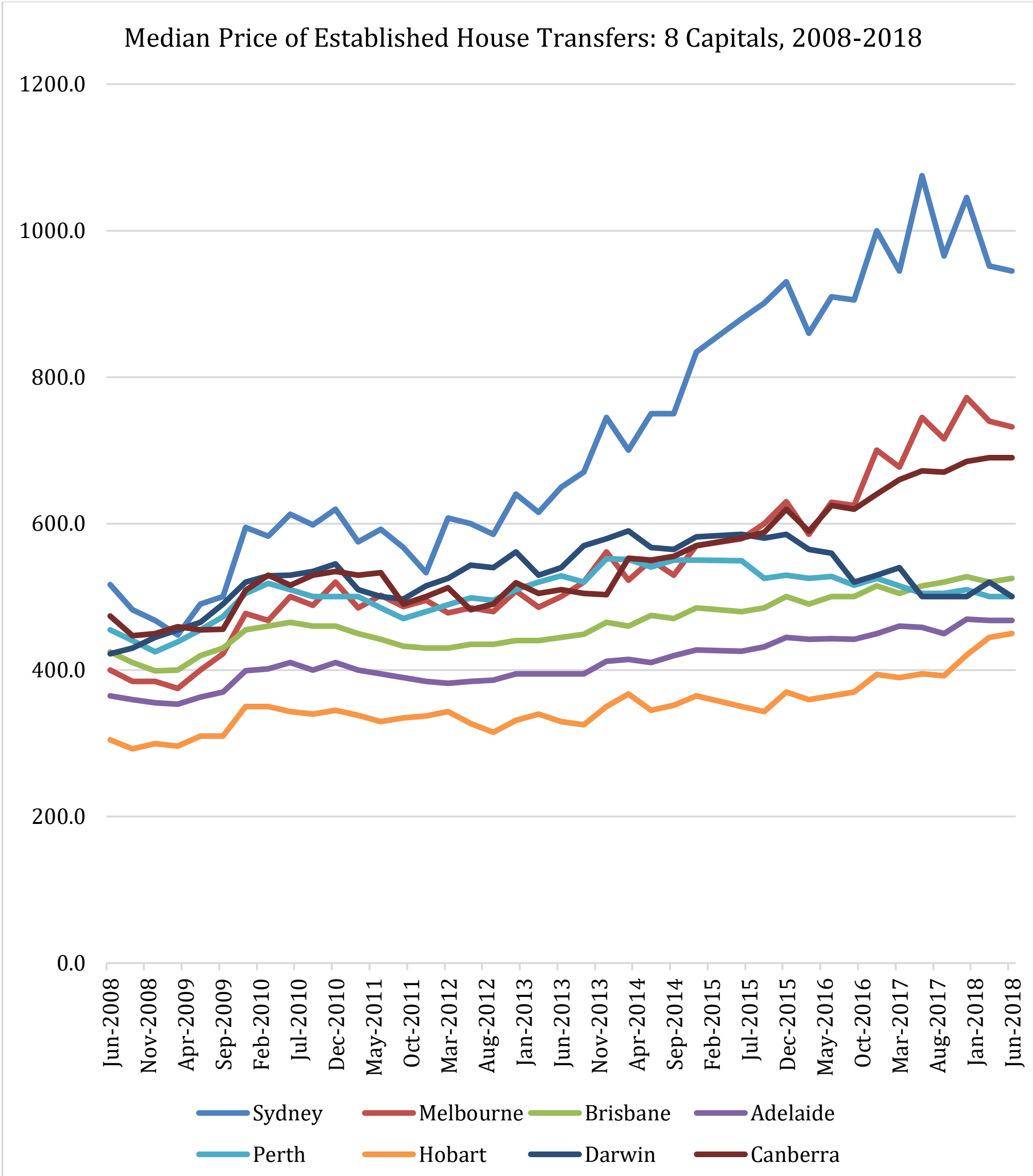

Figure 1.4: Median House Price Growth in Australian Capitals Since June 2008. Source: ABS Cat. 641604

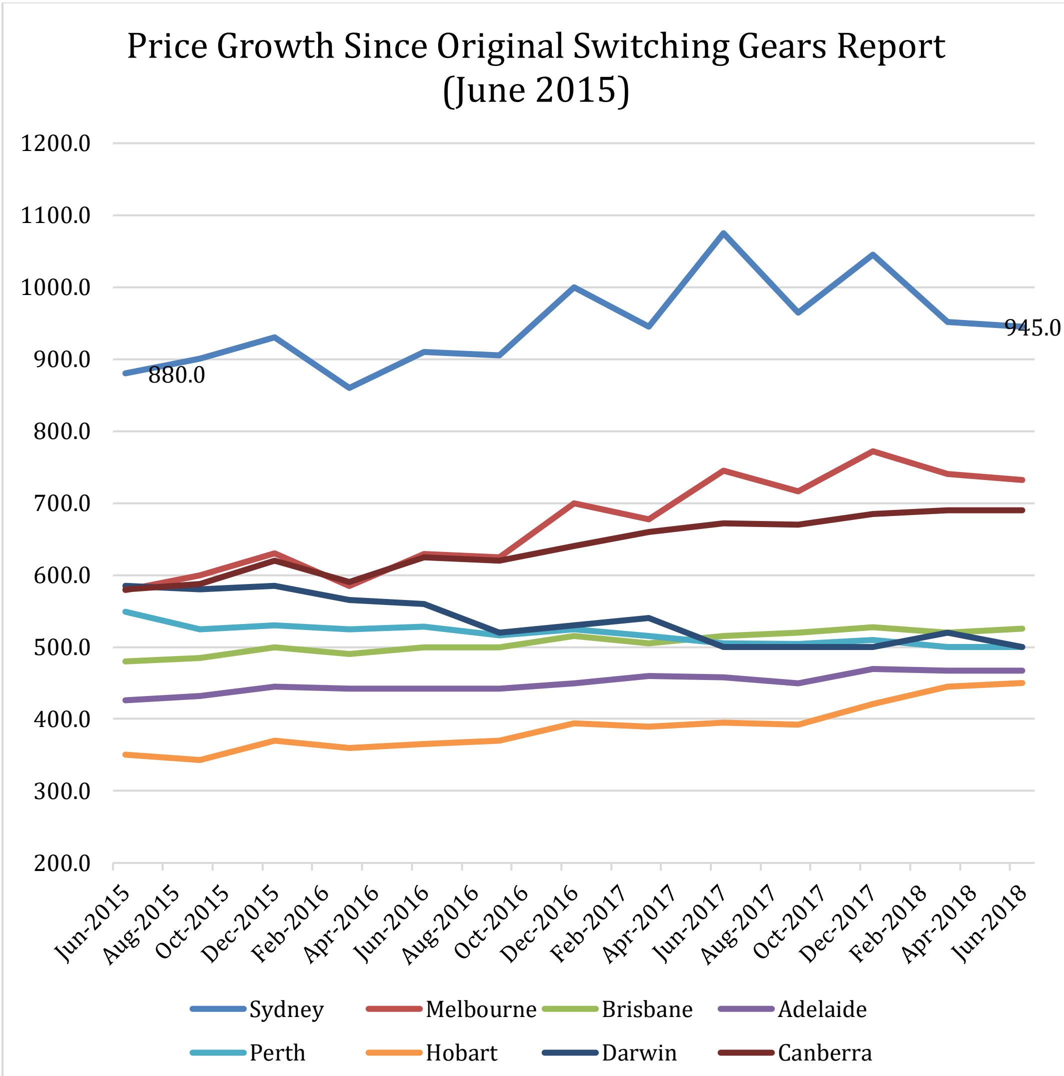

Figure 1.5: Median House Price Growth in Australian Capitals Since June 2015 (Release of Switching Gears). Source: ABS Cat. 641604

The Price to Income Ratio for Houses Continues to Get Worse

HOUSES	SEPTEMBER 2018		JUNE 2015 (*Switching Gears* release)	
	Median House Price	Price/Income Ratio	Median House Price	Price/Income Ratio
Sydney	$ 945,000.00	**17.16**	$ 880,000.00	16.92
Rest of NSW	$470,000.00	**8.54**	$397,500.00	7.64
Melbourne	$732,000.00	**13.29**	$579,000.00	11.13
Rest of VIC	$353,000.00	**6.41**	$299,000.00	5.75
Brisbane	$525,700.00	**9.55**	$480,000.00	9.23
Rest of QLD	$430,000.00	7.81	$420,000.00	**8.08**
Adelaide	$467,500.00	**8.49**	$426,000.00	8.19
Rest of SA	$275,000.00	**4.99**	$257,000.00	4.94
Perth	$500,000.00	9.08	$549,000.00	**10.55**
Rest of WA	$310,000.00	5.62	$372,000.00	**7.15**
Hobart	$450,000.00	**8.17**	$350,000.00	6.73
Rest of TAS	$295,000.00	**5.35**	$254,000.00	4.88
Darwin	$500,000.00	9.08	$585,000.00	**11.25**
Rest of NT	$421,300.00	7.65	$450,000.00	**8.65**
Canberra	$690,000.00	**12.53**	$580,000.00	11.15

Figure 1.6: Price-to-income ratio for established houses, capital cities and states, 2015 and 2018. Source: ABS Cat. 641604

Alarmingly, housing price to income ratios remain uncomfortably high in much of Australia – particularly in capital cities. This has, in fact, got worse in Australia's major cities, with the notable exception of Perth and Darwin, since 2015. *Figure 1.7* explores the same ratio when it comes to attached dwellings, which include apartments and units. Predictably, attached dwellings are considerably more affordable than houses, and have in Brisbane, Sydney, Perth, Darwin and Canberra become moderately more affordable since the *Switching Gears* report was released in 2015. However, in Melbourne, Hobart and Adelaide, the price-income ratio has widened since 2015, putting attached dwelling ownership further out of reach for residents in those jurisdictions.

Attached dwellings modestly more affordable in some cities

Attached Dwellings	SEPTEMBER 2018		JUNE 2015 (*Switching Gears* release)	
	Median Attached Dwelling Price	Price/Income Ratio	Median Attached Dwelling Price	Price/Income Ratio
Sydney	$710,000	12.89	$675,000	**12.98**
Rest of NSW	$390,000	**7.08**	$351,800	6.76
Melbourne	$550,000	**9.99**	$507,000	9.75
Rest of VIC	$280,000	**5.09**	$250,000	4.80
Brisbane	$398,000	7.23	$410,000	**7.88**
Rest of QLD	$385,000	**6.99**	$350,000	6.73
Adelaide	$373,800	**6.79**	$345,000	6.63
Rest of SA	$182,000	*3.31*	*$275,000*	*5.28*
Perth	$410,000	7.45	$440,000	**8.46**
Rest of WA	$210,000	3.81	$320,000	**6.15**
Hobart	$355,000	**6.45**	$283,800	5.45
Rest of TAS	$240,000	4.36	$225,000	4.33
Darwin	$361,000	6.56	$435,000	**8.36**
Rest of NT	$345,000	**6.27**	$325,000	6.25
Canberra	$430,000	7.81	$430,000	**8.27**

Figure 1.7: Price-to-income ratio for attached dwellings, capital cities and states, 2015 and 2018. Source: ABS Cat. 641604

Rate of first home buyers entering market has flatlined

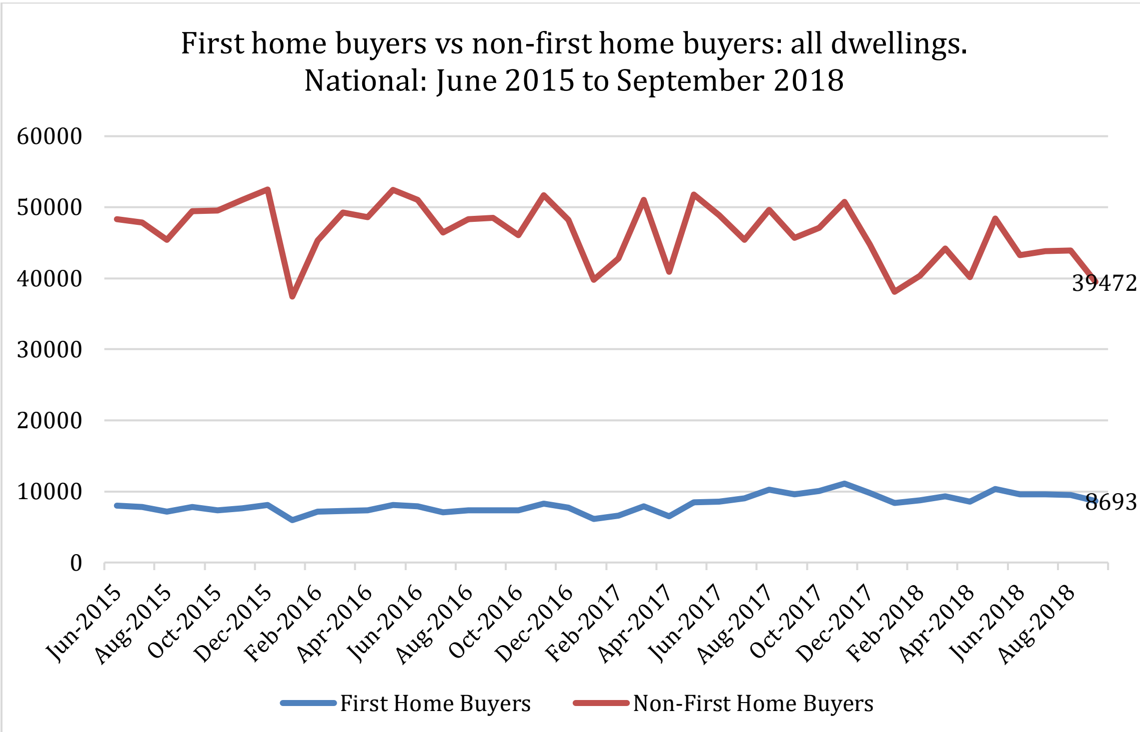

Figure 1.8: First Home Buyers Compared with Non-First Home Buyers, Monthly Figures from June 2015 (Release of Switching Gears) to September 2018. Source: ABS Cat. 560909

First home buyers continue to occupy only a small percentage of the market. In September 2018, a total of 48,165 properties were transferred. 8,963 were bought by first home buyers, with 39,472 purchased by non-first home buyers (a figure which includes investors and owner-occupiers). In September, non-first home buyers purchased 81.95 per cent of properties transferred during that month.

	First Home Buyers	*Non-First Home Buyers*	*Total*
Sep-18	8693	39472	48165
Per Cent	18.05	81.95	100

Figure 1.9: First Home Buyers Compared with Non-First Home Buyers, September 2018.

Wages still growing slower than property prices

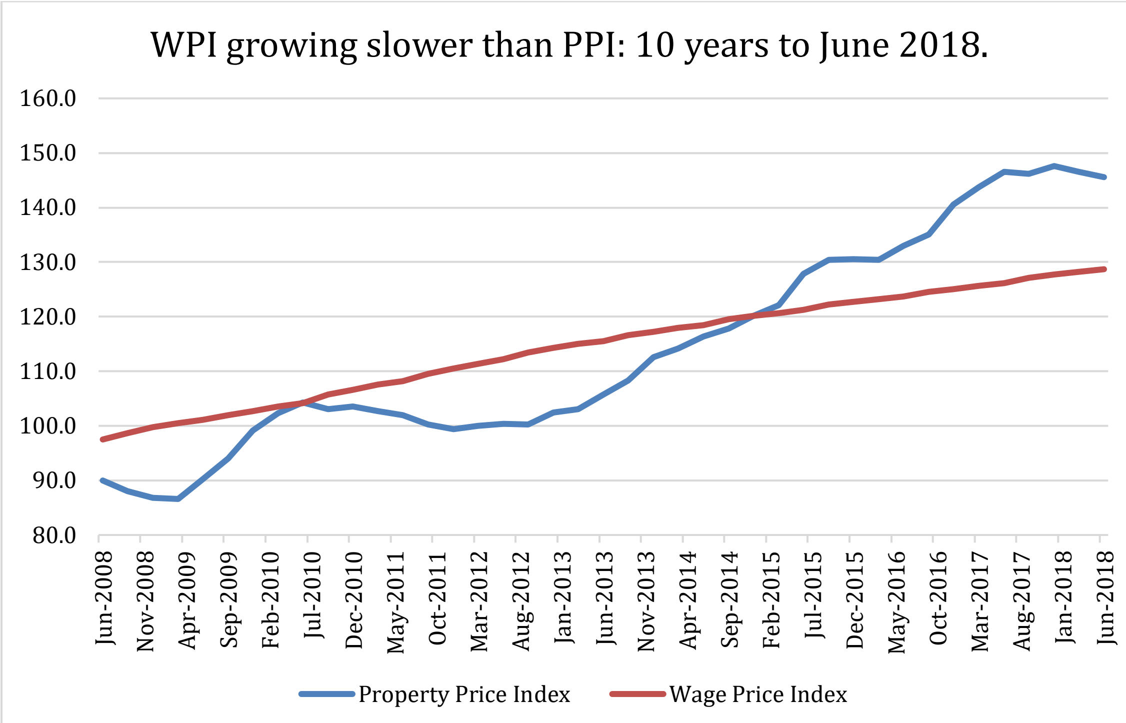

Figure 1.10: Wage Price Index Compared with Property Price Index, 2008-2018. The PPI continues to grow at a faster pace than the WPI, despite modest downturn in property prices in 2018. Source: ABS Cats. 634501, 641601

Despite a recent reduction in median property prices in some of Australia's major property markets, housing unaffordability continues to trend upwards. *Figure 1.10* compares the growth rates of the Wage Price Index (WPI) with the Property Price Index (PPI) over the past decade. While the PPI begins to level out as of early 2017, the WPI is growing slowly to a point that it would take years before it reaches PPI. Simply, wage growth is not keeping pace with the growth in property prices, particularly when a long-term view is taken. Correcting this trajectory requires policy that aims towards improving wage growth throughout the economy, as well as keeping a lid on excessive price rises in the housing sector, much of which is caused by speculative investments on existing housing stock, and the inadequate construction of new housing supply.

Less than 6 per cent of property purchases are new dwellings

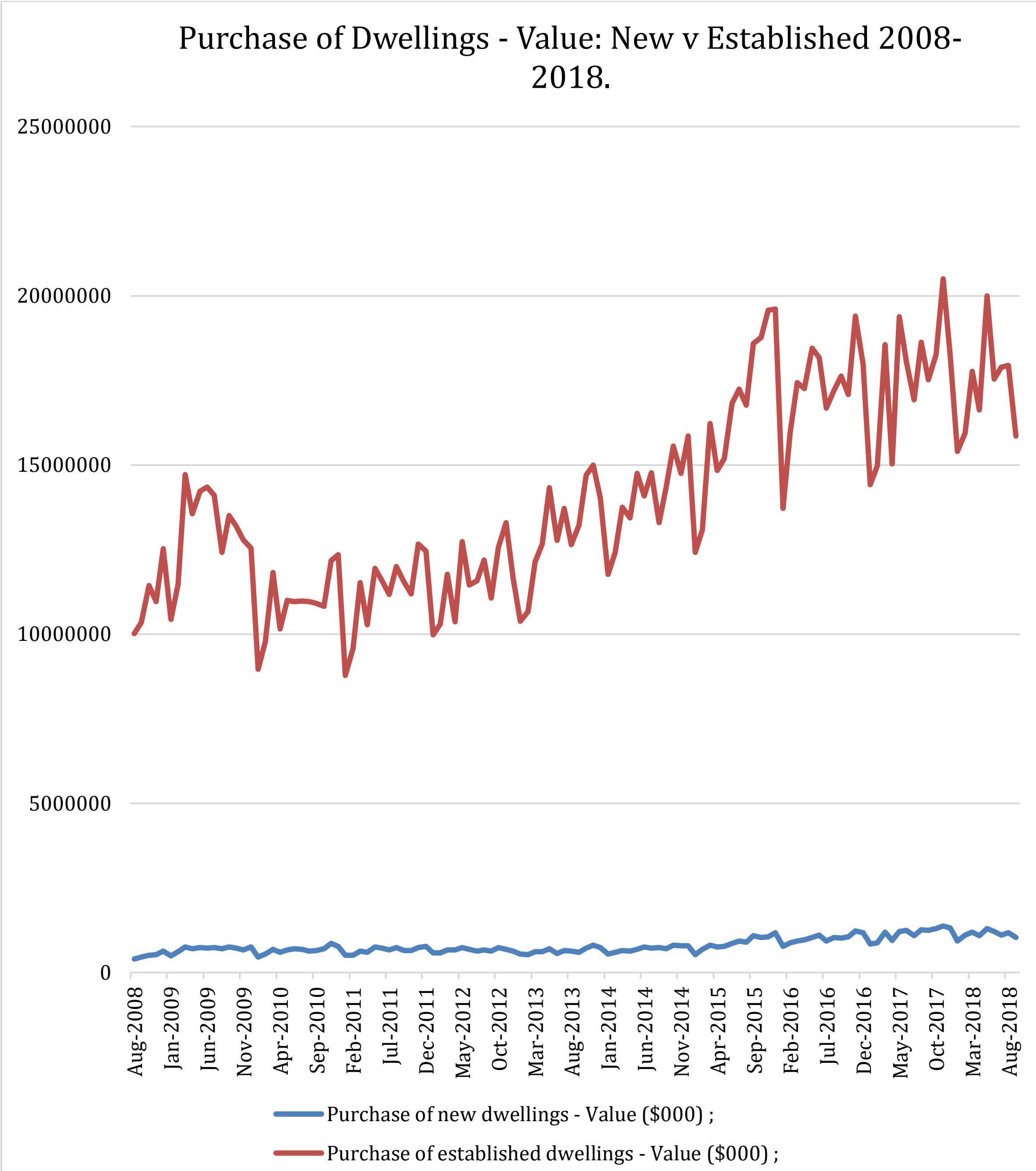

Figure 1.11: Value of new and established dwellings purchased, time series, 2008-2018. Source: ABS Cat. 5609

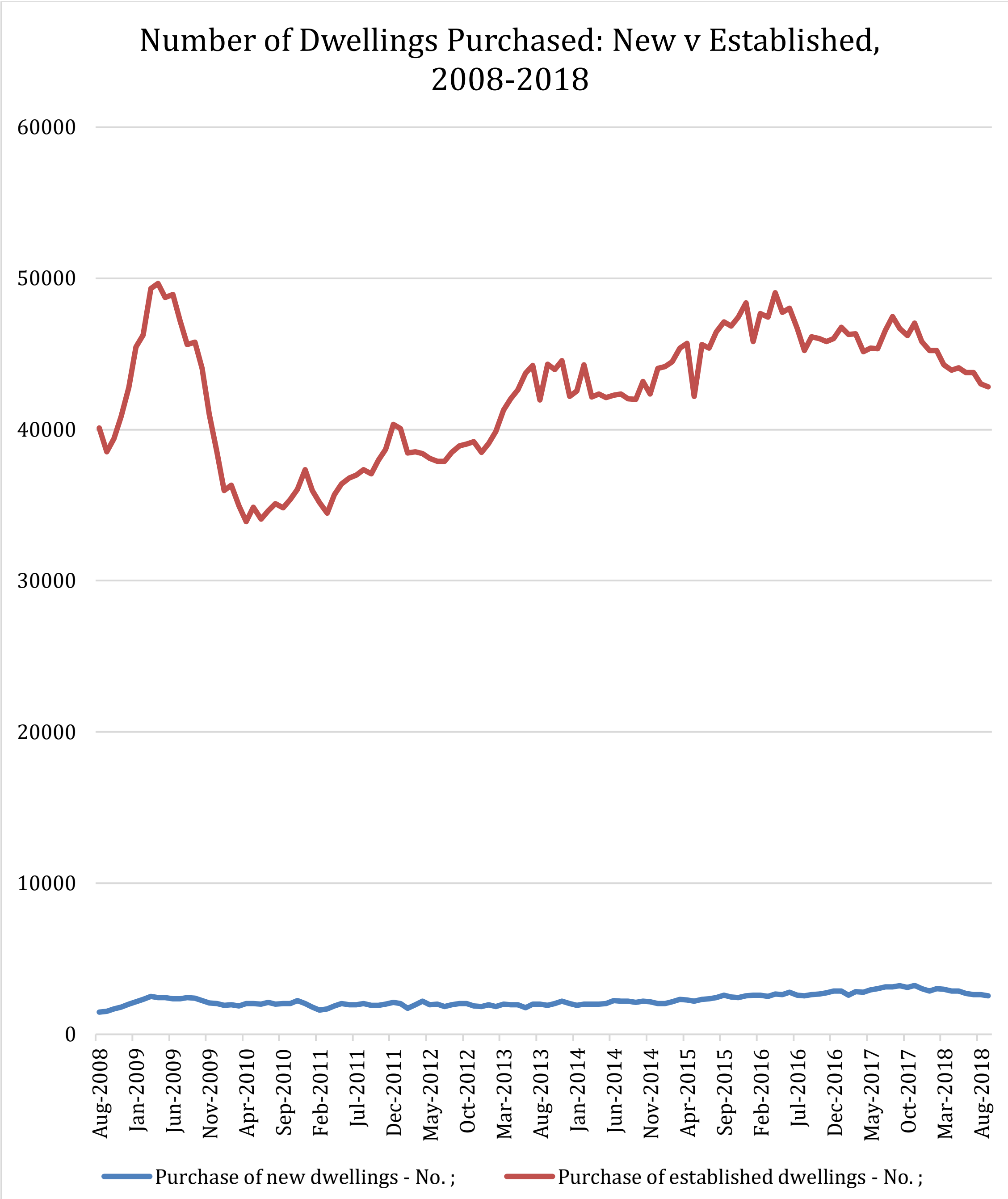

Figure 1.12: Number of new and established dwellings purchased, time series, 2008-2018. Source: ABS Cat. 5609

In August 2018, $15.8 billion worth of established dwellings were purchased, compared with slightly over $1.03 billion in new dwellings. While 2,539 new dwellings were purchased in this period, 42,824 established dwellings also changed hands. This means just 5.92% of dwelling purchases are new housing stock. This rate has remained steady for a decade, as *Figure 1.12* demonstrates, and has exacerbated the current housing affordability challenge, particularly for first home buyers, who have been locked out of the market to a significant degree.

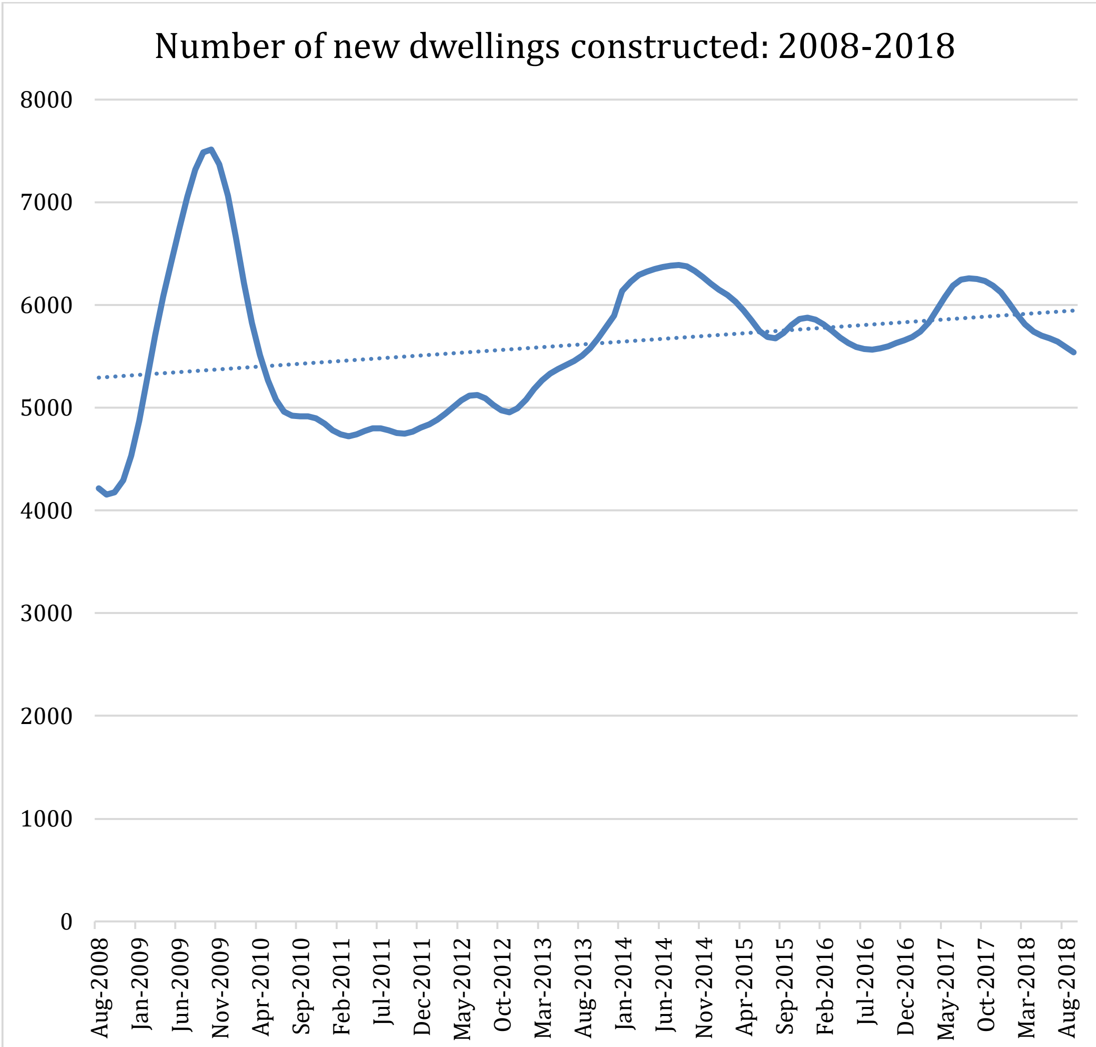

Figure 1.13: Number of new dwellings constructed: !0 years to September 2018. Source: ABS Cat 560901

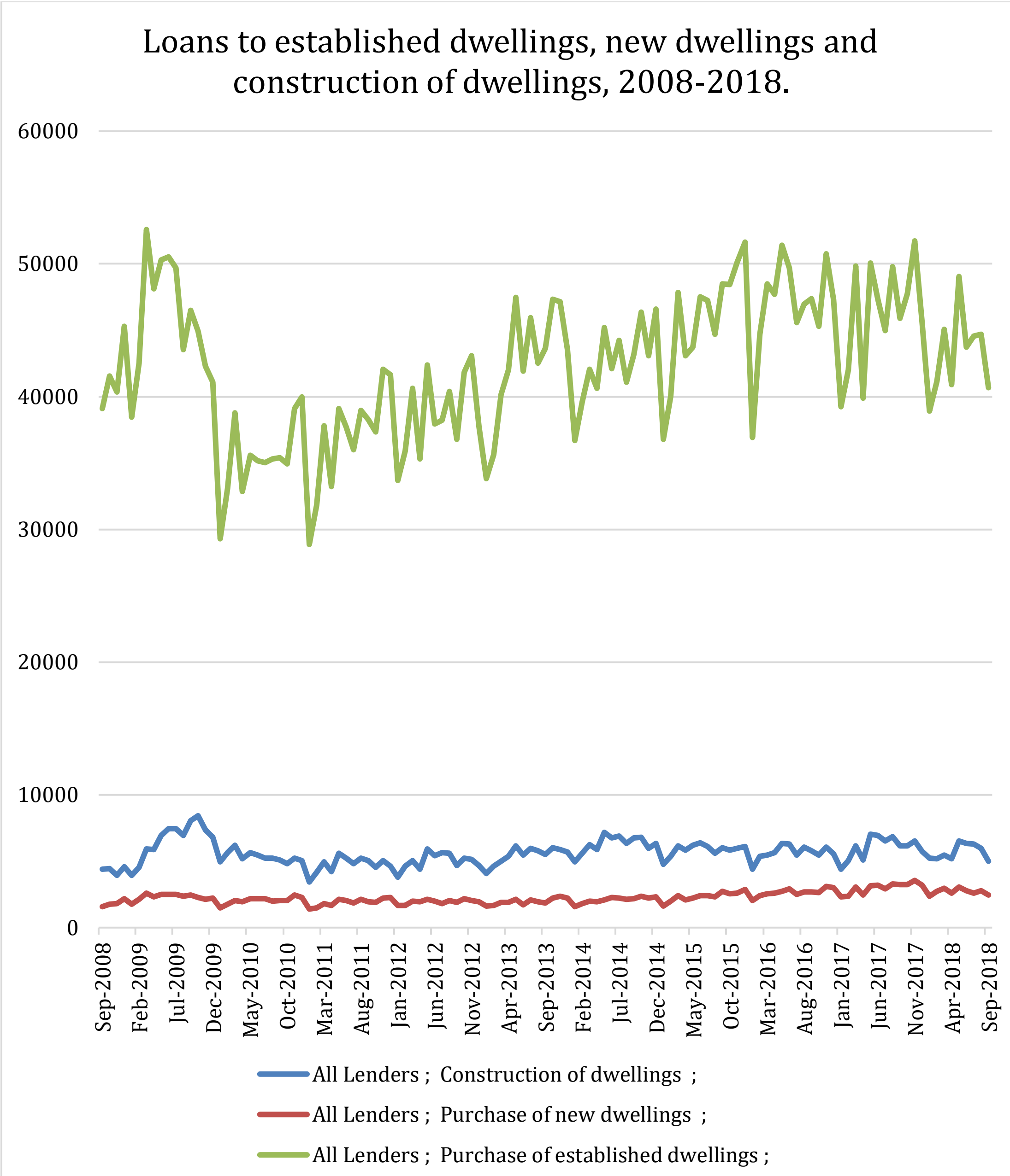

Figure 1.14: Loans to established dwellings, new dwellings and construction of dwellings, 2008-2018. Source: ABS Cat 560901

Part 2: Understanding Negative Gearing's Influence on Prices

There are three aspects of property price that are important: price stability, the overall level of house prices, and the impact on rents.

As outlined in *Switching Gears*, negative gearing creates financial instability, with a significant number of people owning three or more investment properties (118,412 in the 2014-15 tax year). In the same year the number of people owning five or more investment properties was 19,254. In the 2015-16 tax year the number of people owning three or more investments properties grew to 122,696 and those with six or more to 20,023.[iii]

As the Reserve Bank of Australia has observed[iv]

> *Given the strong growth in investor housing credit and riskier types of borrowing over this period, investors with multiple properties have likely contributed to higher risk.*

Negative gearing fuels this financial risk and creates the potential for systemic problems. Transitioning away from negative gearing with existing properties grandfathered would help mitigate such risks to investors and financial institutions.

There have also been questions raised about the price level of existing houses and the impact on rents. The claim that Treasurer Frydenberg has made is best summarised by the following quote on Radio 2GB[v]

> *Labor's policy will make sure that people who own their home will see the value of their home be less, and fall and if they rent their home, their rent will go up as a result of Labor's policy.*

The Demand Shift: Getting More Owner-Occupiers into the Market

The Treasurer's claim about falling house prices is based on the assumption that fewer investors will compete for existing properties. There are two problems with this claim. The first is one of composition. By levelling the playing field between owner-occupiers and investors there will be more owner-occupiers actively in the market. Given the pent-up demand that has come from years of strong investor demand this effect could be substantial, and it would serve to push up prices, all else equal.

The second problem is one of magnitude. It is well known from auction theory that the price an asset is sold for in a first-price auction is equal to the valuation of the second-highest bidder.[vi] Since bidders valuations have an idiosyncratic component—some people value certain attributes in a property differently that others—this implies that once there are several bidders, adding additional bidders may not lead to a significant increase in selling price. Correspondingly, some investors leaving the market may not lead to significant decrease in selling price.[vii]

Taken together these two effects suggest it is far from clear that prices will fall as a result of transitioning away smoothly from negative gearing. It should also be remembered that because of the grandfathering provisions, existing investors will enjoy their tax shield until they sell the property.

What are the major drivers of prices?

As recent history has shown, the biggest drivers of house prices are factors such as: interest rates, the availability of credit, real wages growth, and the balance between housing supply and demand.

House prices in Darwin have fallen 12% in the last year, but risen 19% in Hobart—neither of which were due to negative gearing, but to the broader factors such as credit availability and the balance between supply and demand. The end of the Liquefied Natural Gas (LNG) construction boom in the Northern Territory is widely seen as an important factor in the price drops in the Darwin market.[viii] The end of the mining boom is rightly seen as having played a similar role in Perth property prices.[ix]

By comparison, the changes to negative gearing proposed by the McKell Institute and now the Australian Labor Party, have been calibrated to have a modest impact on prices. The grandfathering provisions are a key component of this.

However, the changes will have an important set of effects: levelling the playing field between owner-occupiers and investors, improving financial stability, and boosting the federal budget bottom line.

The drivers of rental prices

As noted in *Switching Gears*, the vacancy rate for rental properties is a good indicator of rents. Locking potential owner-occupiers out of the housing market by tilting the playing field in favour of investors does not help housing supply. By contrast, levelling the playing field on the large stock of existing dwellings but providing negative gearing for new construction has a positive impact on supply and puts downward pressure on rents.

Part 3: The Economic Logic for Reforming Negative Gearing Remains Clear

There continues to be a strong economic logic for reforming negative gearing and this logic has not been affected by recent price declines. As emphasised above, prices and price-to-income ratios remain high by historical and international standards.

There has certainly been a decline in house prices, particularly in Sydney and Melbourne, in the second half of 2018. However, property prices remain significantly higher than when the original *Switching Gears* report was released in 2015. House prices in Sydney—where the reduction in prices has been most evident—have, in fact, returned to prices seen as recently as early 2017.

The argument that the recent decline in house prices is a case against reforming negative gearing is illogical and has no basis in fact.

Levelling a Still-Uneven Playing Field

If negative gearing is maintained for existing properties, then owner-occupiers—particularly first-home buyers—will continue to be at a competitive disadvantage relative to investors. The tax shield that comes from negative gearing is a powerful advantage for investors and one that is not enjoyed in most comparable jurisdictions.

The advantage that negative gearing hands to investors has been a major contributor to the housing affordability crisis in Australia.

An Increasingly Positive Budgetary Impact

The Parliamentary Budget Office costings for the Labor policy estimated that the combined negative gearing and capital tax gains reforms would "improve the underlying cash and fiscal balances by…$1.4 billion in 2019-2020, rising to a $7.7 billion improvement in the budget balances in 2026-27"[x]. This represents significant fiscal consolidation. Additionally, tax receipts have recently been unexpectedly strong, and the government forecasts a return to budget surplus in 2019-20 and net debt peaking at 18.6% of GDP.

It should be emphasised that strong external factors, including commodity prices have played a role in the recent uptick in tax receipts. There are certainly risks to the outlook. However, the reduction in tax expenditures from transitioning away from negative gearing would permit some combination of: a buffer against negative external shocks, a further reduction in government debt, increased investment in social infrastructure, and possibly personal income tax cuts.

A Boost to Much-Needed New Construction

By allowing negative gearing to continue for new construction, the plan has the potential to boost housing stock. This would have a positive economic effect on jobs and incomes in the construction industry.

As pointed out in Switching Gears, state- and local-based policies regarding land releases and zoning are also an important component to unlocking supply. The shift to negative gearing for new construction only may provide incentives for state and local government to adopt policies that increase prospects for new construction.

Indeed, Liberal minister Kelly O'Dwyer made an essentially identical argument regarding foreign investment in new dwellings rather than existing housing stock, saying[xi]:

> *Currently the framework seeks to channel foreign investment in residential real estate into new dwellings in order to increase the housing stock for Australians to build, buy or rent. Foreign investment is encouraged in new dwellings whether they be apartments, units or homes because in addition to creating more supply, it also creates more jobs for the building and construction sector – all of which helps to grow our economy.*

Subsequent research by the McKell Institute noted the economic benefits the proposed changes were likely to bring, including the creation of up to 25,000 jobs in the construction sector, with a likely boost to Australia's overall gross domestic product[xii].

It's also worth noting the importance of new construction keeping up with expected housing demand in coming decades. The nature of Australia's population growth and composition is such that demand for property will continue to grow indefinitely. As noted in *Switching Gears,* the Housing Industry Association has previously argued that as many as 185,000 new dwellings need to be constructed in Australia per annum to keep up with demand. In this context, it is important that tax concessions associated with negative gearing are leveraged towards achieving the construction of new dwellings - a broader social and economic necessity - outcome rather than encouraging speculation on existing assets.

Reform could place downward pressure on rents

Opponents to the changes tabled in *Switching Gears* argue that the sensible reforms to negative gearing currently being debated will hurt renters. However, rents are unlikely to rise because of the proposed changes to negative gearing, for two key reasons.

First, because negative gearing will still be able to access the tax advantages for new construction, there will be a downward effect on rents. Second, as existing renters who want to purchase will now be on a level-playing field they will be more likely to transition from being renters to owners. This also puts downward pressure on rents.

Investing in property will still remain lucrative after reform

Opponents of reform cite how negative gearing remains utilized by not only institutional investors or individual investors with three or more properties, but by regular 'mums and dads' in Australia. While negative gearing is most lucrative for property investors – particularly those who do own multiple properties – there are undoubtedly benefits for all investors, be them professional property investors, owner-occupiers acquiring a second investment property, or 'rent-vestors'.

Those who argue against reforming negative gearing often insinuate those who advocate for reform are against investment in property. However, the reform option tabled in *Switching Gears*, which has subsequently informed the policy of the Federal Opposition, not only welcomes investment in property, but actively encourages it by orienting existing negative gearing concessions towards the creation of new housing supply. Investors of all persuasions will not only be able to continue to invest in property if the proposed reform is implemented, they will also continue to receive all existing tax concessions if that investment is directed towards new housing supply. Of course, the ability for investors to acquire existing housing stock will remain unhindered, albeit with existing properties no longer liable for the generous tax concessions that have pushed more than 90 per cent of property investment into existing housing stock.

Conclusion

There is still a compelling case for a smooth transition away from negative gearing that involves grandfathering existing negatively-geared properties and in the future allowing negative gearing only for new construction.

The recent declines in property prices in many Australian markets have come off extraordinary highs—indeed significantly higher prices than when the original *Switching Gears* report was published in 2015. Moreover, these falls in prices have been associated with a substantial reduction in housing credit in the wake of a tightening of lending standards and the Royal Commission.

This is no time to abandon the goal of levelling the playing field between owner-occupiers and investors while at the same time improving financial stability and further repairing the Commonwealth budget.

Moreover, the recent rise in interest rates—particularly on interest-only loans—has meant that the budgetary cost of negative gearing has increased by $1.6 billion per annum.[xiii] This makes the budgetary impact of reforming negative gearing more attractive and more important than when The McKell Institute first proposed the changes in 2015.

Far from being a bad time to provide sensible reform of negative gearing, it is now more important than ever.

About the McKell Institute

The McKell Institute is a progressive research institute dedicated to providing practical and innovative solutions to contemporary policy challenges.

www.mckellinstitute.org.au

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[vi] See, for instance, Paul Milgrom, *Putting Auction Theory to Work*, Cambridge University Press, Cambridge, 2004.

[vii] A formal way to see this is that the valuation of the second-highest bidder is the second order statistic from the parent distribution of individual valuations. In the theory of order statistics, it is well known that the expect value of the second-order statistic increases more and more slowly as additional draws are taken.

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