NEGATIVE GEARING & HOUSING AFFORDABILITY

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Switching Gears

Reforming negative gearing to solve our housing affordability crisis

JUNE 2015

PUBLIC POLICY QUESTIONS

- Should negative gearing of residential property continued to be permitted in Australia?
- What are the options/scenarios for change?
- What would be the budgetary impact of those scenarios?
- What would be the economic principles behind those scenarios?

SOME CAVEATS

- Not my typical talk
  - No model
  - No theorems
  - No empirical work
  - Some data
  - Numerous heroic assumptions

OUTLINE

- Principles
- The 5 scenarios
- Budgetary impact & other considerations

PRINCIPLES

- In a first-best world expenses incurred in generating income should be tax deductible
- Sequestration by income type?
- Positive versus negative gearing
- Taxation of capital versus ordinary income

AUSTRALIAN CONTEXT

- More credit available for property loans than, e.g., margin lending -> market failure in non-property markets
- Lower rates, easier to qualify -> non-level playing field
- Non-rational behavior?
- May want to intervene in residential investment lending market

THE 5 SCENARIOS

- Business as usual
- Grandfather existing
- Grandfather existing plus $1 million cap on new
- Grandfather existing plus allow for new construction
- Abolish immediately

1. BUSINESS AS USUAL

- Just a benchmark
- Assume 5% p.a. growth in negative gearing balances
- Assume no change in marginal tax rates, no bracket creep
- 10 year cumulative tax expenditure =$51 billion

2. GRANDFATHER EXISTING

- Key question is amortization schedules—endogenous to policy choice
- Base case: 20 year aggregate pay down
- Low case: no pay down
- High case: 10 year pay down
- Base case impact relative to status quo = +$31.7B

3. GRANDFATHER + $1M

- Key issue is on whom cap is a binding constraint
- 1.76M individuals have rental properties
  - 1=1.28M; 2=318,295; 3=96,991;4+=65,000
- Suppose cap binding for 3+ ->24.3% of benefit of scenario 2
- Base case impact relative to status quo = +$7.7B

4. GRANDFATHER + NEW CONSTRUCTION

- Q: what counts as "new construction"?
- 10% increase in construction ->+$4.5B of GDP
- At current 25.8% tax mix ->+$1.1B
- Lose a tad on current 5% negative gearing that is already new construction
- Total 10 year cumulative benefit relative to status quo = $41.7B
- Plus housing affordability effect

5. ABOLISH IMMEDIATELY

- Naive account says grab $3.9B in existing annual tax expenditures
- Lots of endogenous behavioral responses
- Fire sales?!
    - 60% of negatively geared properties are interest only
    - Correlated selling
- Grattan 5-year phase in but rational anticipation could front-load selling

SERIOUS WORK…

- Would be good to know more about the housing demand system
- Kulish-Richards-Gillitzer (2011) calibration of an Alonso-Muth-Mills model
- We've learned a lot about estimating demand systems in the last 20 years (e.g. BLP)
- Apply these techniques to housing demand?
    - Con: black-box nature
    - Pro: counterfactuals
- Nice chapter by Holmes-Sieg (Handbook of Regional and Urban Economics)

BLP FOR HOUSING

- Housing quality as unobserved variable, recover using market shares, then use GMM to estimate rest of the model
- Bayer-Ferreira-McMillan (JPE, 2007)
- Want to address neighborhood peer effects, too
- Tricky, because standard BLP IV strategy problematic
    - Ferreira (2009) exploits property tax limitations (Proposition 13) in CA on household sorting
    - Galiani-Murphy-Pantano (2012): random assignment of vouchers in Moving to Opportunity housing assistance

CONCLUDING REMARKS

- Post-mining-boom budget outlook grim
- Investment fueled property bubble??
- Housing supply a major issue
- Should respect existing arrangements