NEGATIVE GEARING & HOUSING AFFORDABILITY

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Switching Gears
Reforming negative gearing to solve our housing affordability crisis
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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