Senator Marise Payne
Chair
Senate Select Committee on Housing Affordability
in Australia
Parliament House
Canberra ACT 2600

SUBMISSION TO THE SENATE SELECT COMMITTEE ON HOUSING AFFORDABILITY IN AUSTRALIA

Dear Senator Payne

I welcome the Senate's holding of an inquiry into the the issue of housing affordability, and appreciate the opportunity of providing a submission to the inquiry.

Attached is my submission.

I look forward to the opportunity of further discussing the proposals in the submission with the Select Committee, if that is sought.

Yours sincerely,

Paul Pollard

31 March 2008

SUBMISSION TO THE SENATE SELECT COMMITTEE ON

HOUSING AFFORDABILITY IN AUSTRALIA

PAUL POLLARD

Paul Pollard is an economist and town planner, who has been observing housing and land value issues for many years. He provided submissions to the 2004 Productivity Commission Inquiry into First Home Ownership, gave evidence in hearings of that Inquiry, and was quoted several times in its Final Report.

March 2008

SUBMISSION TO THE SENATE SELECT COMMITTEE ON HOUSING AFFORDABILITY IN AUSTRALIA

SUMMARY

There is a crisis in housing affordability and home ownership in Australia, and unless there are changes in thinking and policies there is every prospect of Australia developing into a two-tier society, with many locked out of home ownership. Claims about a growing economy and rising living standards are hollow if a large fraction of

the population faces life-long rental insecurity.

This submission focuses heavily on making the rental market much more affordable, as well as measures to make ownership much more affordable. As is explained, the rental market is actually crucial to improving home ownership levels, quite apart from the enormous social benefits that arise.

There are many, interrelated reasons for poor home affordability, including Australia's urban structure; lack of public funding for new urban infrastructure in recent years; planning processes; community opposition to redevelopment; high immigration levels without commensurate action on housing provision; the flood of investment funds into housing in 2000-03 based heavily on tax provisions; and the self-generating nature of house price rises, especially in housing price booms.

A strategy to make housing more affordable needs to address aspects of the problem that are amenable to change, specifically excessive money demand for housing which does little or nothing to increase supply of housing but forces up prices, and insufficient supply of new housing, especially low-cost housing. The proposals in this submission relate to areas where the Commonwealth has a direct responsibility, or where it can work with other levels of government on feasible measures.

The proposals for the Select Committee to consider in this submission relate to: the setting of home affordability target figures for urban regions; the provision by the Commonwealth of funds for the building of low-cost housing for rental and ultimately purchase, in a way that can leverage large amounts of private funds; the recognition by the Commonwealth that the setting of immigration levels has direct implications for housing affordability; the recognition that local community opposition to redevelopment can undermine a crucial aspect of dealing with this problem; a change in the way that new fringe urban infrastructure is funded, to lessen development charges, but with fringe urban development managed so as to ensure that home buyers benefit from any change; and an amendment to the tax deductibility of interest costs by housing investors ('negative gearing') so that such tax deductibility contributes to solving the problem of housing affordability rather than being a significant part of the problem.

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INTRODUCTION

The enormous benefits, financial and otherwise, to families and society, of home ownership are universally recognised in Australia. In the decades following WWII home ownership reached levels of over 70% of all households, and home ownership was achievable often on one average income. This is now clearly changing. Currently, using maximum lending criteria, about two full-time, long-term average incomes are needed to pay off a mortgage on a median-priced dwelling, and any family dependent on one average or lower income is now ruled out of home ownership. These figures obviously have profound implications for society. For instance, a recent report by the Institute of Family Studies, on the birthrate compared with the number of children couples would prefer to have, cited house prices as one of the key obstacles to couples' fulfillment in this regard.

If present trends continue there is every prospect of Australia developing into a two-tier society, where a substantial and growing part of the population never own their own home, but rent all their lives in an increasingly competitive rental market. Lives for many will be marked by housing desperation and insecurity. Compared with the satisfactory situation until recently in Australia, this makes a complete mockery of claims about 'rising living standards', a 'strong economy', etc. We have allowed an appalling situation to arise in Australian society, and rethinking and new approaches are desperately needed.

TERMS OF REFERENCE

The main term of reference of the inquiry is about home ownership. This submission proposes a number of measures which relate to the main issue. It does not address each specific term of reference, although the measures proposed relate directly to many of them.

THE ROLE OF THE RENTAL MARKET

This submission makes a number of proposals which relate in the first instance to improving the the housing rental market, rather than the market for owner-occupied houses. The reason for this is that the two markets cannot be viewed on their own. In particular, a far better rental market than now is an essential underpinning for a home ownership market which allows most household to become home owning. (A desirable rental market would be one where rental housing would be widely available in every region, with typical median rents at never more than 25% of average earnings in each particular region). As we know from many recent news reports, there is currently a crisis in rental markets throughout Australia's main cities. Addressing the rental crisis will simultaneously address the home ownership crisis.

The reasons that a far more household-friendly rental market profoundly assists the home ownership market are:

- reasonable rent levels greatly assist people to overcome the first obstacle in home ownership: saving a deposit;
- achieving a satisfactory rental market, where there is a reasonable vacancy rate and overall an adequate supply of housing in relation to rental demand, means by definition that there will also be an adequate supply overall of houses in relation to demand, because houses can be changed from rental to owner-occupied and vice-versa very quickly. This will greatly assist the home ownership market; and
- the lower rent levels likely to obtain in a more reasonable rental market will mean that the return to investors will be lower than in a tight market, and this will act as a financial incentive for investors to sell to owner-occupiers.

The fundamental reason why a more renter-friendly housing market will assist home ownership is that there is a tremendous value given by Australians to home ownership. Given the opportunity, they will enter into heavy financial commitments to meet this goal, because they readily perceive the long term financial and nonmaterial benefits of ownership. A more affordable rental market will not make more people renters – in time it will make more people home owners.

The only caveat to this is that government needs to ensure that there are no regulatory obstacles to people moving from renting to owning, and that this shift is assisted by government in whatever actions it takes to improve rental markets. For instance, in projects where it assists in the provision of rental housing, it should ensure wherever possible that the ownership structure of projects facilitates renters becoming owners of their dwelling.

REASONS FOR POOR AFFORDABILITY

There are many reasons why home ownership has become so unaffordable. These include:

- **Australia's urban structure.** The concentration of Australia's population in a few urban areas means that very strong demand pressures have developed for housing in the limited areas within existing urban areas, or on the available fringes of these areas. These demand pressures relate particularly to employment opportunities. The absence of new growth centres, or a network of cities and towns as exists in some countries, limits the scope for generous expansion of suitable new areas for housing at low marginal cost, and limits the scope for competitive bidding for new development between urban areas. In each state there is only one main urban region monopolising urban opportunity, and fringe development is relatively unattractive and distant from the main benefits of each area.
- **Lack of public funding for urban infrastructure.** Historically infrastructure for urban development was funded by public borrowing secured against the rate income of the housing it serviced. This was a highly successful model. The investment was extremely safe, and there was no immediate financial burden for new home owners to carry. Unfortunately various circumstances changed: up-front infrastructure needs became more costly; governments (unwisely) became reluctant for any of their agencies to incur debt; and the opportunity arose, with rising land values, to raise funds at least partly through development charges. Thus the prospect of new growth centres, or affordable but attractive new fringe development, became less likely.
- **Planning processes.** Planning processes at times became part of the problem. Based on the urban structure that planners faced in each state, plus the inadequacy of up-front infrastructure funding, planners and governments often adopted policies of urban consolidation as a way of dealing with this. This approach depends on increased densities in existing areas, or along particular growth corridors, to absorb growth. It necessarily involves releasing less fringe land than otherwise would be the case. Depending on the city, this would tend to increase the cost of land for housing. (The smaller the urban area, the more significant fringe land releases become. But in Sydney, for instance, totally derestricting land releases of the only available land, on the western fringe, would have minimal impact on land prices in most of urban Sydney). Planning processes designed to be fully consultative inevitably slow redevelopment proposals. However, it should be noted that in light of the housing problem, state governments are improving planning systems, in various ways.

- **Community opposition to redevelopment.** Proposals to increase densities in existing areas have often faced strong opposition from local communities who in turn forced local government bodies to take the same view. Efforts by state governments to facilitate redevelopment are portrayed as undemocratic overruling of local communities.
- **Immigration levels.** Australia has experienced a high level of immigration in recent years. Immigration adds immediately to housing needs, but no apparent planning or policies were adopted to ensure that there was increased housing to meet this increased demand which is directly controlled by government decision (perhaps on the basis that in the past this problem had always been solved in time). Recent figures relating house prices in Sydney and immigration levels into Sydney show an astonishing correlation.
- **The flood of investment money into housing 2000-03.** In the four years 2000-03 there was a flood of investment money into the housing market that led to house prices broadly doubling in nominal (money) values. This flood was driven by several factors: the collapse of the share market during these years, relatively low interest and thus mortgage rates, the 1999 change to capital gains tax, the rise of easier conditions for many borrowers, and the rise of real estate promoters. Underpinning investment in housing was the ability of investors, as opposed to owner-occupiers, to 'negatively gear', that is, be able to tax deduct interest costs of borrowing against income from other sources. (After plateauing for two years, prices are now on the rise again, although interest rate rises at the end of 2007 and into 2008 may slow this).
- **The self-generating nature of house prices.** Most finance for housing (80-90%) is based on existing house prices: owner-occupiers upgrading (at least 50% of finance) are able to spend more because of rising values for their existing house. Investors (currently at least 30% of finance) are able to use the security of rising values of their existing dwelling, or other house investments, to facilitate further borrowing. Thus rising values generate further rises. Also, news about rapidly rising values draws in more investment, another self-generating effect.
- **The negative effect of high house prices on supply.** It has become clear that high house prices inhibit new supply, thus further compounding the problem. High prices drive up the value of residential land, whether it is new urban fringe land or sites for redevelopment. This raises the price of the new housing, thus inhibiting demand. The opposite effect that might have been expected to operate, of high land values inducing people to sell land, or houses for redevelopment, does not seem to be happening, because the expectation of even higher prices induces people to hold onto property, particularly when holding costs are low.

PROPOSALS TO THE SELECT COMMITTEE

It is clear that some of the causes of unaffordable housing are long-term and profound, and relate to the levels of government other than the Commonwealth. Proposals to the Committee, for instance, that Australia's urban structure be altered are unlikely to be feasibly implemented. The proposals put forward below for findings by the Senate Committee are focused therefore more on areas where the Commonwealth has a direct responsibility, or where a finding by the Committee relate to more feasible actions by government at all levels to improve housing affordability.

A STRATEGY TO MAKE HOUSING MORE AFFORDABLE

A practicable strategy to make housing much more affordable in Australia needs fundamentally to address two key aspects of the problem which are amenable to change: excessive money demand, which drives up prices without assisting supply, and insufficient supply, especially of low-cost housing.

We need to recognise that we are seeing a vicious circle with these two aspects: excessive money demand for housing has driven up prices in a self-generating way, set off by floods of investor money into the market in periodic booms. But these price rises, and the expectation that values will keep rising, undermines supply because they drive up the values of residential land. Less supply in its turn further drives up values, and the vicious circle continues, cumulatively. Unless governments act to change this situation, the outlook is for ever increasing prices, with the only stop to the process likely to be from very high interest rates and/or a recession, 'remedies' which will bring other problems and which might stop price rises but will not ensure more affordable house values, for buying or renting.

(It should be noted in this context house prices have long ceased to be 'cyclical', as they are sometimes described. This term suggests they go up and then they go down, in real terms. For at least 20 years now the pattern in the Australian market as a whole, and in metropolitan markets as a whole, has been for prices to rise in investment booms, then plateau for a time, then rise again in the next boom. The effect is a periodic ratchetting up, not a cycle).

The proposals that follow are aimed at these two immediate objectives: lessening excessive money demand, and increasing supply, especially low-cost supply.

PROPOSALS

That home affordability target figures, expressed as the cost of buying or renting housing as a proportion of average incomes, be adopted by Commonwealth and State Governments. No government has such a target, aspirational or otherwise. Housing is an absolute necessity, and high-cost housing can completely undermine other income support systems such as minimum wages, or age pensions. Housing affordability targets should rank with other current welfare objectives, such as keeping the age pension at 25% of full-time earnings. Current Commonwealth rental assistance is quite infeasible on a larger scale and does not address the basic problem of supply, but rather pushes up rents overall. Given the complex role that governments play in housing, it simply cannot be left as something for the market to solve. In order to be practicable, targets would need to relate renting, and buying, costs of modest housing to average incomes in major sectors of each urban area. Specific target figures are essential to measuring the scale of the problem, measuring progress and the effect of actions, and holding governments accountable.

That the States and the Commonwealth (through the Commonwealth-State Housing Agreement and additional spending) administer programs to bring about large-scale building of low-cost, low-rent housing in urban sectors to achieve these targets. Currently the CSHA provides about $1bn a year for public housing. This is far too low to even maintain public housing levels, which have fallen from about 10% of all housing 30 years ago to about 5% now. But direct funding of the full cost of more public housing is not a feasible way to address the present problem. The main way to proceed is to use CSHA funds, and new funding from the Commonwealth, to leverage larger investment by superannuation funds and other sources in housing.

The recent initiative by the Rudd Government, to provide a tax credit of $6,000 a year per dwelling, supplemented by $2,000 in state government support, for ten years to private developers, for renting 20% below market rates, is an example of how government funding can leverage private sector funds to assist the housing crisis. However, the model proposed here is somewhat different. It does not propose a yearly subsidy per dwelling nor even a requirement that the housing be let for a below-market rent. What it proposes is that the Commonwealth and the relevant state provide a subsidy simply to build low-cost housing for market rents. (State support could be 'in kind' such as planning facilitation, low- or no-cost land, and/or tax remissions),

Currently new housing overwhelmingly tends to be middle or high cost housing. The housing industry mostly does not build low-cost new housing. The proposed subsidised dwellings would have to be necessarily modest and simple, and be in lower income areas, so that they would cater for lower income groups. Because they could be let for market rent, and involve a simple up-front subsidy to build, they could be an attractive alternative to complement the tax credit scheme. The total cost of subsidy per dwelling proposed here, of 25% of the cost of land and building, is roughly what is involved in the tax credit scheme. The benefit would be that a sufficient additional supply in an area would tend to lower market rents across the entire rental market in that area.

Take a region of a city, where the vacancy rate of rental accommodation is very low, say 1-3%, typical of most urban areas in Australia now, with consequent rents for many well above the 25% of income figure. We know that there would be a dramatic fall in market rentals if the vacancy rate were say 5-8%. If additional housing for rental at market rates, amounting to 4% of rental housing in the area, is provided, the effect is that at a cost to the Commonwealth of 1% additional rental houses in that area (based on 25% subsidy of 4%), market rental rates could well fall enormously across the area, perhaps of the order of 25%. This reflects the nature of rental markets.

This proposal amounts to a leveraging of a relatively small amount of public funds to use much greater private funds, to strategically affect the market. This would involve greater Commonwealth funding, as does the tax credit scheme, but it should be remembered that the Commonwealth currently spends about $4bn a year on housing – about $1bn on the CSHA, $2bn on rental assistance, and $1bn on the First Home Owners Grant scheme. As many have pointed out, the latter two schemes, justified as they might be in individual cases, basically worsen the home affordability problem because they amount to adding to money demand without adding to supply. As circumstances permit, therefore, funds directed to these schemes should be redirected to highly leveraged increase in low-cost housing supply, as proposed here.

Any projects that the Commonwealth is involved in should include measures to facilitate the switch from renting to home ownership. For instance, body corporate ownership structures, and arrangements so that payment of rent over a period could be taken as a contribution towards a deposit.

That the Commonwealth acknowledge that the level of immigration has a direct bearing on housing demand, and that it therefore has a responsibility when setting the level of immigration to see that housing is correspondingly adequate. Immigration has a direct and immediate impact on housing demand, and statistical analysis shows that in recent years high levels of immigration have directly driven house price rises. The level of immigration is one of the few areas where the Commonwealth Government can directly influence housing demand. Given the state of house prices in Australia today, the Commonwealth cannot assume as in the past that state and local government measures, and markets, will deal with housing pressures from immigration.

That governments at all levels put into place measures to facilitate redevelopment in established urban areas, and acknowledge that local community opposition to housing changes can undermine a crucial part of dealing with the housing crisis, and needs to be approached in that light. If we cannot change Australia's urban structure, and population growth continues, then some increased density right across Australia's cities in unavoidable in providing affordable housing. This need has been highlighted by the 'essential worker' problem in some US and Australian cities, where large, more expensive areas of cities simply cannot get a range of essential workers, from teachers to cleaners, because it is far too expensive for them to live anywhere near where they are needed. It is short-sighted and selfish for residents in any area to unreasonably oppose properly designed higher density housing redevelopment or infill, and to pressure local councils to oppose this, just because it represents change to their area. Unless a development directly infringes their own property, such as significantly overshadowing or overlooking, residents of particular areas do not have the right to influence developments greater than the rights of other citizens of the city. If local governments are not strong enough to take a responsible city-wide view, clearly state government has to take this responsibility.

Every major sector of each city should provide a balance of high to low rent, and high to low purchase prices, of dwellings. This does not mean that Vaucluse or Toorak should be redeveloped to provide ample low-rent accommodation. It does mean that within the broad sector of metropolitan area that they lie in, there should be low-rent accommodation, and low cost apartment acquisition possibilities. Of necessity such housing would be modest in size, and target figures for housing values would need to recognise that there will always be variations between major areas across cities – the eastern suburbs of Sydney will always be somewhat more expensive than the outer western suburbs.

This is mainly a matter for state and local government planning processes, but the Commonwealth could back up the other levels of government by acknowledging the importance of balancing metropolitan areas in terms of housing availability and affordability. How well cities work is vital to achieving many national goals: the interest of the Commonwealth springs from its responsibility for employment, the efficiency of the economy, for environmental goals, and for social welfare. The Commonwealth could back support for balanced redevelopment by making its financial participation in housing programs dependent on such redevelopment of metropolitan areas.

That the Commonwealth, as the manager of the national economy and provider of social welfare, endorse the approach that infrastructure charges for new urban areas be financed predominantly by the historically successful model of loan funds secured against long-term rate income, rather than through up-front development charges, noting that this approach, if it is to assist home buyers, necessitates government management of the urban fringe development process.

As noted earlier, the traditional approach to funding new urban infrastructure was through government loan funds secured against future rate income. This was a highly successful model which reduced the immediate financial burden on those developing and buying new land. (Public-private partnerships, if well-designed, can be a thoroughly suitable modern variation of this model). But this successful model has been significantly replaced by development charges which tend to force up the price of new urban land. The development industry has argued strongly against these up-front charges. While their argument is broadly correct, a simple switch away from high development charges may have no benefit to buyers, depending on how it is managed.

This is because if there is a sellers' market of urban fringe land releases, there may be no lowering of prices with removal of high development charges, and the benefit of lower charges may simply accrue to either the developer, or the original seller of the greenfields site. The fact is that the generally unspoken justification for high developer charges has been that, in this sellers' market, they act as a de facto betterment tax, where some of the financial gain to the original owners of the land accrues to the public domain in the form of financing community infrastructure.

Essentially the fringe development process needs to be managed or overseen by state government to ensure that the benefit of low development charges is passed on to buyers, and more generally to ensure that too much of a sellers' market does not occur, with large unearned gains to land holders or developers through inadequate supply. This may require all new fringe land being developed passing through government ownership (the government buys land at its non-residential value and sells to developers in sufficient quantities and with low development charges, so prices are kept low). In this model the private sector undertakes all its normal functions of building and marketing. Or it may be achieved by government overseeing the process and having to intervene in only part of the fringe land market, sufficient to keep prices low. In its submission to the Productivity Commission inquiry into first home ownership in 2004, the South Australian Government described how it had successfully kept Adelaide fringe land prices at reasonable levels, essentially by being the owner of about a third of the fringe land, and also ensuring low development charges.

That the Commonwealth amend (but not abolish) the tax deductibility of interest costs on investment in housing ('negative gearing'), in order to slow the growth of house prices, and make for a more level playing field between investors and owner-occupiers in bidding for housing, in a way that will ensure that supply of new housing is boosted. The example attached, relating to the finances of the purchase of a dwelling, shows what an enormous advantage the investor has over the owner-occupier in bidding to buy a house. It shows that the greatest advantage that the investor has arises from the ability to tax deduct against other income all the interest cost of acquisition. Thus interest cost for an investor are effectively from 30% to 45% lower than for an occupier, depending on the investor's marginal tax rate. Added to this for the investor is the income from net rent, building depreciation tax deduction if the building has been built in the last 20 years, and fixtures and fittings depreciation tax deduction.

This lower cost of finance has led to investors being willing to borrow heavily, driving up house values dramatically in times of housing boom when investment floods into the housing market. It has led to the situation where, relying on continuing capital gain to make their investment profitable, investors have driven up prices to a situation where they accept an uneconomic yield from net rent (often only 2.5-3.0%). This means they are making an immediate income loss on the property through their borrowing (hence 'negative gearing'), but more than offset in their minds by expected capital gain.

This has led to the extraordinary situation in Australia in recent years where it is quite uneconomic to invest in housing based on rent as a reasonable return on investment. There are no large commercial firms investing in renting housing accommodation in Australia, in contrast to other comparable countries, and house renting in Australia is completely a small investor field, based on individuals deducting losses against other income, and, for some, a belief in ever-increasing capital gain.

Investment booms, based on this investor bidding advantage provided by the tax deductibility of interest costs, are what have driven house price rises in Australia in recent years. The pattern has been a ratchetting up, through boom, plateau, boom, and so on. This can be seen in the proportions of housing finance coming from investment in recent years: around 10% in the early nineties, rising to 50% at the height of the 2000-03 boom, and currently being at 30%, causing the recent increases in house prices after a pause for a year or two.

Thus 'negative gearing' lies at the heart of the home ownership problem in Australia. It has been the main underpinning of high house prices, it greatly favours the investor over the owner-occupier, and the high housing prices it causes undermine supply, as described earlier. Housing affordability will never be properly addressed until significant changes are made to 'negative gearing'. Comparable countries do not allow investors' full deductibility of housing interest costs in the way Australia does.

One argument against changing tax deductibility of interest costs for housing investment is that it is wrong to discriminate among financial assets. However, while such deductibility in acquiring an income-producing asset is a normal tax principle, housing is an utterly different type of asset from other financial assets. It is a social necessity, quite different from shares, gold or any other type of financial asset that people might want to speculate in. Those buying other financial asset types are bidding against other investors who can also access interest deductibility. But in housing, the main other bidders are owner-occupiers who do not have access to this advantage. Housing is already treated as a quite unique form of asset, if we look at government intervention in its supply, such as provision of subsidised social housing, rental assistance, exclusion from capital gains tax of the family home, first home owners grants, etc.

There is a sound general economic argument for tax deductibility of the interest costs of acquiring an income-producing asset. This is that it encourages real investment, the production of real capital. This is the main argument used by those who support the retention of 'negative gearing': they claim that it encourages investors to invest in housing, including the building of new housing, so maintaining supply.

This is largely not the case. The vast majority of investment funds driven by negative gearing is spent on established housing, not new housing, so its predominant effect is to drive up prices, not finance new supply, and these higher prices then undermine new supply, as discussed.

If a way could be found to remove the extraordinary favour to investors (for whom a house is not a necessity but a financial add-on), while assisting additions to supply, home-ownership would receive an enormous boost, both through making for a more level playing field, and in lowering house prices in the long-term.

The destructive long-term effects of 'negative gearing' are why such a wide range of commentators have criticised it in the unqualified way it operates in the Australian housing market, in fact almost everyone who looks into the issue of home ownership who hasn't a financial interest in its maintenance. Those who have criticised the way tax operates in relation to home ownership, including 'negative gearing' as part of the mix, include the Reserve Bank of Australia and the Productivity Commission, and figures such as Saul Eslake, chief economist of ANZ Bank, and John Symond of Aussie Loans have directly attacked 'negative gearing' in the housing market.

Proposal

It is not proposed in this submission that housing interest tax deductibility for investors be removed in relation to contracts already entered into, in other words, retrospectively. What is proposed is that, for housing acquisitions entered into after the announcement of the tax change, it would be retained in cases where it is used to acquire newly built dwellings, but abolished where it related to established (already built and owned) dwellings. (Investors in new dwellings, if they sold these dwellings, would be able to pass on to the new buyer the tax deductibility of interest, to the extent of the original purchase). In this way tax deductible interest would fulfill its economic justification, the creation of new capital, and it would cease to operate where its only effect is to raise the price of housing assets, rather than add to new supply.

The effect of this essentially simple change would be that investment in established housing would be far less financially attractive, and investors would be much less advantaged in relation to owner-occupiers than they are now. There would be a very substantial lessening of investor interest in established housing, which comprises most house sales. The effect would not be an immediate drop in house prices, because the majority of demand is not motivated by negative gearing, being from would-be occupiers, and there is the well-known 'sticky downwards' aspect of the house market. But over the longer-term, real house price growth would be greatly moderated, or perhaps prices would be stable, because the great incentive for the floods of money in investment booms would have gone.

Perhaps the greater effect, certainly in the shorter term, would be that anyone interested in negatively geared housing investment would turn to investing in new housing. Because most investment going into housing buys established houses, if only a small part of this were switched to new housing instead, there would be a greatly increased level of investment in new housing supply. In time this would lead to significantly increased housing stock, helping to lower house prices for buyers and renters.

Such a proposal, when its likely effects are understood, would be welcomed by almost every interest group, including the house building and development industries because it promises higher building levels. Only those with a direct industry interest in long-term house price rises would object.

The main argument used against the abolition of negative gearing when this subject is raised is that it would lead to higher rents, in particular because landlords would withdraw from the rental market. The argument has been that negative gearing acts in effect as a subsidy to landlords to hold rental property, necessary because renting is otherwise an unprofitable activity. Broadly, this has always been a specious argument because, as we have seen, negative gearing has been a major force for the rise in house prices that has made renting unprofitable as a return on the value of the asset.

In particular, the proposal in this submission would not lead to higher rents. All landlords presently using negative gearing would continue to benefit from it, and have no incentive to withdraw from renting their property, because the proposal is not retrospective. Increased new housing supply would be encouraged by this change, tending to lower rents. The only way in which it could be argued that rents would be increased is because prospective landlords would no longer bid for established houses, leaving the market more to owner-occupiers, so that in time there would be fewer established houses available as rented properties. However, this argument ignores the fact that, in each case where an additional property becomes owner-occupied and thus not available for rent, the demand for rental accommodation decreases because of the increase in owner-occupation. Therefore the overall number of renters in relation to the overall number of rental properties remains the same, and there will be no pressure for rents to rise.

Appendix 1

Example of the financing of a typical dwelling valued at slightly over $400,000

Year 1

Mortgage loan (assumed that deposit, if necessary, already provided)	$400,000
Mortgage repayment (say) 8% p.a.	$ 32,000
of which repayment of principle, say 1%	$4,000
interest on mortgage therefore 7%	$28,000
Net rent p.a. ($350 a week gross rent, less 40% costs)	$10,920
Building (2.5% on $150,000) and fixtures and fittings (9% on $50,000) deductible depreciation	$8,250
Tax deductible total by investor (sum of depreciation and interest less net rent received)	$25,330
Tax payable lessened at a 30% marginal tax rate of other income	$7,599

Therefore the investor in a dwelling subject to both forms of depreciation has a net outgoing of $32,000, less net rent received of $10,920 and tax minimised $7,599, or net outgoing of $13,481, versus outgoing by an owner-occupier of $32,000.

Thus an investor is in a far more favourable position to bid for housing finance than a would-be occupier. If the investor's marginal tax rate is greater than 30%, the advantage becomes far greater.

This still applies even if the building has no depreciation deductions available. This worsens the position of the investor by only $8,250x30%, or $2,475.

It is clear that the removal of NG would make the investor worse off to the extent of $28,000x30% or $8,400, so that he pays out in the year $21,881, compared with the owner-occupier paying $32,000. If there is no depreciation the difference becomes only net rent after tax, which is $10,920 less 30% or $7,644 ($32,000 versus $24,356).

Thus abolition of NG would put the owner-occupier in a far better position to bid for housing against the investor.

It is clear that the investor would make a loss if this property were sold at its purchase price after a few years of ownership, when there had been net outgoings of the order of $13,481 a year (diminished only by any rise in after-tax net rent). It would be just profitable if the property rose in capital value at a rate of about 3.5% nominal (money) a year ($400,00x3.5% = $14,000), or slightly above the likely inflation rate. It would only be a decidedly profitable sale if the nominal rate of capital appreciation were well above this, say 6% a year, or a 3% rise in real price, (which would mean a doubling of real market price over 24 years, even though it is exactly the same asset - same dwelling, same piece of residential land). Thus it is capital gain that drives any but very long term investment in housing.

Without real capital gain (or even if only money value were maintained for a period, that is, if real value fell for a period) investment in new housing under this proposal would still be profitable in the very long term, essentially because, in the end, a much more valuable asset, in money terms, unencumbered by any debt, would be owned, at a net finance cost of only about 2.5-3% a year of the original loan.

It can be seen from this example that the 1999 change to capital gains tax for individuals was not as significant as claimed by many, as a financial incentive to housing investment. Say the property rose by 6% in money value ($24,000). Prior to the 1999 change this 6% increase would then be decreased by the (assumed) 3% inflation rate. The taxed increase in value would therefore be $12,000 ($400,000 by 3%) which at an assumed 30% marginal tax rate would mean tax of $3,600 (when finally paid). Under the 1999 change, the marginal tax rate for capital gains for individuals was halved, but no account was taken of inflation. So tax when finally paid would be 15% of $24,000, or the same $3,600. With a typical inflation rate of 3%, and below a nominal (money) capital appreciation rate of 6%, the taxpayer is worse off, and the appreciation rate has to be well above 6% for the taxpayer to be significantly better off under the 1999 change.