

Will house prices 'collapse' if negative gearing is changed?

Written by The Conversation

There is much confusion about the effects of Labor's tax proposals with respect to investors in rental housing. They propose to grandfather existing arrangements. But investors in the future can only negatively gear newly constructed housing, while the policy recommends the capital gains discount fall from 50% to 25%.

Claims by Prime Minister Malcolm Turnbull that house prices will collapse appear to be contradicted by his assistant treasurer Kelly O'Dwyer who claims that housing costs will soar. These puzzling assertions arise due to a failure to distinguish between the market in rental housing, where housing is leased, and the market in which investors and owner occupiers buy and sell housing. Critically these two markets are interrelated.

To see why, consider the first round effects of Labor's proposals when we put the grandfathering arrangements to one side (for the moment). Some existing investors will sell up when leases come up for renewal. There are now more tenants seeking rental housing opportunities than there is supply to meet their demand. Rents will begin to rise.

But the houses which investors quit add to the properties available for sale; there are now more houses available for purchase than there are buyers. House prices will begin to fall.

These market signals trigger a second round of effects. Some tenants will elect to buy rather than rent. After all renting has become more expensive and home ownership has become cheaper. These second round effects help to put a floor under falls in house prices, and help cap rent rises.

By considering the inter-relationships between the two markets we can understand how the government has issued apparently contradictory statements. Rents will rise and so the housing costs of tenants will increase. But there will be falls in house prices (or more likely a slower growth in prices); while existing owners take a hit, first home buyers housing costs are lower and attainment of home ownership becomes more affordable.

The second round effects mean that impacts are likely to be muted. This is made even more likely by a grandfathering proposal that should prevent a stampede by existing investors

seeking to relinquish their property investments.

A disappointing aspect of the debate so far has been its neglect of the longer term structural consequences of Labor's suggested reforms. Our current arrangements encourage high tax bracket investors to take on debt in the "chase" for capital gains. Capital gains are leniently taxed as compared to ordinary sources of income, such as earnings and rents.

Only 50% of capital gains are added to assessable incomes. This is particularly attractive to high tax bracket investors. Moreover, they are taxed on realisation rather than as they accrue. The shrewd investor realises the gains when assessable income from other sources declines; for example, following retirement when the investor's marginal tax rate commonly falls.

There are not enough high tax bracket investors willing and able to invest in all our private rental housing stock. They tend to cluster in those segments of the market where healthy capital growth is expected, but rental yields are lower. Low tax bracket investors tend to cluster in segments where capital growth is expected to be subdued. Typically these are areas with lower house prices. To ensure adequate returns rental yields have to be higher in these low house price segments.

We therefore get a distorted investment pattern that disadvantages the supply of affordable rental housing.

Labor's proposals will curb these distortionary effects by reducing the capital gains discount. They will also reduce the tax incentives to leverage investments. Rising indebtedness is a threat to the resilience and stability of our housing market.

Many believe that repayment and investment risks carried by heavily indebted home buyers played a central role in precipitating the global financial crisis. Tax concessions that favour taking on debt exacerbate those risks. If Labor's proposals succeed in attracting attention to these and other structural problems that plague Australian housing markets, they will have a much wider significance.

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