- Increases in capital gains tax for all dwellings and disallowance of negative gearing for established dwellings will increase the user cost of investors and, other things equal, will mean some combination of higher rents and lower prices, ie higher rent-price ratios. In Appendix 1 set out below the Poterba (1984)[1] framework for analysing the impact of tax and tax changes on user cost.
- While the economics are clear, there is scope for argument over the orders of magnitude of the increases in rent and decline in prices. The BIS Shrapnel estimates[2], which assumed negative gearing changes would cause Sydney unit prices to fall 6.1% and rents to rise by 5.8% are probably on the high side (even allowing for the fact that it did not incorporate the effects of the proposed lift in capital gains tax) but they are not fanciful, as suggested by the Grattan Institute.[3] The competitive effects etc. which constrain rises in rents alluded to by the Grattan Institute are all incorporated in the Poterba (1984) analysis. When Poterba (1990)[4] used his framework to look at the impact of comparable US tax changes in 1986 (when they cut negative gearing), he was strictly taking an academic view of the matter. Poterba assessed that the long-run effect will mostly be higher rents, while the short run effect will mostly be lower prices. In markets such as those in Australia with higher land/structure ratios, more of the effect would logically fall on prices.
- Benchmarked against the Henry Tax Review, which sought to reduce the wedge between high taxes on voluntary savings relative to owner-occupied housing and superannuation, by cutting taxes on interest and rental income, the proposed changes will rather increase the wedge. The changes to capital gains tax, not applied to superannuation, will lead to very high effective tax rates on capital gains – perhaps fine if you believe capital gains will repeat recent history but not in a more realistic world. It is therefore highly problematic describing this as tax reform. In Appendix 2, I look briefly at the changes proposed.
- What would I propose? NZ is the gold standard in my view, benefiting from the Douglas/Lange Labor Party reforms of the 1980s, which included a GST! And NZ is on a par with Australia in terms of income distribution![5] But that is a forlorn hope. Next best is to revisit the Henry Tax ideas: phase in lower tax rates on saving which will naturally lead to lower negative gearing, while constraining access to superannuation. My tweaks on that would be a return to inflation-indexed capital gains and not allowing superannuation funds to borrow.
- In terms of new housing, the oft quoted statistic that less than 10% of investor borrowing (some quoting 5%, others 7%) goes to new dwellings is plain WRONG. A moment's thought says it makes no sense given the role of investors in the building boom in new units. The ABS figures do not give an actual figure but a reasonable assessment of the ABS data (see discussion below) is that true figure is about 20% of investor loans and that it represents over 30% of all new dwellings and, in the current cycle, it is likely to be running in the order of 40%. With the new segment already very likely dominated by high income investors, the budget savings if new dwellings are exempt will likely be significantly less than projected by the PBO.

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[1] Poterba, J. (1984) "Tax Subsidies to Owner-Occupied Housing: An Asset Market Approach." The Quarterly Journal of Working Paper 3270, February 1990.

[5] 5

- While the McKell Institute paper[6] has argued that there would be a boost to new housing, that proposal assumed no change to capital gains and also assumed the sub-

Assessing the Economic Impact of Tax and Tax Changes on Housing

The best way to assess the economic effects of taxes on housing is the user cost framework set out by James Poterba in 1984. The user cost for non-taxed entities (owner-occupiers) and taxed entities (investors) are set out over. We can use this in two ways. Firstly to look at the absolute effect of changes in(t)2(ax)24(ed)4.33(s)5 t5T2( )13.4(c)-2.7(ha)1

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Appendix 1: User Cost and the Taxation of Housing

In the first part the user cost is set out for owners of housing subject to tax, ie investors. In the second part the user cost for owners of housing not subject to tax is set out, ie owner-occupiers. In the subsequent parts, the net advantage to owner-occupiers is set out. In equilibrium, user cost is equal to gross rent (R), so we can identify the relationship with rent-price ratios (e.g. see equation 1)

1. Investors User Cost (UC)

Current user cost:

$$UC_{(I)} = R = P[\hat{\tau}_O . i + (1 - \hat{\tau}_O). i \quad + exp + lt - \pi \cdot \tau \cdot \frac{1 - 4.9c}{1 - c}]$$ [1]

$$Rearranging \quad \frac{R}{P} = \hat{\tau}_O . i + (1 - \hat{\tau}_O). i \quad + exp + lt - \pi \cdot \tau \cdot \frac{1 - 4.9c}{1 - c}$$

User cost proposed (by Labor Party 2016).

$$UC_{(I)} = P[\hat{\tau}_O . i + (1 - \hat{\tau}_O). i \quad + exp + lt + (\hat{\tau} - \hat{\tau}_1)(\quad).\tau \quad - \pi \cdot \tau \cdot \frac{1 - 4.9c}{1 - c}]$$ [2]

Where: $\hat{\tau} =$ ... ; $i =$ ... ; ... ; $exp =$ ... ; $lt =$ ... ; $\pi =$ ... ; $\tau =$ ... ; $\tau_a =$ ... ; $\hat{\tau}_O =$ ...

Term in bold red in equation [2] is negative gearing benefit where a loss can be used against income from other sources, e.g. labour income or other investment income. Note that this element in equation [2] has a positive

The major benefit to owner-occupation occurs when equity is high. For new entrants to the owner-occupied market with low equity, the immediate value of this benefit is small – the benefit comes later. It is when equity is low that first-time buyers face the hurdle (or barrier to entry) of interest costs coming out of their after-tax income,