Squaring the circle: The contradictory arguments against limiting negative gearing to new homes

By Gavin R. Putland

Of all the proposed reforms to negative gearing, the one with the best chance of being supported by a major political party — hence the best chance of getting through Parliament — is to disallow or quarantine negative gearing on future purchases of established homes, while continuing to allow full negative gearing for new homes, and for past investments ("grandfathering"). This measure is politically attractive because it calls the bluff of those who defend the status quo: "You say negative gearing reduces rents by increasing the supply of rental property? Very well: Require future negative gearers to support new construction, thereby increasing the supply for rent without reducing the supply for owner-occupation — that is, without forcing prospective owner-occupants onto the rental market!"

For the same reason, of all the proposed reforms to negative gearing, limiting it to new homes is the one most vehemently opposed by the property lobby. Owners of established properties don't want to encourage further supply. They want to restrict supply in order to maximize the values of their own assets. In other words, they want to restrict competition. But of course they can't give that as their reason for opposing a change to negative gearing. If the change would manifestly make housing more affordable for renters and first-time buyers, established owners and their representatives will pretend, by all necessary sleight of hand, that it would have the *opposite* effect.

So, when the Property Council of Australia and the Real Estate Institute of Australia commissioned "independent" consultants to produce a report on "the potential impacts of reforms to the existing negative gearing and CGT arrangements" (cf. p.9 of the report), there was no need to specify that the report should contain a section on limiting negative gearing and the CGT discount to new homes, or what conclusions the section should reach. That was too obvious. It was therefore inevitable that the relevant section (5.5, starting on p.46) would be the one in which the consultants performed the most painful intellectual contortions in order to reach the conclusions required by their well-heeled clients.

The section is headed "5.5 Limiting negative gearing and the 50 per cent discount on CGT to new dwellings". It begins with a howler:

A general principle of good taxation policy is that it should not favour particular investment classes.... Limiting negative gearing to new dwellings will only add a distortion.

If the "general principle" were always true, it would rule out exemptions or discounts for capital gains, which would favour "particular investment classes" whose expected returns are disproportionately in the form of capital gains — such as residential property!

But of course there is an overriding general principle, namely that the tax system should not reduce production. Loss of production is the real meaning of "distortion". If favouring "particular investment classes" reduces the loss of production, so be it! In view of the nexus between income and production, income tax by its very nature is highly distorting. But if the income-tax system favours productive activities, such as construction, over unproductive ones, such as speculation on existing assets, the distortion is reduced.

The two sentences omitted from the above quote are also revealing. Here's the first:

The broad intent of limiting the use of negative gearing in residential property investment to new dwellings would be to channel tax benefits to investment that increases the stock of housing and reduce purchases of existing houses that is thought to raise dwelling prices.

Only "thought" to raise prices? If you have more buyers for the same stock, what can they do except raise prices? The quote continues:

However, as noted in Section 3.4, already around one third of loans for the construction of new housing are by investors.

And this is trumpeted as a good thing. So why is it suddenly a bad thing to encourage more of the same?

Now let us see how the authors define the proposal that they are trying to discredit:

...defining 'new' properties to include the vacant residential lots...

Note the bait-and-switch: The title of the section refers (correctly) to new dwellings, not new properties. A vacant residential lot is not a new dwelling! Moreover, if you want to claim negative gearing on a residential property under the current regime, you need to claim that the property is rented or available for rent. That could be difficult if the property doesn't include a dwelling! The purpose of limiting negative gearing to new dwellings is to increase the incentive to build. Allowing negative gearing for vacant lots would reduce it. That's not the proposal.

Next, given that "only 7 per cent of property investor housing finance is committed to the construction of new dwellings," the authors calculate that the proposal would reduce tax deductions by about $1 billion per annum if it produced no change in the behaviour of investors, but that the impact would be reduced if some investors shifted their attention to new properties. Fair enough. But now prepare for a more subtle bait-and-switch, leading to an unsubtly absurd conclusion.

If a large proportion of negatively geared investors do not shift to purchasing new dwellings or there is insufficient new stock available in future years to accommodate the shift of investors from existing to new dwellings, the main effect would be to impose an increase in the taxation of savings invested in residential property.

But the point of the proposal is that the increase in taxation would not apply to new dwellings. If that induces only a few investors to switch their attention to new dwellings, or if there is not enough supply-side response to satisfy those who do, that means the increase in construction will be smaller than you think. It doesn't mean construction of rental housing will fall, let alone dry up altogether. Yet the authors immediately include:

The implications of this tax proposal could stop new investment into residential property.

What orifice did they pull that out of?

Moreover, the anecdotal evidence strongly suggests that negative-gearers who switch their attention to new dwellings will not have any trouble finding enough off-the-plan suppliers. Foreign residents who invest in Australian housing are supposed to buy or build new dwellings. This requirement — which is widely discussed in the media, but conveniently not mentioned in the report — has led to an explosion of high-rise apartments in the CBDs of large Australian cities and in inner-suburban hubs such as Chatswood and South Yarra.

So much for the authors' suggestion that "property investment would be skewed to outer suburbs where employment opportunities are scarce and where transport infrastructure is poor." But before that, they claim:

Furthermore, limiting negative gearing and the 50 per cent CGT to new dwellings would be a negative shock to the market which would likely result in upward pressure in prices.

A negative shock to which side of the market? It can't be the supply side, because skewing investment towards new homes increases supply. And a negative shock to the demand side *reduces* prices!

Subsection 5.5.4 begins by glossing over the fact that investors who exit the market, rather than switch their attention to new homes, will exit the market for *established* homes because that is the market segment in which taxation of future investors will increase. And as many established homes as are consequently *not* bought by investors will directly or indirectly turn tenant households into owner-occupant households. This will reduce the demand for rental homes by as much as it reduces the supply of *established* rental homes. Meanwhile, those investors who switch their attention to new homes will cause an *increase* in the supply of *new* rental homes, with no further increase in demand from renters.

Then the authors complain that switching investors towards new homes would have investors competing with prospective owner-occupants for new homes. Funny how they have no such scruples about similar competition in the market for established homes! Meanwhile the Real Estate Institutes in the various states and territories complain about the recent trend of restricting first home owners' grants to new homes, on the ground that most first home buyers prefer established homes. So it seems that the property lobby doesn't want *anyone* driving construction of new homes — not investors, and not owner-occupants.

Limiting negative gearing and/or the CGT discount to new homes would switch investment to new homes. For this reason, the authors conclude that the proposal would raise prices for new homes. That much may well be true. It's also an admission of what the authors are otherwise at pains to deny: that negative gearing raises prices! But for the same reason, any increase in prices of new homes would be offset by a reduction in prices for *established* homes. Furthermore, upward pressure on prices of new homes due to demand from negative-gearers would be partially offset by the supply-side response. Thus the overall impact on prices, taking into account both new and established homes, would be *downward*.

The authors conveniently ignore the supply-side response when they claim that the reduced investment demand for established homes and the higher owner-occupation demand for established homes (due to competition from investors for new homes) would be "likely to be in balance over the national marketplace". No they wouldn't, because some of the extra new homes bought by investors would be homes that would not otherwise be built — not homes from which prospective owner-occupants would be displaced. Consequently, if there were any "widespread and enduring displacement of the opportunity for first home buyers to actually own a new dwelling", it would be more than offset by the new opportunity to buy an established dwelling — which most first home buyers prefer!

Subsection 5.5.5 begins:

In summary, removing negative gearing and the 50 per cent discount on CGT for investment in existing residential property would probably increase investor demand for new dwellings, displace owner occupier buyers and stall further investment in established dwellings. If new housing supply is weak, higher rents and higher new dwelling prices would be expected.

Now that's a bit sleazy, because this subsection is headed "Summary", but the body of text that it purports to summarize does not mention higher rents. In the context, if "new housing supply" is weak, that means the *increase* in supply due to investors switching to new homes is small. It doesn't mean a *decrease* in supply. Consequently, it doesn't mean higher rents.

The "summary" that's not a summary leads to a "conclusion" that's a non sequitur:

Limiting negative gearing and the 50 per cent discount on CGT to new dwellings would be bad policy. It risks stalling investment in existing property and higher rents.

In reality, "stalling investment in existing property" does not increase rents, because "investment in existing property" (a macro-economic contradiction in terms) does not reduce rents; it merely turns owner-occupied homes into rented homes and throws an equal number of owner-occupant households onto the rental market, with no effect on rents. Meanwhile, switching investors' attention to new homes would induce a supply-side response, leading to higher supply and *lower* rents.

That of course is precisely what the property lobby is afraid of. But in its efforts to avoid that outcome, it must pretend to be afraid of the opposite.