The Role of the Taxation System in Australia Having the Biggest Housing Bubble in the World and a Framework for Affordable Housing for ALL Australians

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Summary

The housing affordability crisis is one of the most significant challenges facing our society and economy at present. A major factor in causing the crisis and the associated housing bubble are the market distorting taxation policies which promote speculative activity in Australia's housing market by small scale investors.

Through the current housing price bubble: 1) Australians have over-invested in housing by paying more and more for the same existing dwellings, 2) this has been to the detriment of lower income Australians and has caused an increase in the gap between the "haves" and "have-nots" in our once proudly egalitarian society, 3) most thinking Australians without vested interests, and particularly young Australians, know that perhaps the greatest factor in stimulating demand was taxation "incentives" for property investors, 4) the bursting of this once in a lifetime house price bubble is inevitable, even though Governments may attempt to prevent this from happening by adding even greater distortions at great cost to taxpayers, and 5) the long term repercussions for our society and economy will be serious.

Some will say that housing booms, or even bubbles, occur from time to time, and the market will eventually rationalise as it always does. However, this misses the point that each and every boom – or bubble – places extreme and unnecessary stress on young and old Australians, and working families.

What is more, this current bubble is so extreme that it now appears that our political leaders have much vested in attempting to put a floor under massively inflated prices. If they manage to do so – as unlikely as that seems – it will come at extreme cost to Australian society and the long term competitiveness of the Australian economy.

The overlying conclusion of this submission is that Australians would benefit greatly – in the form of much more stable housing markets – if the rental accommodation industry were structured so that large scale investors replaced small scale investors – who rely overly on capital gains – as the dominant segment. To do this, the entire Government policy framework surrounding residential housing must be restructured. (This process commenced with the introduction of National Rental Affordability Scheme.) Taxation policies which have over-stimulated investor and speculator demand must be eliminated and a raft of other policy initiatives – some unrelated to taxation, but necessarily mentioned herein – must also be initiated.

The specific recommendations are these:

<u>Recommendation 1</u>: Taxation laws should be reinterpreted or modified to prevent negative gearing – if not on all investments, then specifically on residential property recognising its unique status in our society as our homes and a basic necessity.

Recommendation 2: Full capital gains tax should be reinstated on investment income – if not on all investments, then specifically on residential property recognising its unique status in our society as our homes and a basic necessity.

Recommendation 3: Self managed superannuation funds should be precluded from borrowing to invest directly in residential property.

Recommendation 4: Governments, and their agencies, should further encourage large scale investment in residential housing. In regards to taxation, this will involve investigating ways to create incentives for this to occur, perhaps on a temporary basis, which will ultimately benefit all Australians through stable rental prices and stable returns within superannuation accounts.

Recommendation 5: The burden of land development charges and taxes for infrastructure should be removed from new developments and borne by the entire community.

Recommendation 6: State governments should fund the construction of significantly more government and community housing.

Recommendation 7: Federal, State and Local Governments should work to expedite land release and reduce processing times.

Recommendation 8: The Federal Government should instigate a review into the operation of the realestate industry, particularly over the last decade through this long property bubble, to provide confidence to the community that it is running optimally to serve the community (a la the petrol and groceries reviews).

Recommendation 9: The Federal Government should extend competition policy to the realestate industry and restructure it so that no business can both let residential realestate and sell it so that competition in the provision of housing is increased (as an adjunct to the general restructuring involved in the move towards large scale investors being the dominant provider of residential rental property).

This restructuring would require political courage. However, the socio-economic benefits to Australians are enormous, especially young and old Australians, and working families, and they absolutely justify the means. The untenable alternative is to allow this opportunity for real reform to pass only to witness further suffering, especially by these groups of Australians, again and again in the future.

Introduction

The following poignant quotes form the basis of my views on the affects of the tax system on Australia's housing markets and their impacts an Australians. The first is from Adam Smith, the father of free markets and modern economics:

> "A dwelling house, as such, contributes nothing to the revenue of its inhabitant…….. It cannot yield any to the public, nor serve any function of a capital, and the revenue of the whole body of people can never be in the smallest degree increased by it" (Taken from PJ O'Rourke 2007)

In an address to the 2008 Economic and Social Outlook Conference on the 27th of March 2008, Anthony Richards, Head of Economic Analysis Department of the Reserve Bank of Australia (RBA), said (Richards 2008):

> "Both home ownership and ownership of rental property tend to rise with incomes (Graph 2), so it is lower income households that tend to <u>suffer</u> [my emphasis] from rising housing prices and higher income households that tend to gain"

Alan Bollard, the Governor of the Reserve Bank of New Zealand, said on Radio New Zealand on the 5th of August 2008 regarding their (very similar) situation with regard to taxation on housing:

> "We need to have domestic policy in a way that it doesn't mean it's advantageous from a tax point of view for people to pile money into housing… monetary policy can only work in a reasonably neutral environment, not one where there's other incentives on people to get into housing."

All three award winning essays in the RBA Economics Competition 2008, which addressed the trends in housing costs and affordability in Australia over the past two decades and the role of government in improving housing affordability, highlighted the role of taxation incentives in causing Australia's current low level of housing affordability.

Burns (2008) stated:

> "Short term factors encouraging these price hikes are lower real interest rates and an easier access to credit as well as a tax system which encourages debt-financed property investment with incentives to purchase additional homes (see Figure 3). Greater investment in property and speculative activity stimulated by negative gearing and capital gains tax concessions has led to the inflation of housing prices and the creation of a 'housing bubble' (Australian Council of Social Service 2003, 4)."

And Thrift (2008) made the following policy recommendation:

> It has been estimated that the tax breaks given to investors by capital gains tax arrangements, land tax exemption and negative gearing is $50 billion per year.[23] An end to these arrangements would control demand from investors and significantly reduce house prices. This would also be an efficient option, as the market would not be distorted by the government giving tax breaks to only one group of buyers.

Finally, billionaire US investor made the following observations on CNBC Squawkbox on the 7th of March 2008 which gives an indication of the pragmatism of national housing policy relying heavily on small scale investors:

> "I was in England about two weeks ago, and my take of the housing market there is that it is in at least as bad a shambles as what we have in the United States. They had an activity there called "build to let" where little people, not real realestate professionals, but average citizens were building houses, highly leveraged, on speck, with the idea of renting them out. And I don't think that realestate is a very good game to play "Amateur Hour". And it's now coming back to haunt them."

Of course the sequence of the quotes is both intentional and telling. They spell out my contention that: 1) Australians have over-invested in housing by paying more and more for the same existing dwellings, 2) that this has been to the detriment of lower income Australians and has caused an increase in the gap between the "haves" and "have-nots" in our once proudly egalitarian society, 3) that most thinking Australians without vested interests, and particularly young Australians, know that perhaps the greatest factor in stimulating demand was taxation "incentives" for property investors, 4) the bursting of this once in a lifetime house price bubble is inevitable, even though Governments may attempt to prevent this from happening by adding even greater distortions at great cost to taxpayers, and 5) the long term repercussions for our society and economy will be serious.

It is just as important – perhaps more important – to apply the common sense test. What does the average person on the street think? And there can be no doubt that the view from the street is that we've had an enormous housing bubble driven by speculation in house prices, that the rich have gotten richer while the poor are increasingly becoming homeless because they can't afford rents, and the saturation advertising over the last few years tells them that the tax system has had a lot to do with property investing hype (See Figure 1 for an example).

As I said in my testimony quoted in the final report of the Senate Select Committee on Housing Affordability (2008):

> "Houses are being valued as speculative assets, not as homes for Australians anymore"

The quotes stated above, and especially the calibre of people behind them, argue my views far better than I could in my own words. So I will keep my comments on the current situation brief, instead concentrating on the impact of the housing bubble on Australians and the best way forward from where we are today.

Over the next few pages I will provide some findings from my own research showing the degree of speculation in housing, briefly point to the problems within the tax system that have contributed to Australia having the biggest housing bubble in the Anglophone world, briefly outline its impact on my family and expand that to the wider Australian community, and I will suggest a framework for a more balanced treatment of housing taxation within a wider Federal government policy mix.

Figure 1 - Typical advertisement promoting a negative gearing strategy, this one from “b Magazine” 08 April 2008 (and is still running as at October 2008). Note the text within the circled area.

Speculation in Australian housing

Now that house prices have declined significantly in the US and the UK, it is widely stated that both countries experienced spectacular housing bubbles along with most others in the developed world.

That Australia has similarly experienced a massive housing bubble is perhaps not as widely acknowledged – yet – is due to our market, on a national basis, peaking more recently at March 2008. However, by many measures of value, our house prices were more overpriced than any other developed country through the global house price bubble. This is borne out in the graph from Richards (2008) of the RBA (Figure 2).

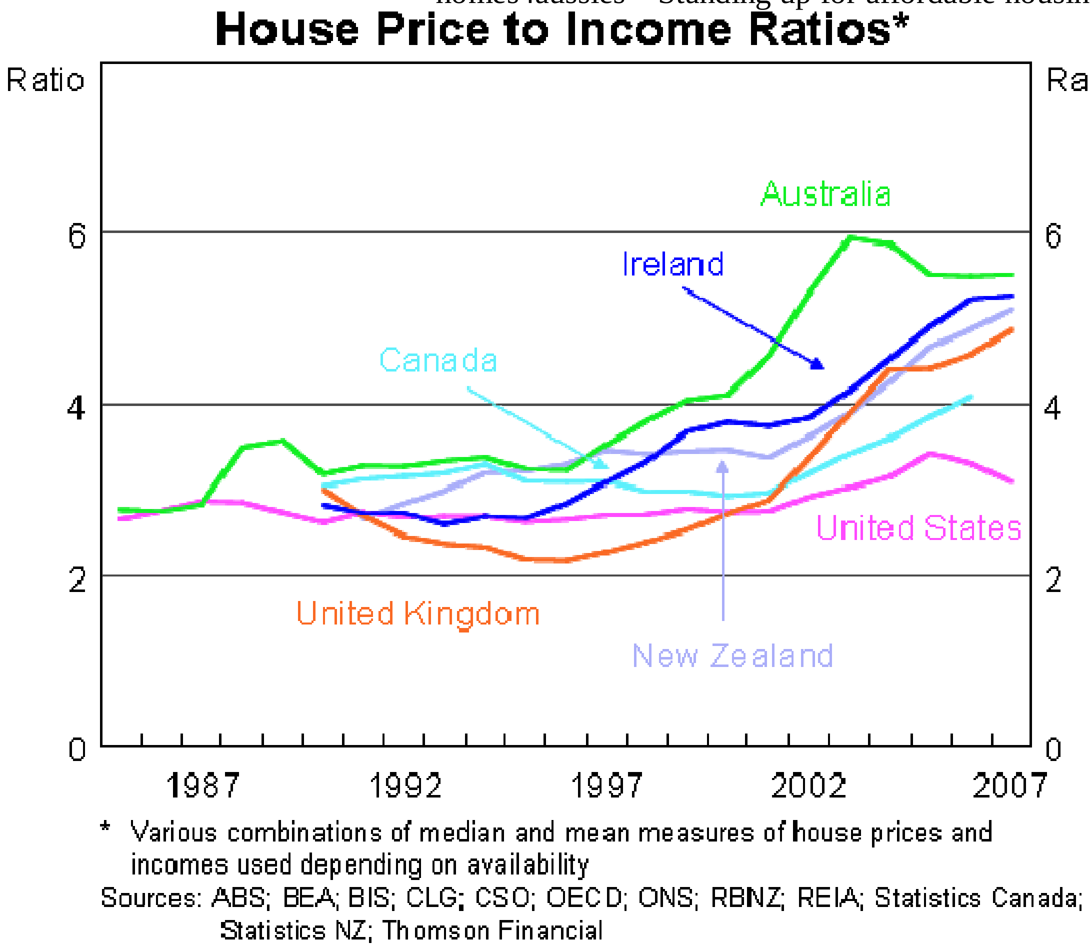

Figure 2 – Graph of the house price to income ratios for the Anglophone countries. (Reproduced from Richards 2008)

It is universally accepted that the relative synchronicity of the global house price bubble suggests that there are causes common to all countries. Most highlight the role of abundant cheap credit emanating from credit markets, particularly those in the US.

However, it is noteworthy that Australia has consistently had the most expensive houses – as a ratio of house price to income – among the Anglophone countries shown in Figure 2.

It is also important to note that, although it is universally agreed that the US housing market experienced a massive bubble, the ratio of house price to income "only" reached 3.5 – about half of Australia's peak in the ratio – and with house price declines there the ratio had fallen back close to 3 at the end of 2007. Moreover, this graph is now somewhat dated and it does not capture the fall in house prices witnessed in most of the other countries.

There must be some characteristics peculiar to our society – our system – that has caused Australia to consistently have the highest priced houses in the Anglophone world. And the economics students who won prizes in the RBA economics competition all pointed to one of the greatest factors – our taxation system which encourages speculation in housing, and has done so for decades.

My own research gives some indications of the sheer level of speculation in Australian housing markets (Appendix 1). Briefly, the anatomy of Australia's housing bubble shows that it began around 1999-2000 – both the introduction of the capital gains tax (CGT) concessions and the First Home Owners Grant (FHOG) played significant roles in its genesis – in Sydney and Melbourne. The rapid build up in house prices in our two largest cities, together with the 50% reduction in CGT payable on investment properties owned for 12 months or more, and the maintenance of the negative gearing provisions, encouraged the benefactors of those price rises to borrow against the increased equity in order to buy investment properties. They moved westward in Sydney, and further a field to the other eastern capitals (See Figure 3 for two examples of Australian capital city house price growth). This ignited markets that had been stable for nearly a decade. On the ground in Brisbane in early 2003, it was common to see at open houses "Sydneysiders" who had flown in for the weekend to buy a property going around in taxis. But, clearly "locals" were quick to join the speculative frenzy, and first home buyers were faced with the unenviable decision of jumping in at already expensive levels or risk delaying buying a home by many, many years.

By late 2003 the RBA had managed to "lean against the bubble" and slow house price growth in the eastern capitals. However, just as the slow down was occurring in the eastern states, the effects of the massive boost to the terms of trade began to be felt and the bubble spread to Perth and Darwin. By 2006 there were newspaper reports of companies chartering aircraft to take speculators to Perth for the weekend to buy property!

The property speculation bug then reignited in the other eastern capitals, with the exception of Sydney and Melbourne where, due to their more mature bubbles, mortgage stress combined with an inability to refinance due to slower price growth, and even price falls, resulted in a lowering of irrational exuberance in those markets. The Perth house price bubble stopped inflating when the sheer absurdity could no longer be ignored by speculators that, if prices continued to rise at the same relative rates, it would very soon have the most expensive houses in Australia! The final stage of the bubble was marked by newspaper reports of companies chartering aircraft to fly Perth-based speculators to the eastern capitals to purchase property. Again, at Brisbane open houses in 2007 I personally talked with several speculators from Perth who had flown in to invest in residential property over the weekend.

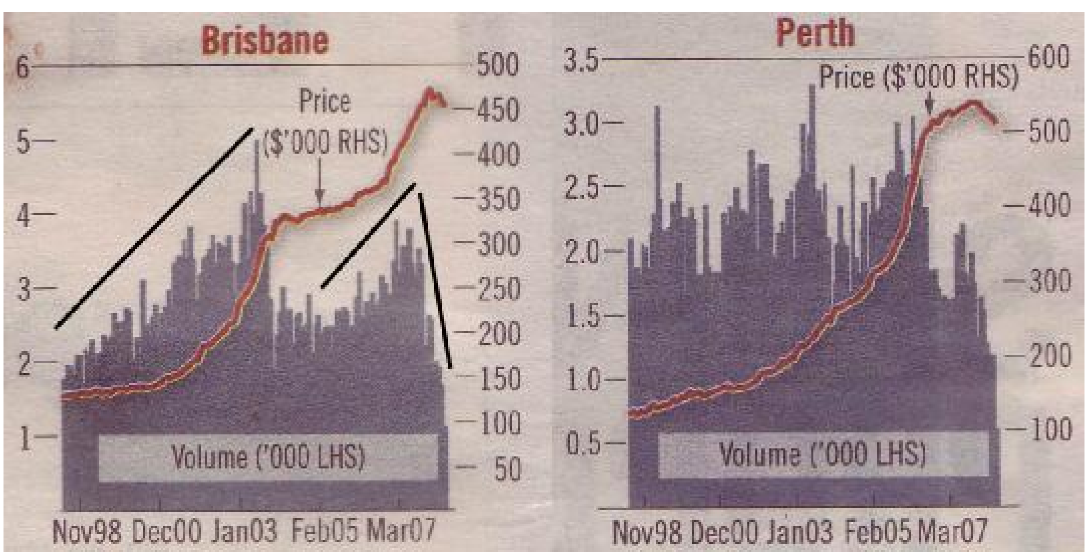

Figure 3 – Graphs of Perth and Brisbane house prices and volumes of sales. (Extracted and modified from page 20 of The Weekend Australian Financial Review on September 6-7, 2008.) Note that the bubble in Brisbane occurred in two distinct phases of rapid house price growth accompanied by significant peaks in buyer activity, whilst the Perth bubble occurred in one phase.

By late 2007 market participants were being buffeted with negative feedback loops from many directions – western Sydney house price declines, together with those emanating from the US housing bubble collapse, then the UK's early stage collapsing market, and the Perth market looking fragile. It could also be argued that the RBA was behind the curve on interest rate rises in the final term of the Howard government, with the catch-up in the first stages of Rudd government acting as a "circuit breaker" in housing markets. But the continual recording of a record low in first home buyer affordability, together with low rental yields, played at least an equal part in ending the housing bubble.

In other words, the irrational exuberance which pushed Australian house prices to ridiculous levels sewed the seeds for the bursting of the bubble. But that was not before prices had gotten to around 8 times average earnings on a national basis. The FHOG of course played a role in establishing the bubble. However, by 2007 very, very few young Australians could afford to buy a home because the risk of not being able to meet repayments on their consequently large mortgages was extreme if indeed they could borrow sufficient funds in what was still an easy credit environment.

The taxation incentives to investors have acted as a massive distortion in our housing markets. The resultant piling in of money into housing, using the words of New Zealand's Reserve Bank Governor, has maintained a speculative premium in our house prices. Keen (2007) showed elegantly that much of this "pile of money" was borrowed, and that much of it went to paying more and more for existing housing.

The taxation incentives to investors have acted as a massive distortion in our housing markets. The resultant piling in of money into housing, using the words of New Zealand's Reserve Bank Governor, has maintained a speculative premium in our house prices. Keen (2007) showed elegantly that much of this "pile of money" was borrowed, and that much of it went to paying more and more for existing housing.

Moreover, with the words of Adam Smith ringing in our ears, we can be certain that we have built up these IOUs to the rest of the world for virtually nothing – it was completely unproductive use of capital for the country and for the individuals that paid the high prices.

And Wilbur Ross kindly gave us a glimpse of what will be the end result.

Clearly, housing bubbles are of no benefit to Australian society, and to the extent that our taxation system encourages their formation, Australians would benefit greatly from the removal of these massive distortions.

How the housing affordability crisis has affected our one income family and other Australian families

I have written to my local State and Federal Members, including Prime Minister Mr Rudd in his capacity as the sitting member where my realestate agency (that manages the property in which I live) is domiciled (Appendix 2), and to the Treasurer Mr Wayne Swan (Appendix 3) to explain how the housing affordability crisis has impacted my family, to express my support for some of their planned policies which are in the process of being implemented, and to suggest significant additional measures that I strongly view as being necessary if a timely resolution to the crisis is to be achieved.

At the Federal level of I have received a response from the Office of the Treasurer (Appendix 4).

In the copies of my letters that I provide herein I have removed personal details. Instead I will briefly outline the impacts of the crisis on my family which consists of my wife and I, my 3.5 year old son, and a Christmas baby on the way.

I am 38, an ex-scientist (Ph.D. and work experience with QDPI, policy development in AQIS, and a number of overseas positions) and now stay at home dad to a my little boy. My wife is an accountant with 15 years experience. We did not purchase a house in the late 90's because we planned to work overseas for an extended period to advance my scientific career and contribute to mankind's understanding in my field. For personal reasons, we cut that period short by a number of years and returned to Australia in 2003. I remained unemployed, but worked as an associate through UQ for around 12 months attempting to gain employment or funding to continue my research. We had delayed starting a family for my career, but time was getting away – so when my wife fell pregnant in 2004, I gave up on my scientific career and prepared to be a stay at home dad. Based on the development of the housing bubble, we were going to need maximum income if we were to ever purchase our own home – and my wife's earning capacity was already significantly above mine with the gap sure to grow.

By mid-2007 it was clear that the bubble had taken prices beyond all levels of rationality. Even though we could easily qualify for a loan, we felt that it was an extremely unwise decision from a financial perspective. So we continued with our savings program with the view that over time house prices relative to wages would correct downwards to their long-term trend, as long as governments did not enact policies which further distorted housing markets in an attempt to place a floor under prices.

Our savings ability was dealt a very, very serious blow in January 2008 when our rent was raised 20%, by $260 per month! Then 6 months later it was increased again. Our annual increase amounted to an increase of over 31%, or $100 a week!! Our rent now consumes one-third of our disposable income.

But I know only too well that we are in a very fortunate position compared to other Australian families. The media is increasingly reporting the disadvantage now in our community as a direct result of the housing affordability crisis.

To highlight this, I will mention the details of a particularly sad story of one Australian family as published in The Courier Mail on 13 October 2008 on page 5 (Figure 4). Sara Hughes is a single mother of a 10 year old daughter. She receives a disability pension and is caring for a terminally ill relative. Over two years her rent has been increased by a staggering 67%. It is particularly pertinent to mention that Sara did not have any choice in these matters – she did not take a decision to borrow above sensible levels. She is merely attempting to provide a safe environment for her daughter – a roof over their heads - a necessity.

That people are being placed in this situation after 18 years of unbroken economic growth, when $billions were given to "investors" each year supposedly encouraging them to provide rental housing, but instead was used to gamble on further house price increases and inflating the housing bubble, is a disgrace!

Others families in our society are more fortunate and can more easily afford the basic need of housing. Some, like my own, are comfortable enough to be able to afford an extended period of absence of one parent from the workforce to parent their child(ren). It saddens me greatly that many parents are stating in the media that housing costs are forcing them to work more than they intended. In some cases this is due to their decision to overpay for a home during the bubble. But either way, the end result is that many families are spending significantly less time together – they are compromising family life to provide housing.

I feel certain that Australian children and society will pay a high price for the new millennium Australian housing bubble. Moreover, the reprioritisation of financial matters above career and societal contribution made necessary by the skyrocketing cost of housing is sure to have seriously negatively impacts on our society.

Short on money but big on love

IN two years, the rent on Sara Hughes' two-bedroom Yeronga unit has risen from $195 to $325 a week.

At best, that leaves the disability pensioner, who has a 10-year-old daughter, just $125 a week for electricity, groceries, mobile phone and school fees.

Ms Hughes, who is unable to work because of her health and the need to care for a terminally-ill close relative, has disconnected her home phone and can't even consider running a car. Clothes come from charity stores. "It's impossible technically (to survive on this amount)."

But the 34-year-old still considers herself lucky.

"A lot of people don't have family or friends to turn to when they're desperate, we're pretty lucky in that regard," Ms Hughes said.

"If it weren't for them, for this year, we would have been knocking on the door of Vinnies for some regular assistance."

Ms Hughes said moving house was not an option because of high rents – and even if something was available, she would have to get a loan to afford to move.

"Really the money is entirely accounted for every week, and it's pretty much gone as soon as it's paid.

Ms Hughes, who volunteers at Lifeline and hopes to study psychology, said there was no point focusing on the negative.

"It's at these times you can't afford to be down or dispirited, it's when you're in that situation that you've just got to keep going."

Leanne Edmistone

Figure 4 – An article from The Courier Mail dated 13 October 2008 (page 5)

The specific problems with the taxation system relating to housing

Given the number of submissions to past government inquiries into housing, I am certain you will receive many detailed submissions which unequivocally show that the taxation incentives on housing – which George Megalogenis writing in the Weekend Australian on 17 March 2008 called the "Property Tax Rort" – provide investors with significantly more purchasing power which results in first home buyers being priced out of the market.

Moreover, these incentives provide a convenient marketing tool used by property spruikers to ramp up speculator activity (as seen in Figure 1).

Another incentive which has largely remained "under the radar" of many was the adjustment in 2007 to rules for self-managed superannuation funds allowing them to borrow to invest in assets including property. This too runs the risk of boosting demand for investment in residential housing further from small scale investors.

All of these measures assist generally higher income Australians to invest and speculate in residential housing – because they are the ones with the disposable income and tax obligations to make it worthwhile – creating artificial demand for housing which denies young and lower income Australians the opportunity of home ownership. Moreover, as is now evident in the post-bubble environment, small scale investors' desire to increase operating revenue in the absence of capital gain is causing rents to skyrocket.

I was concerned by one element of the response to my letter that I received from the Department of the Treasurer. Instead of just pointing out that this review on taxation was taking place – which had not been announced 7 months earlier when I wrote to the Treasurer – and suggesting that I make representation to it, the letter sets out over 2 paragraphs a justification for continuing the negative gearing provisions relating to housing. (And this approach varies from the mention of the CGT concessions which is the point at which this review is mentioned.)

This is clumsily written because it suggests that, politically, this government has drawn a line under negative gearing. It suggests to me that regardless of what this review recommends, the government intends to maintain negative gearing on residential property investment.

I mention this specifically because this review of taxation provides an opportunity to argue against the one and only point that was made to justify the maintenance of negative gearing – that removing the provisions would be to "discriminate by treating investment in property differently to investments in other assets, for example shares."

For me – and I suspect the average person on the street – the answer is very simple. Residential housing IS DIFFERENT TO OTHER ASSETS. They are our homes! You cannot live in your shares (or bonds), or even the underlying companies. You will not raise your children in them and your family will not return to your shares each Sunday to enjoy being together and to pass on family values. Housing clearly is different to other investments and should be treated as such, including in the tax system. Then housing would be priced according to its intrinsic value as a home, not as casino chips, and a reasonable rental yield would be a fair return for a stable and secure long term investment.

What's more, that it is different to other investments is already reflected in the tax laws – the income from selling your own home is not taxed!

If my analysis of the letter is correct, and if the Government were to continue with that approach, the consequences to young and future generations of Australians will be severe. It will maintain the speculative premium in Australian house prices. Moreover, recent developments with the global financial crisis – including the use of Future Fund resources, the purchase of (announced to this point) $8 billion of residential mortgage backed securities, and the extension of RBA activities to accept more risky assets as collateral in repo agreements – all of which is aimed at keeping interest rates low to protect overleveraged borrowers, and ultimately overpriced assets, adds to my concerns. So too does the increases to the FHOG which has the aim of stimulating demand and attempting to put a floor under prices, not of improving affordability.

Maintaining policies that inflate house prices, and adding new policies which support prices at inflated levels, will result in declining home ownership in Australia. And the wellbeing of Australians will be impacted because renting in Australia is more stressful and less secure than in other countries. Because house prices remain high, the majority of young Australians that purchase a home take on very significant financial risk and families' lives are certain to continue to suffer.

At this stage it is important to consider the effects and the likely movement in Australian house prices in the foreseeable future within the taxation and policy frameworks that are currently in existence. In doing so I will draw heavily on a research paper published on my website and reproduced at Appendix 5.

I developed two forecasts of Brisbane house prices – which herein can be extrapolated loosely to apply to most Australian markets in general, with the probable exception of western Sydney - based on these two scenarios:

1) negative gearing and CGT concessions are ceased in early 2011; the first home savers accounts (FHSA) are successful in attracting a high proportion of first home buyers, thus decreasing their demand until late 2012 when there is a surge in demand as the first participants gain access to their funds; Federal and state governments' plans to increase supply of housing succeed; and
2) investors continue to receive significant taxation concessions which continue to be funnelled into established houses, rather than new dwellings, especially in the lead up to the first participants of the FHSA gaining access to funds; the FHSA initially attracts many first home buyers, thus decreasing their demand until late 2012 when there is a surge in demand as the first participants gain access to their funds; Federal and state governments plans to increase supply of housing succeed.

In the first scenario, the forecast was for house prices to decline to trough at September 2011 at 30% below the 2008 market peak. Markets then form solid bases there over several quarters, and with the increase in demand from first home buyers, prices begin to rise in late 2012/early 2013. Price rises are roughly inline with inflation from 2013 out to the end of the modelling period at March 2016.

In the second scenario, house prices once again trough at September 2011 at 30% below the 2008 peak. However, with the property investor taxation concessions still in place and promoting speculation in housing, investors begin to position themselves to take advantage of the surge in demand from the FHSA participants gaining access to their funds. This surge in demand initially from investors results in house prices quickly moving off their trough in late 2011/early 2012 and accelerating upward through mid 2012. By late 2012, when the first FHSA holders hit the market, house prices are already well above their trough prices (around $70,000 increases in most capital cities). Some FHSA holders decide to buy, others decide not to, but the feedback loop has been reignited to a slight degree by the price gains, so more speculators come into the market further driving up prices. However, the ability of spruikers to build moment in the market is hampered by the coexistence of negative feedback loops from the most recent price declines. In other words, spruikers are unable to re-entrench the myth that "house prices never fall". Through mid 2013 it becomes apparent that first home buyers are still not entering the market due to poor affordability, so the mini price boom is short lived and it peaks at September 2013 at a price below the 2008 peak but well above the 2011 trough. Affordability continues to be a major issue for first home buyers; some make use of FHSAs, many do not. The mini price boom deflates out to March 2016 to finish at the same median price as in the first scenario.

This paper was written before the intensification of the financial market turbulence, and more significantly, the consequent additional market distortions that the government has introduced. These include the $4+4 (and more?) billion made available to the Australian Office of Financial Management to purchase new residential backed mortgage securities, and the appalling policy to double the FHOG (yet again) to $14,000 for existing homes. (To the extent that the $21,000 FHOG on new homes keeps their price elevated, it is also bad policy – if there was a condition that construction must be commenced after 14 October would improve it slightly by ensuring an addition to supply.) Therefore, the quantum of decline in the market from 2008 to 2011 is in question.

One thing is certain irrespective of what happens with house prices up until 2011. If the taxation framework allowing negative gearing and the CGT remains, **young Australians that make use of the FHSAs will not benefit from their hard earned savings and the government co-contribution – instead "investors" will reap a windfall through house price gains from 2011 levels!**

As mentioned earlier, Australia has consistently had the most expensive houses in the Anglophone world. However, house prices are now declining rapidly in most other countries. In the US prices have decreased to the point where, at a national level, housing can almost be considered affordable at a house price to earnings ratio of three.

If Australian house prices remain artificially and unaffordably high, there will also be significant effects on the international competitiveness of our economy. A small economy with the most expensive housing in the developed world is not going to be a particularly attractive proposition to the pool of mobile skilled workers being courted by all and sundry in the global economy.

This factor is constantly raised in the debate over developing a competitive income tax regime. Clearly, it is at least of equal relevance when it comes to living expenses, principally housing costs.

Clearly, the consequences of maintaining a policy framework – including a taxation regime – which promotes speculation in housing, thus inflated house prices, will be severe for Australians at an individual and national level going forward. Thus it is paramount that the framework be restructured.

Towards a more balanced framework for housing emphasising the role of taxation

Balance must be reintroduced to Australia's housing markets by decreasing the utility of residential property – homes – as speculative assets. This will involve a significant restructuring of the rental market so that large scale investors, such as superannuation funds, become the major providers of rental housing, and the involvement of small scale investors is minimised. (See Appendix 6 for a personal perspective on renting in a system dominated by large scale investors.)

Critically, this would not have the affect of reducing diversification choices in Australian investment opportunities. On the contrary, it would open the asset class up to many, many more Australians because every Australian with a superannuation account would have the opportunity to invest in residential property.

Such a restructuring would involve a major restructuring of the taxation system since the distortions within it have had a major role in getting us to this situation. However, it will necessary to undertake a much broader adjustment to policy frameworks. Therefore, it is necessary to loosely sketch out that broad framework that I propose.

Firstly, I support the Government's National Affordable Rental Scheme. This is an important first step in increasing the involvement of large scale investors in the Australian residential housing market. I indicated my support for the scheme in my submission to the Senate Committee reviewing the scheme following their invitation to comment. My one concern is that the scheme is not sufficiently ambitious. It is an absolute crying shame that Australians are struggling, some becoming homeless, because they can not afford rental increases, and the Government is holding back on the funding of the construction of affordable rental accommodation when keen businesses “over-subscribed” to the scheme by 200%. We need those homes, we need them now, and it is great that business wants to build affordable rental accommodation!

The Government encouraging large scale investment in residential housing is commendable. It is to be hoped that all Government departments, and the State and Local Governments, work feverishly to facilitate more large scale investment in residential housing.

At the same time, the market distorting factors which have encouraged rampant speculation in residential housing by small scale investors need to be eliminated.

Moderate investor demand and eliminate speculator demand for residential property

Negative gearing should be abolished. In actual fact, I understand that it is a common view amongst accountants that negative gearing could be abolished without a change in tax law. They suggest that the premise of negative gearing is contradictory to the intention of the rules surrounding earnings in that negative gearing strategies are established with the intention of making a loss. Generally within the taxation system, a loss can only be claimed if the endeavour which resulted in the loss was established with a view to making a profit. Negative gearing strategies, as the one shown in Figure 1 clearly demonstrates, are established with the express intention of continually making a loss over many years in order to claim that loss against other incomes.

So the concept of negative gearing is at odds with the spirit of the tax rules surrounding earnings, and it could be eliminated immediately if the Australian Tax Office chose to interpret the rules accordingly.

If, in fact, this is not legally correct, then the taxation laws need to be altered to ensure consistency in this regard.

Recommendation 1: Taxation laws should be reinterpreted or modified to prevent negative gearing – if not on all investments, then specifically on residential property recognising its unique status in our society as our homes and a basic necessity.

The introduction of the capital gains tax concessions in 1999 coincided with the rapid escalation of investor and speculator activity in residential property. This demand was a major factor in Australia having the largest housing bubbles amongst developed countries.

Recommendation 2: Full capital gains tax should be reinstated on investment income – if not on all investments, then specifically on residential property recognising its unique status in our society as our homes and a basic necessity.

The change to the superannuation rules to allow self managed funds to borrow to invest in assets including residential property has the potential to significantly add to small scale investor demand. This may be especially true at times of stockmarket declines like we are currently experiencing. As such I consider it poor policy.

I understand that the specific rules are outside of the terms of reference for this review. Nonetheless, it is necessary to include this recommendation as it relates to the entire policy framework that I am presenting.

Recommendation 3: Self managed superannuation funds should be precluded from borrowing to invest directly in residential property.

These distortions have been major causes of the housing affordability crisis. Because distortions largely caused the crisis, I would suggest that altering those distortions to help solve the crisis, as a preliminary phase towards their complete removal, might be of significant benefit to Australians. If such a policy were adopted, all of these investor incentives could be maintained for a defined period – perhaps 5 years – strictly on newly constructed residential property, not on existing residential property, to assist in the provision of more rental housing.

Increase large scale investor involvement in residential property

As stated earlier, the National Rental Affordability Scheme is a good start. I note that the government received three times the number of applications as the number of grants available in its first year. Clearly large scale investors are very interested. It is somewhat disappointing that, at a time when Australians are under unprecedented pressure from rental increases causing some to become homeless, and when there are many large scale investors wanting to build affordable housing, that the government is not fast-tracking the scheme to allow them to do so and prevent some Australians becoming homeless.

Recommendation 4: Governments, and their agencies, should further encourage large scale investment in residential housing. In regards to taxation, this will involve investigating ways to create incentives for this to occur, perhaps on a temporary basis, which will ultimately benefit all Australians through stable rental prices and stable returns within superannuation accounts.

Whole of community payment of infrastructure in new developments

It is frequently said by developers, but argued by some, that Governments' infrastructure charges add very significantly to the cost of developing land. One thing that is not debated is that contemporary purchasers of new housing blocks, with or without a house constructed, must pay for significantly more of the provision of infrastructure then earlier buyers. This raises the price of new blocks, and house and land packages, and ultimately flows on to the resale value of existing housing regardless of whether the original owner paid for these services. In essence, earlier buyers are receiving two very significant benefits – 1) they saved in buying the property because they did not have to pay for the provision of infrastructure to it, and 2) when they sell they receive a price inflated to recognise that the property and land is furnished with that infrastructure.

An equitable solution would be to remove these charges from purchases of new developments and the costs be levied across the entire community.

Recommendation 5: The burden of land development charges and taxes for infrastructure should be removed from new developments and borne by the entire community.

Other recommendations relating to the restructured framework, but not specifically to taxation, include:

6) State governments should fund the construction of significantly more government and community housing;
7) Federal, State and Local Governments should work to expedite land release and reduce processing times;
8) The Federal Government should instigate a review into the operation of the realestate industry, particularly over the last decade through this long property bubble, to provide confidence to the

community that it is running optimally to serve the community (a la the petrol and groceries reviews);

9) The Federal Government should extend competition policy to the realestate industry and restructure it so that no business can both let residential realestate and sell it so that competition in the provision of housing is increased (as an adjunct to the general restructuring involved in the move towards large scale investors being the dominant provider of residential rental property).

Concluding remarks

Let’s be fair dinkum here. Everybody knows that the “property tax rorts” have been a major factor in Australia’s housing bubble being the biggest in the world. Their only proponents profit from their affects in promoting speculation in housing markets. At the same time, low income Australians and their working families – many of whom are young – have “suffered”, in the words of the RBA, as they have maintained a speculative premium in Australian house prices.

The negative affects of high prices in Australia are not only felt by the housing “have nots”. As unlikely as it appears, if the added distortions do manage to keep Australian house prices in this bubble – then the most expensive in the Anglophone world by an even greater margin – our lost competitiveness in attracting skilled migrants will have seriously negative impacts on our economy over the medium to long term.

A Government that is serious about solving the housing affordability crisis to help young and old Australians and working families in buying homes and finding affordable rental accommodation would remove the taxation distortions which promote speculative demand.

I mention the Government frequently because I have worked in Federal Government policy development in Canberra, and I understand only too well how things work. I know that if the Government does not have the political will to restructure the housing industry – with the necessary removal of the “property tax rorts” to lessen small investor demand – then it is highly unlikely that this review will have it is a recommendation.

I am concerned that the letter from the Office of the Treasurer has indicated a “line in the sand” under negative gearing. That would be a great shame for young and old Australians and working families.

I admire the Chair of this review, Dr Ken Henry, for the courage and professionalism he showed in publicly challenging the then current and alternative Governments to propose quality policy during the last election campaign. (Dr Bollard’s recent comments regarding housing during the New Zealand election suggest he, too, may have been inspired by Dr Henry’s actions.)

As this review concludes, and the recommendations are being decided, I would appeal to all members of this panel to show the same courage, professionalism and compassion to care deeply for ALL Australians. Read the article about Sara Hughes (in Figure 4) and consider what lies ahead for her family if the “property tax rorts” remain in place. As Dr Bollard said in his interview a short while after the quote that I included herein, this problem will keep arising for as long as tax policies encourage middle and high income earners to pile money into housing. And it will be the low and lower-middle income earners, the people with fewer financial choices, the young and old Australians and working families, who will suffer again in the next housing affordability crisis.

I appeal to you to do all that you can to ensure that does not happen.

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Appendix 1 – Anatomy of Australia's housing bubble (published at www.geocities.com/homes4aussies/bubanat.pdf)

Anatomy of the Australian Housing Bubble:
All Eight Australian Capitals Vs Worst Eight US Cities

Dr Brett F Edgerton
www.geocities.com/homes4aussies

12 August 2008

Introduction

In response to my first paper comparing the Australian housing bubble – using primarily data for Brisbane – to the United States', many people have emailed and asked me how other Australian cities compare.

In this very brief report I present a comparison of house price growth for all eight Australian capital cities versus the eight US cities which experienced the greatest bubbles (had the highest price peak) in relation to the peak in the Australian and US housing markets.

In my original report, I suggested that the March 2008 quarter would mark the peak of the Australian market, and data reported since shows that Australian house prices declined in the June quarter. This adds further weight to my view as I, and others, expect these declines to continue for some time.

Data

Australian house price data are from the Australian Bureau of Statistics and can be obtained at www.abs.gov.au – I used the median house price data for each city and indexed each series with June 1992 = 100. (Data for March and June quarters 2008 are based on provisional quarter on quarter movements.)

US city house price data are from S&P/Case-Shiller and can be obtained at www.standardandpoors.com – indices for individual cities were recalculated with September 1990 = 100.

The data were plotted in 4 graphs after all cities for each country were ranked in terms of house price appreciation over the study period – with the top two Australian cities plotted against the top two US cities, and so on.

Data for the comparison of the Australian and US housing markets, as "a whole", were from the same sources. The Australian data are the Weighted Average of Eight Capital Cities, "post-2005 method", with data pre-2002 from the "pre-2005 method" spliced on following adjustment. The US data are from the "US National Values" series. March 1990 = 100.

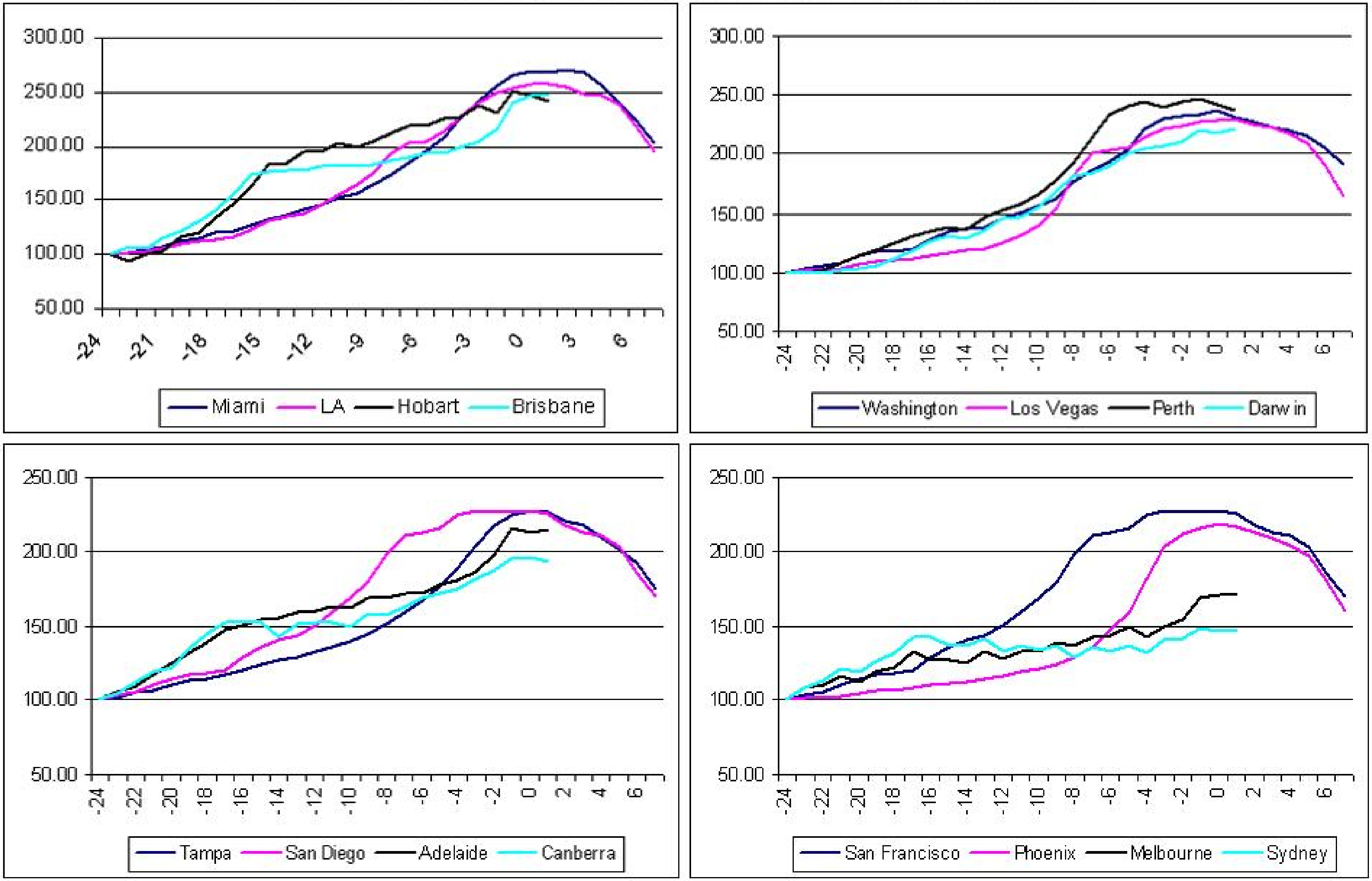
Results

House price appreciation for Australian capital cities was remarkably similar to that for the eight US – the exceptional graph being the final one, of Sydney and Melbourne versus the 7th and 8th US cities (Figure 1). The ranking of Australian cities' house price appreciation over the period June 2002 to March 2008 (descending) was Hobart, Brisbane, Perth, Darwin, Adelaide, Canberra, Melbourne, Sydney (Table 1).

Figure 1.

Comparison of House Price Indices of the Top 8 US Bubble Cities and all 8 Australian Capital Cities (Data Sources: Case Shiller and Australian Bureau of Statistics)

Indices Points (6 years pre-peak = 100)



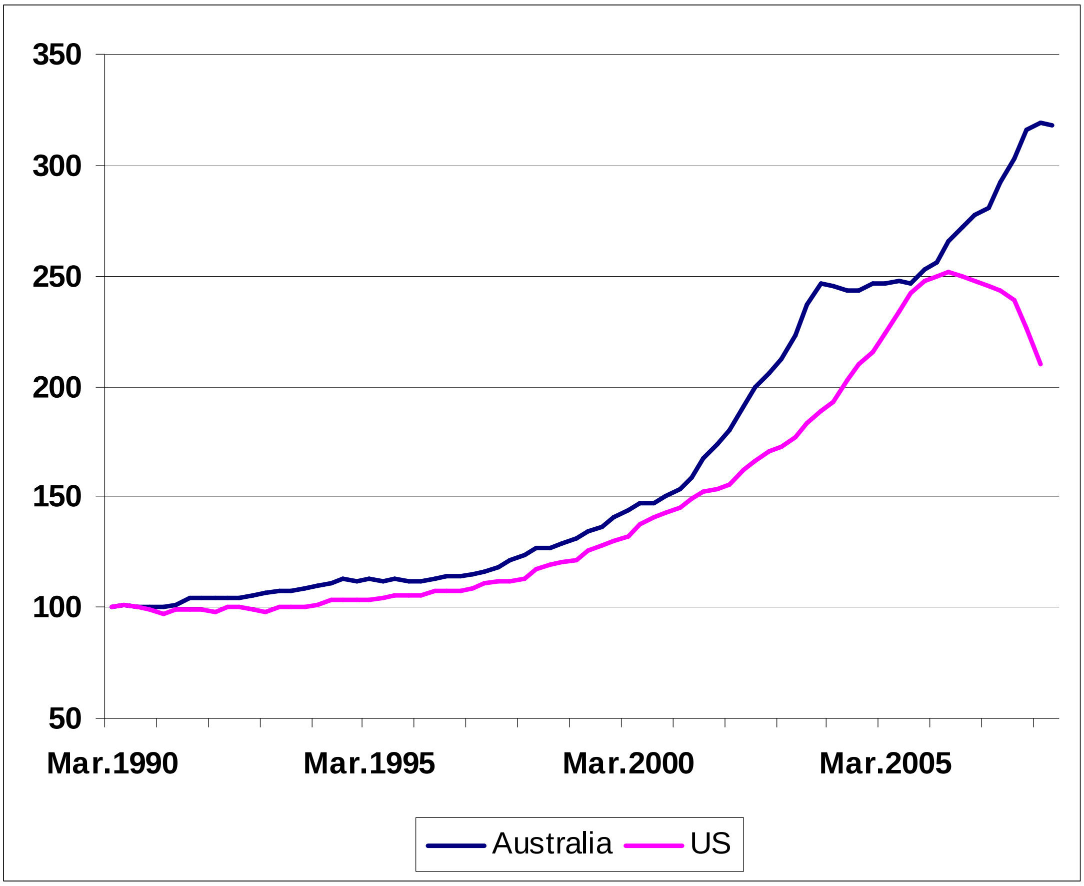
Quarters Relative to Peak (Australia - March 2008, US - June 2006)

Table 1. Peaks in the house price indices (for Australian cities March 2002 = 100; for US cities June 2000 = 100). Time = quarter that the city index peaked relative to national index peak.

City	Index at Peak (Time)	City	Index at Peak (Time)
Hobart	251.42 (-1)	Miami	271.40 (0)
Brisbane	248.35 (+1)	Los Angeles	257.56 (0)
Perth	245.79 (-1)	Washington	236.14 (0)
Darwin	221.08 (+1)	Los Vegas	229.12 (+1)
Adelaide	215.06 (-1)	Tampa	227.77 (0)
Canberra	195.87 (0)	San Diego	227.65 (0)
Melbourne	170.65 (0)	San Francisco	227.65 (0)
Sydney	147.95 (-1)	Phoenix	218.90 (0)

I plotted national indices as a reference point for these analyses (Figure 2). In both countries, house price growth was relatively flat from 1990 to 1998. Obvious in the Australian index, and in several cities' indices, is the fact that the Australian bubble occurred in two phases – the first leg up until December 2003, and the second leg up running from early 2006 to early 2008. The US bubble occurred in one phase. The Australian index at March quarter 2008 was 26.5% higher than the US index peak at June quarter 2006.

Figure 2. Graph of house price appreciation in Australia and the US. (Australia – ABS 8 Capital City Weighted Average; US – S&P\Case-Shiller US National Values; March 1990 = 100).



Conclusions

America serves as a useful comparison for two very significant reasons – 1) they are further along in the housing cycle than most other countries which participated in the synchronized bubble, having been the epicentre of the credit markets (the fuel for the housing bubbles); and 2) it is now universally accepted that they experienced a very significant housing bubble.

That graphs plotting house price appreciation for six of eight of Australia's capital cities very closely resembles the magnitude of the US cities which experienced the greatest bubbles is absolute proof that Australia has experienced a very large housing bubble.

At a national level, it is clear that Australian house prices appreciated more than US house prices. It should also be noted that the S&P\Case-Shiller National Value Index is considered by many analysts to overstate the US bubble because it is rather narrow (after all, there are 52 state capitals and many other large cities.) On the other hand, the Australian data are the weighted averages of ALL Australian capital cities. Thus this graphical representation would tend to understate the difference.

The breadth of the housing bubble in Australia, and its magnitude and duration, suggest that it was significantly larger than the housing bubble experienced in the US.

Some may be surprised that these data suggest that the bubbles in Sydney and Melbourne house prices were not as great as those in the other capital cities. This may be true to a point. But this is also likely to be due to the anatomy of the Australian house price bubble, and the fact that individual markets in Australia were not as synchronized as in the US.

I would suggest that Australia's housing bubble had its genesis in Sydney in the run-up to the 2000 Olympics. Melbourne also got involved as a tag-a-long – not wanting to be outdone by its arch rival, no doubt. As the population of these two cities constitutes about 40% of the Australian population, this produced the uptick in the 8 city weighted average. Certainly, investing would have been a part of this uptick – housing investing had remained part of the national psyche, with the ongoing negative gearing provisions, even through the long flat period in the market. But it is also reasonable to assume that much of the early stage of the uptick was from owner-occupiers in Sydney and Melbourne.

House price growth in the rest of the country remained flat at least until 2001. In 2000 the Federal Government introduced the capital gains tax concession and this was the catalyst to the housing price appreciation spreading throughout the Australian eastern seaboard. The first home owners grant, which was doubled for a period, was also introduced around the same time and no doubt played a part. I would argue that this point marks the start of Australia's housing bubble.

The house price appreciation in Sydney and Melbourne provided an opportunity for residents of these cities to extract equity and invest in the closer capital cities of Hobart, Brisbane, Adelaide and Canberra. No doubt many investors had noted that these markets had remained comparatively flat since the early 1990s. And, of course, local investors and owner-occupiers also entered the fray once the uptick started.

By March 2002, the start of the graphs in Figure 1, the explosion in house price growth was in full swing in these other centres. Because much of the equity extracted in Sydney and Melbourne was invested in other cities, house price growth there was more subdued. From personal experience, it was common place in 2003 to witness "southerners" attend house inspections in Brisbane, driving from house to house in a rental car or even a taxi.

The internet also played a critical role. Even in my small home town of Innisfail, in north Queensland, there was much talk of “southerners” buying houses sight unseen off the internet. Houses were being sold within a few hours of listing on realestate internet sites. This in a town where through the late 1990s it was common for houses to be listed for sale for several years!

In late 2003 the market slowed significantly. I believe that this was primarily achieved by the “jawboning” from the Reserve Bank of Australia and rate policy action. The RBA was outspoken in its concern for a house price correction, and raised rates in November and December 2003. House price appreciation slowed considerably.

But during this plateau period, Australia began to fully feel the very positive effects of the explosive growth in China, and its consequent demand for raw materials which Australia was able to supply. This prompted the spread of the housing bubble to our most remote capitals – Perth and Darwin – which are proximal to the mines and form the base for many mine employees. Of course, this phenomenon was not restricted to capital cities – house prices in Queensland regional cities such as Mackay and Rockhampton also began to skyrocket.

Although it was local factors that initiated price growth in these markets, there is no doubt that many investors who had enjoyed capital gains from investments in the eastern seaboard again withdrew equity and invested in these much smaller markets. This period also coincided with the rapid expansion in credit availability as mortgage providers increasingly sourced funds from the US securitisation markets. At this time, there were reports in the press of operators chartering aircraft to take investors from the eastern seaboard to Perth to purchase residential properties.

Consequently, house price appreciation in Perth and Darwin very quickly caught up to – and in the case of Perth, overtook - the smaller eastern capitals. Perth price growth stopped fairly abruptly in early 2007 – this coincided with common media reports that the Perth median house price was quickly encroaching on Sydney’s, the premier Australian city. In fact, at 1Q2007 the differential was only $17,000 (3.7%)!

“Affordability issues” were the commonly quoted reason for the slowdown in Perth house price appreciation. However, I rather suspect that speculators could no longer ignore the sheer absurdity that Perth would very soon have the most expensive housing in Australia – in nominal terms, not just relative to wages – if house price growth continued at the same rate.

The final stage of the inflation of the bubble was when Perth residents began to fly to the eastern seaboard to invest in property. Again, at house inspections in Brisbane in early 2007 I personally spoke to several groups of people from Perth who had flown in for the weekend to buy investment property. Moreover, at the same time there were press articles discussing realestate marketers chartering aircraft to fly investors from Perth to Adelaide and Melbourne on weekends with the express intention of purchasing investment properties.

I would suggest that the ramping up of investor activity in these markets in 2006 and 2007, together with local investors, and easy credit from foreign markets, was the major reason for the acceleration in house price growth in the Brisbane, Adelaide, Hobart and, a little later, Melbourne. The negative news reports of mortgage stress and significant house price declines in western Sydney served as a deterrent to investor activity in greater Sydney.

The main point that I draw from this anatomy of the Australian bubble is that it suggests that a higher proportion of the house buying activity in the smaller capitals was by speculators and investors. Consequently, I suspect that house price falls through the popping of the bubble will be greater in these cities than in Sydney and Melbourne.

Appendix 2 – A letter relevant state and federal MPs, including the Prime Minister in his capacity as the Member for Griffith, and to the Treasurer.

To:	From:
The Honourable Kevin Rudd, Member for Griffith	Dr Brett F Edgerton
The Honourable Anna Bligh, Member for South Brisbane	PERSONAL
The Honourable Kerry Rea, Member for Bonner	DETAILS
The Honourable Chris Bombolas, Member for Chatsworth	REMOVED

11 December 2007

Dear Sirs and Mesdames

My wife and I have the dream of owning a home in which to raise our family. We are fortunate to both be well qualified. We made sacrifices towards those qualifications which meant that we delayed starting a family and have not yet purchased a home. I am deeply concerned about the impact of the housing affordability crisis on my family, and on my fellow Queenslanders and Australians. I believe that this issue is altering the social fabric of Australia, entrenching a "have and have not" society.

[PERSONAL DETAILS REMOVED

I do not pretend that we are not in a better position than many other would-be first home buyers. We respect and appreciate our fortunate position, and we give back to humanity and our society as best we can. Currently we make regular monthly donations of around $200 to charities including World Vision, The Abused Child Trust and Medicines sans Frontiers. We increase these contributions annually in line with our family income, and we would sacrifice some of our desires before reducing our contributions to those less fortunate than us. So I do not believe that we are greedy people, or that we expect too much.

We simply aspire to have the same opportunities that the previous generation of Australians enjoyed. And now, with house prices around 7 to 8 times average wages, whereas they used to be 3 to 4 times, I do not think anyone can argue that there is no housing affordability crisis affecting my generation. If my family can not afford to buy – or should I say, the prudent decision is not to buy – then honestly, how many families can genuinely afford to buy their first home?

The question is what to do about the housing affordability crisis.

I fully understand that Federal Labor outlined some initiatives to assist with this issue. And I appreciate that, and intend to avail myself of those initiatives as much as our impaired budget will allow. I also understand that State Labor is looking at what it can do to help.

I'm just a bloke with a reasonable level of intelligence, with a reasonable level of "worldliness", who pays a reasonable amount of attention to what is happening around him. I am not an economist. But I believe that there are many more aspects that need to be looked at if your Governments sincerely wish to help families get into their first home. And common sense suggests that the following issues need to be high on your priority list.

1. Conflict of interest in the realestate industry

This is a big concern. There is a clear and blatant conflict of interest here, not unlike those in the Wall Street investment banks which were highlighted, and legislated against, after the bursting of the tech bubble in 2000.

Allowing the same agencies to both sell and let realestate provides very significant potential for the manipulation of both selling and rental prices. They have it both ways. You go in the door to enquire about renting. They tell you that you will need to spend at least $400 a week to rent something livable for your family. You suggest that you should be able to buy a house for that, and they invite you around the other side of the desk. They then tell you that you will need to spend at least $400,000 if you want to buy. You say you can't afford that, so they invite you around the front of the desk again to look at those rentals that you can only just afford (if you are lucky).

I suggest that with such a huge potential for price manipulation, in the current boom this has been a very significant factor. I have been told by house owners that they frequently get calls from agents to say that "rents are going up". That reeks to me of a concerted industry push to increase rental yields, on the one hand to justify the already sky-high prices, and on the other hand, to lay a platform for further price increases.

Suggested responses:

- Establish an inquiry into rental accommodation prices to determine whether there has been any collusion on the part of the realestate industry;
- Legislate that no organization can both sell and let realestate so as to lessen the potential for price manipulation.

2. Discrepancy in cost imposts on new developments as opposed to previous ones

I know that this is a sensitive issue, and I have no idea of what is the actual cost on a new house and land package. But I think it is accepted that, unlike in the past, the infrastructure costs are now borne by the purchaser. The lack of fairness here is two ways: not only does the younger buyer need to pay the costs of developing new infrastructure, the older seller has the benefit of these features (which they never paid for) inflating their sale price.

There needs to be a way of smoothing this out. If an owner, who has never paid the cost of services to the block, sells, then there needs to be a tax taken from that sale to cover those costs. Or maybe you need to have a higher land tax (or some other form of lien) on people who have owned property for longer, the payment of which can be delayed until the property is transferred out of their name (to ensure that pensioners are not disadvantaged). These revenues would flow to subsidise the cost of infrastructure development in new housing so that, irrespective of when the area was developed, all residents pay a fair and even contribution to the provision of infrastructure.

Suggested Response:

- Extra tax on sale of older property; or
- Higher land tax on people who have owned property longer.

3. Negative gearing

It is clear to all and sundry that this generous tax treatment, together with the reduced capital gains tax regime, has had a distorting affect on the housing market in Australia.

Adam Smith stated "A dwelling house, as such, contributes nothing to the revenue of its inhabitant…….. It cannot yield any to the public, nor serve any function of a capital, and the revenue of the whole body of people can never be in the smallest degree increased by it" (Taken from PJ O'Rourke, 2007, "On The Wealth of Nations"). Though that may be the case, we will always put a high price on the security of a reasonable roof over our head, and so, will be susceptible to speculative property booms such as Australia (and indeed, most of the developed world) has experience this decade.

The favourable tax treatment of residential property "investment" in Australia exacerbates this. Ideally, negative gearing should be ceased. The only argument I have seen against doing so is that the last time this was done investors fled the market. The reality is that this speculative boom has not been marked by significant new construction. As Keen (2007; "Deeper in Debt: Australia's addiction to borrowed money", CPD) shows, this boom is more accurately described as a Ponzi scheme turning over already built houses. It is a credit boom not a housing boom. So getting rid of the speculators – genuine investors would stay put – would be advantageous to the Australian economy and society. Speculators that leave the sector will sell to longer term investors or owner occupiers.

Again, I realize this is a politically sensitive issue. So an interim measure could be to allow after a certain point in time (ie. Budget night) that negative gearing only be applied to the purchase of a newly constructed house. Thus, the remaining heat in the Australian property market will at least be directed towards addressing the housing construction shortage (according to census data).

Suggested response:

- Abolish negative gearing on property investments; or
- Only allow new negative gearing arrangements on newly constructed dwellings.

4. Market operations free from interference

I believe that Australian property markets are over-valued relative to fundamentals, especially rental yields and ratios of house prices to average incomes. The latter, in particular, needs to drop before the reasonable aspirations of younger Australians to own their own home will be widely met.

I believe that implementation of the measures listed above would assist. But one of my greatest concerns is that politicians at all levels may find such an occurrence to be unacceptable to their own aspirations. I am extremely concerned that, faced with such a reality, pressure will be brought to bear on Governmental instruments to place a floor under house prices in the guise of economic stability. I have concerns that this has already happened under the previous federal Howard Government with the RBA extending its operations to purchase residential backed mortgage securities.

I read with interest research reports by the RBA and other central banks about the dangers of asset bubbles and what could/should be done about them. All concluded that nothing could be done because they could not accurately detect a bubble. All they should do is mop up after the crash.

An obvious follow-up question is, "if you can't detect the bubble, then how can you accurately detect a crash?" This seems to be a one-sided approach to the issue which allows unrestricted blue sky speculation, but then puts a floor under stretched asset prices when markets attempt to correct.

To me, it is no wonder that Ian Macfarlane (2006; "The Search for Stability", The Boyer Lectures 2006) considered the biggest threat to our economy going forward was asset bubbles. I think it is already plain to see the parallels between the 70's and now – then everyone's eye was on full employment, showing scant concern for the fact that inflation was ballooning – now everyone's eye is on GDP and inflation, while asset prices and personal credit have ballooned.

The "moral hazard" has to be in jeopardy. And Government actions need to give confidence to prudent investors that they are better off acting following careful analysis rather than investing impulsively and unwisely with the herd.

To conclude, as someone at the pointy end, I reiterate that there certainly is a housing crisis. It is already an issue altering the social fabric of our country. Anyone who owned property prior to 2000, and who has drawn wisely on their increased equity, has rapidly become very wealthy. Those who did not own property face an uphill battle to provide housing for their family unless they have a very good salary. Again, I express my gratitude for your efforts thus far to deal with the situation. But I implore you to broaden the scope of your solutions. I realize that some of my suggestions would attract strong opposition from self-interested groups such as the realestate industry. But they have done very well out of the boom, and have the means to handle these adjustments which are needed to maintain a "Fair go for all".

Thank you in advance for your consideration.

Sincerely

Dr Brett F Edgerton

Appendix 3 – A letter to the Treasurer.

The Treasurer The Hon Mr Wayne Swan MP PO Box 6022 Parliament House Canberra ACT 2600 CC: Assistant Treasurer, The Hon Mr Chris Bowen MP	The Edgerton Family Dr. Brett F Edgerton (B.Sc., Ph.D.) Mrs. Chandima Edgerton (C.P.A.) Master Roshan Edgerton [PERSONAL DETAILS REMOVED]

17 February 2008

Dear Mr Swan

We submitted a response to the paper "First Home Saver Accounts: Outline of proposed arrangements". As the scope of our response went beyond specifics relating to the implementation of the scheme, it was suggested that we contact you directly. This letter has been copied to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs as some of our concerns go to the regulation of the real estate industry. (Please also note that we sent a letter dated 11 December 2007 to The Prime Minister, The Hon Kevin Rudd MP, as the member for Griffith, because our realestate agent is located in his electorate. And I met with the Member for Bonner, The Hon Kerry Rea MP, on 7 February 2008.)

Firstly, we wish to applaud the new Government for giving the housing affordability crisis a high priority in its first few months of Government, and for expediting policy development in the area. We appreciate this policy response of the First Home Saver Accounts. However, we strongly believe that it must be seen as only the beginning of a much broader and comprehensive response to this issue which we believe has already altered the social fabric of our wonderful country.

In this letter, from an average Australian family, we present our own circumstance by way of background, and then make specific comment and suggestion relating to the First Home Saver Accounts and on the housing affordability crisis.

[PERSONAL DETAILS REMOVED].

Overall, we consider the First Home Saver Scheme to be a good start to addressing the crisis by providing a tax effective savings vehicle to save towards the purchase of a first home. However, we consider that perhaps its greatest benefit may be in reducing a certain level of demand from what we consider to be "irrationally exuberant" property markets, thereby potentially protecting first home buyers from over-spending in this heated market. The maximum benefit of that will only be achieved if this is just the first step in an overall plan to improve housing affordability (see further comments below).

In our submission to the policy paper on First Home Saver Accounts, we made a number of specific suggestions relating to the policy and its implementation. These included measures to account for "lumpy" earnings of the mostly young people who will make use of the accounts, and a government-prepared brochure on investment considerations for account holders (detailing major potential affects on returns such as fees and asset allocation.)

Our major concern is with its impact on demand, which goes to the heart of the housing affordability crisis. As mentioned above, implementation of the First Home Saver policy should lead to a reduction in demand for property purchase in the short term, which we consider beneficial. However, it is likely to lead to a very significant surge in demand once the four year restriction on accessing the funds has first passed. One would also expect that canny investors will position themselves in anticipation of this in the lead up to July 2012. So we highlighted the need to come up with measures to diffuse this period of higher demand.

While any attempt to assist first home buyers is admirable, we note carefully that, over the last decade, additional funds in the hands of purchasers was quickly negated by price increases. In other words, the ultimate beneficiaries of Government financial assistance were the sellers. Clearly, that is due to simple market fundamentals of supply and demand – there has been a great deal of demand, due to high household formation (especially due to immigration) and investor interest, and there has been significant under investment in constructing new dwellings. (This is now an accepted fact amongst economic analysts and was highlighted in Steve Keen's report in which he described the current Australian housing market as a "Ponzi scheme" and stated that what we actually have is a credit boom, not a housing boom, because very few houses have been constructed.)

Therefore, the First Home Savers Scheme **will not help** first home buyer **affordability** if it is not backed up by other major policy initiatives. Importantly, these initiatives must remove the artificial distortions currently in place in the Australian property market which favour investors over owner occupiers, so that overall demand is reduced. Moreover, the phasing out of some of these distortions, such as negative gearing as discussed below, rather than immediate cessation, would be beneficial in addressing the undersupply of dwellings.

We support the Governments stated objective to encourage private-public partnerships in the provision of affordable housing, thereby increasing supply.

We also support the Governments objective of releasing crown land for development, again increasing supply.

We strongly urge the Government to commence a phasing out of negative gearing. Contrary to industry assertions, the current undersupply of dwellings in the current "boom" proves that negative gearing only serves to increase demand amongst investors, at the expense of owner occupiers, and does not result in more housing becoming available for renters. Negative gearing of existing property should cease as soon as practicable. This will reduce non-beneficial demand.

In the short to medium term, negative gearing provisions should be maintained on newly constructed properties to encourage investor demand in this sector, thereby resulting in an increase in supply. We realize that fiscal and monetary policy is being aimed at cooling overall demand in the economy, to reduce inflation, whilst allowing the "money making" parts of the economy, and related infrastructure, to develop. We note that rapidly increasing housing costs has been a major factor in our growing inflation problem. An increase in housing supply over several years will ultimately reduce the rate of growth of housing costs, and, therefore, inflation.

Again, to reduce investor demand, we urge the Government to reinstate full Capital Gains Tax provisions on the sale of investment property.

We have major concerns about recent changes to DIY superannuation funds, specifically enabling them to gear into asset purchases. In its current form, **this policy will worsen the housing affordability crisis**. Business journalists are describing it as a boon for realestate markets. We urge you to alter the policy so that such arrangements can not be undertaken for single dwellings – to foster large-scale investment rather than increase demand for pre-existing stand alone houses or apartments – or that property forming the basis of such arrangements must be newly constructed, again to increase supply.

We strongly urge the Federal Government to work closely with State and Local Governments to ensure adequate and timely land release and planning procedures to increase the supply of housing.

With the rapid increase in house prices, and more recently rents, we urge the Federal Government to ask the ACCC to conduct a review on the functioning of the residential sale and rental markets to ensure that there has been no collusion or price manipulation.

Moreover, we urge the Government to consider regulating the realestate industry such that no business with a license to sell realestate can let realestate, and that there be a clear separation between these functions to increase competition in the provision of housing.

Overall, we believe in the ability of free markets to correct themselves when artificial distortions are removed. In other words, we feel confident that housing affordability will improve in Australia if a broad program of reform is undertaken. However, we recognize that this may take some political courage. And, when a correction occurs, there may be significant calls to “place a floor” under asset prices in the guise of economic stability. Ensuring that there is a free property market so that Australians can purchase a home at a fair price will be of enormous socioeconomic benefit over the long-term, irrespective of short-term disruptions.

Housing is one of the most basic of our needs. It was a major policy mishap of the previous Federal and Current State Governments to allow a critical shortage of housing to occur. The First Home Saver Scheme is a worthwhile policy response to the issue, but only if it is accompanied by a raft of other policies to decrease investor demand and increase supply. If not, we fear that it is simply postponing and prolonging the pain of many Australians who dearly wish to raise their families in their own homes.

Thank you for your time and consideration.

Sincerely,

Dr Brett F Edgerton
For
The Edgerton Family

Appendix 4 – Letter of response from the Office of Treasurer

OFFICE OF THE TREASURER

PO BOX 6022
PARLIAMENT HOUSE
CANBERRA ACT 2600

Telephone: 02 6277 7340
Facsimile: 02 6273 3420

www.treasurer.gov.au

4 SEP 2008

Dr Brett F Edgerton

[PERSONAL DETAILS REMOVED]

Dear Dr Edgerton

Thank you for your letter of 17 February 2008 to the Treasurer concerning First Home Saver Accounts and housing affordability generally. The Treasurer has asked me to respond to you. I apologise for the delay in responding.

The Government is committed to assisting aspiring first homebuyers achieve the goal of owning their first home.

One of the greatest obstacles to buying a first home is saving a deposit. In recognition of this and that home ownership is important to the wellbeing of Australians, in the 2007 election campaign, the Government undertook to introduce new, low tax, First Home Saver Accounts to assist first homebuyers in meeting this challenge. The accounts will complement the Government's policies to increase the supply of affordable housing including the Housing Affordability Fund, National Rental Affordability Scheme and the release of surplus Commonwealth land.

The Government appreciates your support for First Home Saver Accounts and the effort you have taken to lodge a submission in response to the discussion paper.

The ability to claim a tax deduction for loans used to purchase investment properties flows from the general principle which applies under Australia's taxation system that tax deductibility is allowed for, and generally limited to, expenses incurred in earning assessable income. Investment income from housing is not the only type of income affected by this principle of deductibility. It also applies to reduce other forms of taxable income. For instance, work related expenses may be deducted against wages and salaries, and business expenses deducted against business income.

Removing the ability to claim tax deductions for loans used to purchase investment properties would discriminate by treating investment in property differently to investment in other assets, for example shares.

You propose reinstatement of full capital gains tax (CGT) on capital gains made on the sale of investment properties.

The Treasurer announced in the 2008-09 Budget that the Government will conduct a comprehensive review of Australia's tax system to create a tax structure that positions Australia to deal with the demographic, social, economic and environmental challenges of the 21st century. The review will encompass Australian Government and State taxes, except the goods and services tax (GST), and interactions with the transfer system. In doing so the review will reflect the government's policy not to increase the rate or broaden the base of the GST; preserve tax free superannuation payments for the over 60s; and the Government's announced aspirational goals for personal income tax.

The review panel will be chaired by the Secretary to the Treasury, Dr Ken Henry AC and will also comprise Mr Greg Smith (Australian Catholic University); Dr Jeff Harmer (Secretary of the Department of Families, Housing, Community Services and Indigenous Affairs), Ms Heather Ridout (Australian Industry Group), and Professor John Piggott (University of New South Wales).

The review will be conducted in several stages. An initial discussion paper will be released by the Treasury at the end of July 2008. The review panel will provide a final report to the Treasurer by the end of 2009. In the spirit of the 2020 Summit, the review panel will consult the public to allow for community and business input.

The reinstatement of full CGT falls within the broad scope of the review. As such, I have forwarded your letter to the review team to be considered as part of the review.

Additional information about the review of Australia's Future Tax System, including the terms of reference, can be found on the Treasury website (www.treasury.gov.au) under Reviews, Inquiries and Consultations. As you are aware, recent changes to superannuation laws allow trustees of superannuation funds to invest in certain instalment warrants that involve a limited recourse arrangement. These instalment warrants may be over any asset (for example, real property or listed securities) the fund would be permitted to invest in directly.

However, superannuation funds that invest in instalment warrants must continue to comply with existing investment restrictions, such as those on in-house assets, acquiring certain assets from a related party of the fund and the prohibition on giving a charge over an asset.

In relation to investment in property, the Government does not direct superannuation fund trustees to invest in particular projects, industries or regions. If superannuation fund trustees were directed to invest, or prohibited from investing, in particular activities, the long term success of the Government's retirement incomes policy would be jeopardised. It could be expected to result in lower retirement incomes, and increased Government outlays on the Age Pension.

Rather, trustees of complying superannuation funds are required to formulate an investment strategy that has regard to the risk and return of the fund's investments, expected cash-flow requirements, diversification and liquidity of investments, and the ability of the fund to discharge its liabilities.

I trust this information will be of assistance to you.

Yours sincerely

Ian Davidoff
Economic Policy Adviser

Appendix 5 – Research paper published at www.geocities.com/homes4aussies/bris.pdf

Brisbane House Price Forecast

By Dr Brett F Edgerton (B.Sc., Ph.D.)
www.geocities.com/homes4aussies

8 July 2008.

Summary

Australia participated fully in a relatively synchronised global house price bubble. Abundant cheap credit is believed by most observers to be the primary cause of these asset bubbles. Australian house prices are the most expensive in the developed world, based on price relative to earnings, so there must be specific reasons for our supposedly egalitarian society holding this title. The most important factors are considered to be Australians' penchant for risk taking together with Federal government policy frameworks, especially taxation, supportive of risk taking (i.e. speculation) in housing markets.

With the credit crisis causing the withdrawal of easy credit, the house price bubble is now deflating around the world. In some markets it can be characterised as having "popped". House price indices in some US cities have dropped by around 30% within 19 months of peaking. There are clear indications that Australia's house price bubble has begun deflating – e.g. the Brisbane property market has clearly been under pressure since April 2008. This will begin to show up in house price and other data in mid- to late 2008.

Given that the causes of the bubble formation and deflation are consistent with the US, and because the property bear market is most advanced in US markets, future Brisbane house price movements were forecasted by modeling based on US house price movements. Historical data (from ABS and Case Shiller) shows that Brisbane's house price bubble was, indeed, spectacular – the presumptive peak in March 2008 was firmly between the peaks reached by the Case Shiller 20 US city index and those of Los Angeles and Miami (two of the biggest boom US cities).

Forecasting suggested that Brisbane house prices may decline by 17% between March 2008 and December 2009 to reach a median price of $350,443.

Subsequent house price movements were modeled out to March 2016 by modeling past price behaviour after Brisbane property booms and likely impacts of Federal government policy initiatives – e.g. the possible removal of investor\speculator incentives such as negative gearing and capital gains tax concessions. The modeling suggests that house prices will trough around September 2011 at a median price of $294,000 (a 30% decline from peak).

If maintained, the investor incentives will cause another "mini" bubble around 12 months prior to the first participants gaining access to the First Home Savers Accounts (FHSA). In this mini bubble, house prices are forecast to rise by $66,750 (more than the likely average FHSA balance). Consequently, affordability will continue to impact first home buyers and the bubble will fade out to March 2016.

However, the central forecast is that the Federal government, following the taxation review, will cease these investor incentives because they are shown to be ineffective and damaging through their impact in causing bubbles and maintaining a speculative premium in our house prices. Modeling of this forecast suggests that house prices will form a solid base over a few quarters post

September 2011. Prices will bounce off their lows over couple of quarters in late 2012/early 2013 due to first home buyer activity after first participants gain access to their FHSAs. Price rises are then roughly inline with inflation from 2013 out to the end of the modeling period at March 2016.

Under both scenarios, the median price is $334, 224 at March 2016, the end of the forecast period. If Brisbane wages increase at the rate of 4% pa, at March 2016 the Brisbane house price to income ratio will be 4.43, 10% higher than in 2001! However, over the very long term, beyond the forecast period, affordability will continue to improve for first home buyers as baby boomers sell down their assets through retirement. The continual supply of existing housing on the market should have a downward impact on Brisbane house prices over the next several decades.

In conclusion, this study and its forecasts show that poor Federal government policy has been, and will continue for a long period to be, damaging to the needs and aspirations of everyday Australians, and "working families". That very much includes the less sophisticated investors that joined the boom late, thereby transferring their current and future wealth to the earlier "smart money" investors. And that is precisely why the current Australian federal government must finally take action and get rid of these ineffective taxation policies which promote, and provide an opportunity for spruikers to aggressively promote, Australian houses as speculative assets. They are our homes not casino chips!

Introduction

Australia has participated fully in a relatively synchronized global house price bubble.(1) The breadth and synchronicity of the bubble, across most developed countries and on different continents, suggests that there were some major causative factors in common. Perhaps the greatest global factor was a concomitant credit bubble, emanating from over zealous investment bankers in Wall Street bundling up mortgage debt in complex instruments to sell to investors who accepted very low risk premiums, resulting in plentiful cheap credit around the world. The Bank of International Settlements in its most recent report supported this view (BIS 2008) [http://www.bis.org/events/agm2008/ar2008o.htm].

It is clear that the bubble "popped" in the US in June 2006, with the Case-Shiller 20 City Composite Index exhibiting a roughly 17% decline over the subsequent 19 months to February 2008. The synchronicity of that peak across the 20 individual city indices, which in turn make up the 20 city index, is quite amazing – 11 of 20 cities peaked ± 2 months of June 2006. UK housing prices have also peaked in the last 12 months. And there are early but explicit signs that Australian housing markets peaked in early 2008 with house price declines likely to be evident in data from mid-2008.

That Australia's house price bubble has begun to deflate is unsurprising given the remarkable synchronicity of the house price increases across countries. For a full discussion on asset bubbles and reasons for their synchronicity, the reader is directed to Shiller (2005).

Australia's House Price Bubble

Whilst the housing bubble was a global event, it is important to note that through it Australian house prices have been the most expensive – defined as the ratio of price to income – in the developed world. This is immediately apparent on examination of this graph [http://www.rba.gov.au/Speeches/2008/_Images/270308_so_graph7.gif] published by the Reserve Bank of Australia (Richards 2008).

According to the RBA graph, the ratio of the median Australian house to income was roughly 5.5 at the end of 2007, having reached 6 in 2006. With the exception of the relatively short-lived housing price boom of 1988-89, where the ratio reached about 3.7-3.8, the ratio has been under 3.5 from 1985 until the Australian experience of the housing bubble commenced in 1996.

For a very long term view of Australian house price movements, as well as a discussion of the role of debt in the current bubble, readers are directed to this excellent article [http://www.debtdeflation.com/blogs/2008/03/03/steve-keens-debtwatch-no-20-march-2008-double-or-nothing/] by Associate Professor Steve Keen (2).

Even though much of the discussion of the house price boom and bust centres on the US – where it is openly and uniformly acknowledged as a bubble that is now deflating – their ratio "only" reached about 3.7 at its peak! In other words, equivalent to 1988-89 Australia's mini price boom, and much, much lower than our current level.

Whilst someone, or some country, must hold this position, there must be reasons specific to Australia which allowed its citizens and foreign investors to bid our prices so high. I have read arguments which suggest that we are a people that appreciate owning our own homes more than others. This, to me, seems a nonsense and grasping at straws to justify high prices.

But perhaps a common trait in us Australians, celebrated by many as a national identity trait of which to be proud, has something to do with it. That is a penchant for gambling – the common view that "Aussies would bet on two flies crawling up a wall".

The bubbles throughout the world were marked by very significant levels of speculation on future house price increases – which became an almost fanatical view that "house prices only ever go up" – what Shiller (2005) described as a naturally occurring Ponzi scheme. Essentially people throughout the developed world were gambling that the price of houses would increase. But everybody convinced themselves that it was a no lose game. And Australians, with our penchant for "punting", were quick to join the game!

But I do not believe for a second that Australians' penchant for gambling completely explains why our houses are the most expensive in the developed world.

Of equal, or greater importance, has been Government policy frameworks in Australia, and adjustments to those. (See the Report of the Senate Select Committee on Housing Affordability 2008 [http://www.aph.gov.au/Senate/committee/hsaf_ctte/report/report.pdf] for full coverage of this topic.)

I will just highlight here – as many others have before me – that the implementation of concessional capital gains tax (CGT) rates in 1999, followed by the First Home Owners Grant (FHOG) in 2000, which was doubled for a period, hugely stimulated demand for housing when other conditions were conducive, such as relatively low interest rates. This undoubtedly added momentum to the bubble, and spread it throughout the country from its epicentres in Sydney and Melbourne.

Of course, these are not the only policies which have a distorting influence on Australian house markets. Australia has long permitted negative gearing on residential investment properties, whereby an investor can offset losses from a rental property against other income, such as from salaries.

If we go back to the RBA graph, we note that Australia has had high house prices, relative to other countries, since at least 1985. In fact, there were only two or three years when Australia did not have the most expensive houses.

And I would argue that is mostly due to there being a long-term speculative premium in our housing market, there mainly because successive Australian federal governments have endorsed, or even promoted, house price speculation as a completely acceptable wealth creation tool in Australia.

I say promoted because yet another speculator/investor incentive was legislated by the then government just prior to the 2007 federal election – the option to leverage into residential property, as well as other assets, in self-managed superannuation funds. These funds have a maximum of 4 members, usually a wealthy individual, couple or family, and had an average balance at end of year 2007 of $800,000! Moreover, around 30% of funds had a balance of less than $200,000. So there are some very wealthy people that have been given further taxation incentives – through the very significant tax benefits for superannuation – to speculate/invest in residential property.

The very significant disadvantage that first home buyers are at in comparison to property investors, in a very similar government and tax policy environment, was recently highlighted in a paper from the Reserve Bank of New Zealand (Hargreaves 2008) [http://www.rbnz.govt.nz/research/discusspapers/dp08_06.pdf].

Thus, it is little wonder that, as the RBA put it, higher income earners tend to gain when house prices rise, but lower income earners tend to "suffer"! (Richards 2008) [http://www.rba.gov.au/Speeches/2008/sp_so_270308.html]

Brisbane House Prices (3)

I analysed data from 1989/90 onwards, but an excellent paper by Abelson and colleagues (2005) [http://www.econ.mq.edu.au/research/2005/HousePrices.pdf] looked at house prices throughout Australia from 1970. They noted 4 house price booms over that period: a) from 1972-74, and they stated "the combination of high inflation, full negative gearing and no capital gains tax produced high returns to investors"; b) 1979-81, and they stated "policy setting continued to be favourable for investors"; c) 1987-89, and they stated "the collapse of the stock market in September 1987 sparked a flow of funds into housing"; and d) 1997-2003, and they stated "Investor demand for housing was high. The boom appeared to get a second wind … from favourable policy settings for investors, including negative gearing combined with high marginal tax rates and a perceived lowering of the CGT."

For Brisbane, they found that, real house prices (i.e. adjusted for inflation) fell between 1974 and 1980, and1982 and 1987.

My analysis of ABS data, adjusted for inflation using the calculator on the RBA website, shows that Brisbane house prices failed to keep up with inflation for over 9 years from 1991/92 to 2000/01 (Figure 1).

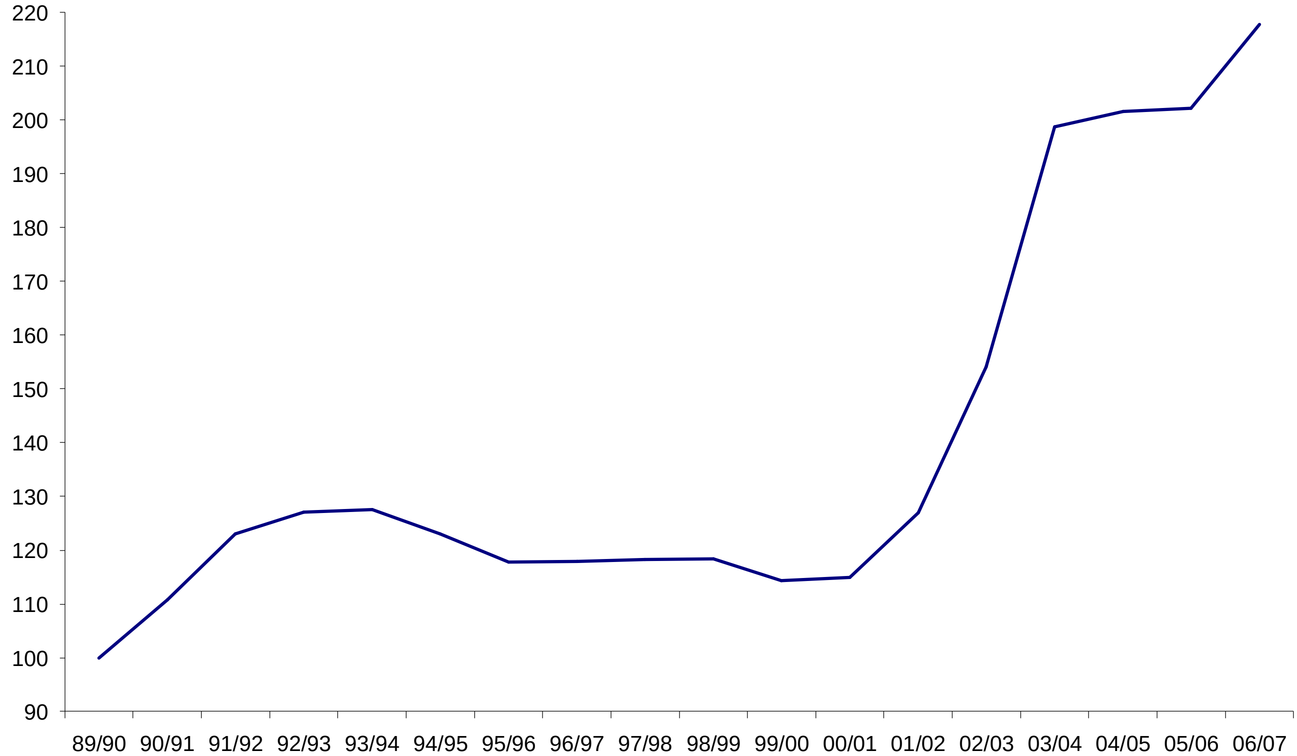


Figure 1. Brisbane house price index 1989/90 to 2006/07 adjusted for inflation. 89/90 = 100. (Original index data from ABS. Adjusted for inflation using the RBA calculator on its website.)

However, the housing bubble spread to Brisbane in 2001, and the Brisbane median house price essentially doubled (92% increase) in three years from June 2001 and June 2004. House price growth slowed for a few years, but picked up strongly again in 2007. Between March 2001 and March 2008, the Brisbane median house price increased by a staggering 168% - from $156,600 to $420,000!

At time of writing, there are clear signs that the Brisbane house price bubble has popped, along with the rest of the country. Various data sources point to a sharp contraction in the demand for credit, especially for housing. Newspaper articles have highlighted that sales in Brisbane are dropping whilst more houses are coming onto the market. Brisbane auction clearance rates have been below 30% for a number of weeks. At end of June 2008, there were over **20,000 more houses listed for sale** in Queensland compared to the same time last year; **an increase of 150%** (4). And in the three months to May 2008, 1575 fewer Queensland houses were sold in comparison to the same period of the previous year, **a decrease of 22%** (5).

Clearly, people are trying to sell many more houses, but significantly fewer are willing to buy. This is having the effect of lowering asking prices on listed houses in mid 2008. It will also flow through to selling prices, negotiated discounts, and time required to sell.

It is important to note, however, that these changes may not become clear in the widely published data until late 2008 or early 2009 for a number of reasons. Firstly, the organisations that typically publish these data benefit from turnover, and therefore strong markets, of established and new housing, and publishing data is meant to be a positive influence on that, as well as free promotion. And secondly, most of these data are based on moving averages over 6 to 12 months, which have the affect of smoothing out the data so that the early stages of booms and busts are not immediately evident. Most likely, the first data to confirm the burstingg of the bubble will be the quarterly ABS data house price data.

Note, organisations that benefit from strong realestate markets include those in the realestate industry, property wealth advising and consultation industries, building and construction industries, and finance including mortgage broking and banking industries. Moreover, it is important to note that even state governments have become particularly dependent on increased taxes from increased property prices – property tax revenue increased 72% in 5 years! (6).

A counter argument to the first point above might be that organisations have provided data to be used in the quoted newspaper articles. But I strongly suspect that, at this early stage of the bear market, those organisations are attempting to "kick-start" some momentum back into the market by spreading a "buy on the dip" mentality. If they were successful, it would almost certainly be referred to as a "suckers rally" in the medium term.

Given the sheer number of houses listed for sale – presumably due to stressed sales and long-time owners' concerns that they are not likely to have as profitable an opportunity to exit that market for some time – I would argue that it is highly probable that we have already entered a bear market in residential property. The Brisbane residential property bubble has indeed popped.

I will not spend a lot of time discussing why – as the "bubble psychology" fades the reality will be clear to most, and there is sure to be much said of it over the coming months. I would like to think that house prices just got so ridiculously high that it became blindingly obvious to most potential buyers. But I do not think that is the main reason – the fear of never being able to afford to buy a house was palpable. Forget the old fable of cabbies telling you where to buy, three day old embryos were yelling from the womb "buy me a home, it'll never go down in value!" (I do mean this in a literal way – most parents assumed that house prices would always stay high and were deeply concerned about whether their children would ever be able afford to buy a home.)

The bursting of the bubble was probably due to three events, and their interaction with the market fundamentals of affordability and investment returns. In chronological order the events were the bursting of the US housing bubble, the credit crisis and interest rate rises in early 2008.

I think that Shiller (2005) is right that bubbles are essentially created by feedback loops, and in late 2007 Australians received a lot of negative feedback on housing markets from the bursting of the US housing bubble and the credit crisis. Australians were highly aware of the troubles in the housing market in Western Sydney, but that seemed not to matter. Then the RBA and bank interest rate rises in early 2008 seemed to have a major impact not just on affordability, but confidence. Perhaps it was more to do with interest rate uncertainty. (And very few people are even aware of the potential for a serious current account funding crisis!)

To sum it up, I would suggest that the bubble has popped because those events allowed buyers to analyse the market with a different frame of reference. Investors, especially more experienced ones, and speculators decided that prices had gone as high as they were likely to for an extended period. Most first home buyers were excluded from the market due to record low affordability and tighter credit availability from the credit crisis, and many of those that could afford to buy knew it was imprudent to do so.

(I would like to think that my blogging, along with others, played a very small part in people coming to their senses also – I have no doubt whatsoever that industry groups spend significant funds on attempting to influence public opinion though those channels – it would be interesting for Shiller et al. to research this issue.)

Forecast for Brisbane house prices (3)

The factors that led to the popping of the Brisbane house price bubble are similar to the popping of the US bubble. House price rises and interest rate rises led to very low levels of affordability. Stressed sales began to occur, by owner-occupiers and the large number of speculators that had come into the market, with fewer buyers able or willing to take up the slack. Thus a negative feedback loop commenced and the bubble began deflating. In some US cities it has popped.

Many will argue that the US situation is different because it is now clear that a lot of people were given loans that they would never be able to repay. I would argue that things were not that dissimilar in Australia. I know from personal experience that, so called full-doc (our equivalent to prime) lenders, were prepared to lend, without witnessing any history of savings, mortgages that required repayments equivalent to 60% of net income (when interest rates were at 7% and lower). Australia was no different to anywhere else – quantity of credit sold by lenders was the key driver, not quality! That caused a very significant reduction in lending standards, which as of writing is being reversed (because lenders know that they now need to have very good quality mortgages if they are to have any hope of on selling the credit through those complex instruments – residential mortgage backed securities.)

To come up with a forecast of what might happen to house prices in Brisbane over the next few years, I plotted an index of the median Brisbane house price versus the Case Shiller 20 US city index and indices for Miami and Los Angeles, two of the more spectacular boom cities (Figure 2). I realigned the US indices so that the peak of the 20 city index was in line with the presumptive peak in the Brisbane index at March 2008.

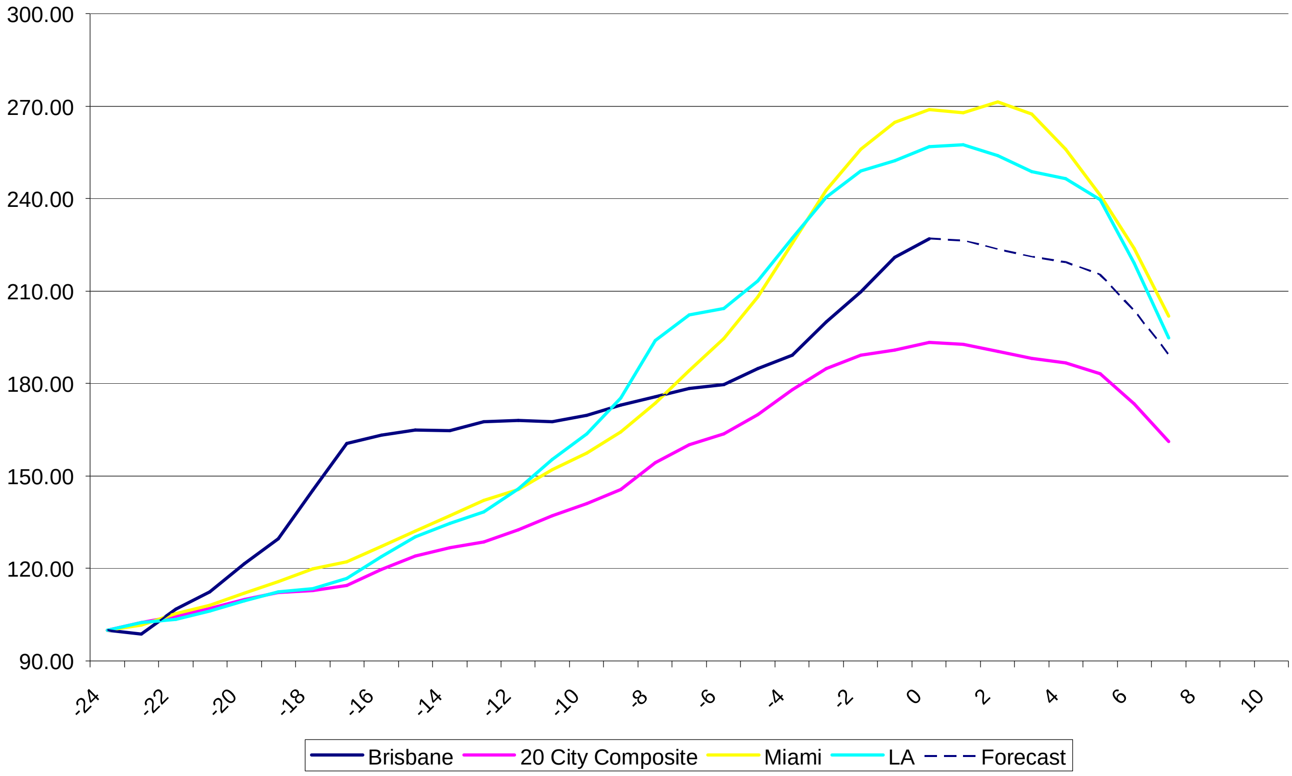


Figure 2. Comparison of house price indices for Brisbane, 20 US cities, Miami and Los Angeles. Data sources – ABS and Case Shiller. Six years pre-peak = 100.

The early stage of the Brisbane bubble was more rapid. The 20 US City index took over 4 years, and the Miami and LA indices took 3.5 years, to achieve the gains that the Brisbane bubble made in the first 18 months! Ultimately the Miami and LA bubbles proved to be bigger than the Brisbane one, but the presumptive peak of the Brisbane bubble is well above the peak of the 20 city index.

The LA and Miami house price bubbles were two of the biggest in the US, and their price indices have since collapsed by 26% and 28%, respectively. That the Brisbane house price index peaked between the peaks of these two cities, and the 20 city index, shows just what a huge bubble Brisbane house prices have been.

Because the causes of the bubbles were virtually identical, the magnitudes of the bubbles were similar, and the reasons for the bubbles popping were similar, I would argue that it is valid to forecast the likely movement of the Brisbane house price index based on movements of these Case Shiller Indices of US house prices.

It would be valid to develop a forecast between LA/Miami and the 20 US city index seeing as the Brisbane house index peaked between them. However, I used a more conservative approach of applying the movement of the 20 US city index to forecast the likely movement of Brisbane house prices.

<u>**This forecast results in the median price of Brisbane houses having decreased by 17% by December 2009 – from $420,000 in March 2008 to $350,443**</u>.

I wanted to take my modeling further. From house price movements since 1970, reported above and in Abelson et al. (2005), we know that: a) this has been the largest house price boom, a bubble, Brisbane has experience in at least 4 decades, perhaps ever; b) it is typical for real house prices to decline for extended periods after price booms, and c) government policy settings, particularly applicable to investors, are major factors in house price movements. The new Federal government has given some clear indications in this respect (Table 1).

Table 1. Federal government policies, current and planned, related to housing and likely impacts.

Increasing Investor Demand	Increasing Owner-occupier Demand	Increasing Supply by/for Investors	Increasing Supply by/for Owner-occupiers
•Negative Gearing •CGT Concessions •Gearing within SMS ALL UNDER REVIEW	•No CGT •First home owners grant •First home savers accounts	•Affordable rent initiative – subsidise construction of 50,000 houses in 5 years (100,000 in 10 years if necessary)	•(perhaps initiatives to stimulate first home buyers' demand for new dwellings will come from the tax review) UNDER REVIEW

As continually stated by Abelson and colleagues (2005), as well as many, many others, Federal government policy settings affecting investor demand for housing – particularly those relating to taxation – have a very significant affect on housing markets over the medium to long term. With the taxation review, "Australia's Future Taxation System", there is considerable uncertainty surrounding these settings, and policy frameworks will not be clear for several years.

I modeled future Brisbane house price movements based on two scenarios: a) my central forecast that the Federal government will end negative gearing and the CGT concessions following the taxation review because of mounting evidence and public concern that they promote speculation in house prices, and b) taxation concessions to investors remain as is, and other setting stay as per table 1.

The following assumptions are implicit in each forecast scenario:

a) Central forecast: negative gearing and CGT concessions are ceased in early 2011; the first home savers accounts (FHSA) are successful in attracting a high proportion of first home buyers, thus decreasing their demand until late 2012 when there is a surge in demand as the first participants gain access to their funds; Federal and state governments plans to increase supply of housing succeed.

b) Alternative forecast: investors continue to receive significant taxation concessions which continue to be funneled into established houses, rather than new dwellings, especially in the lead up to the first participants of the FHSA gaining access to funds; the FHSA initially attracts many first home buyers, thus decreasing their demand until late 2012 when there is a surge in demand as the first participants gain access to their funds; Federal and state governments plans to increase supply of housing succeed.

The results of that modeling are presented below in Figure 3.

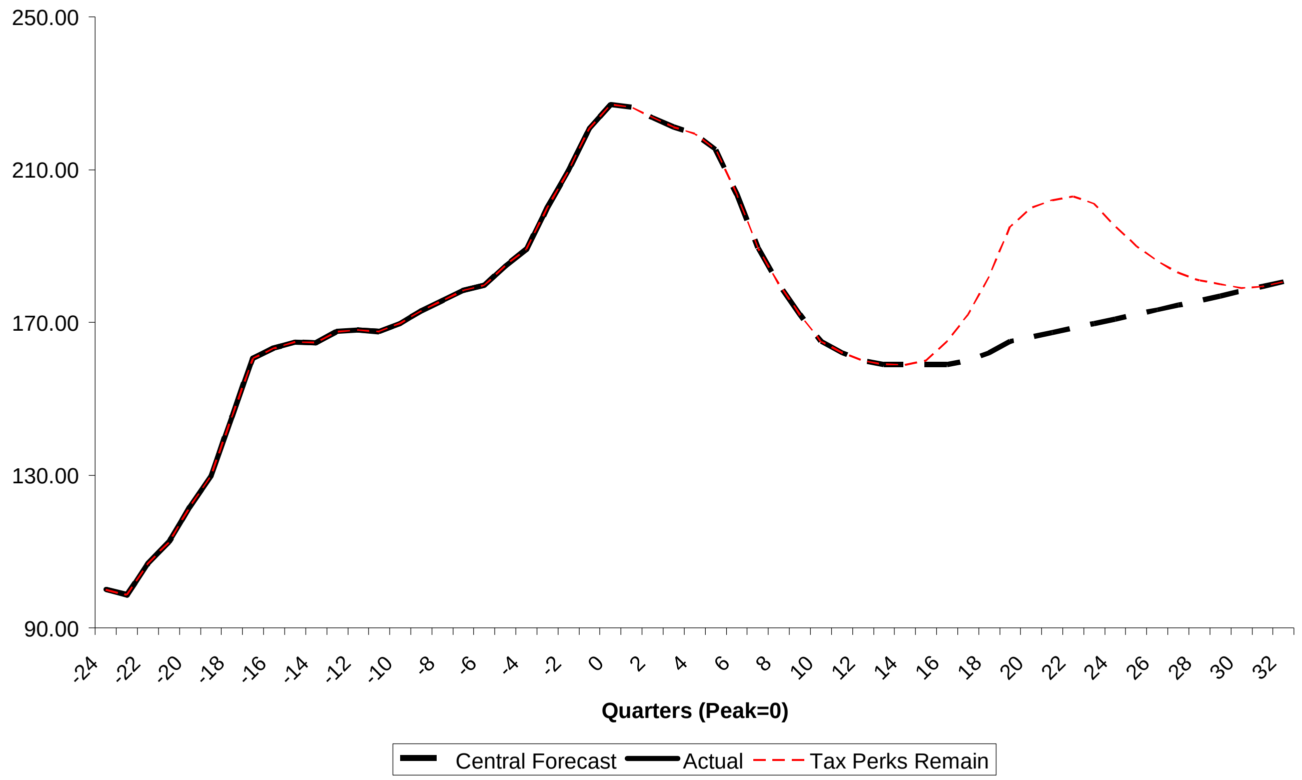


Figure 3. Forecast of future Brisbane house prices. Stage 1 of the forecast, up until 18 months (6 quarters) post peak, is modeled on the 20 US city house price movements. Stage 2 modeling, from 18 months to 8 years, involves two scenarios of whether investors continue to receive favourable taxation treatment.

In the central forecast, house prices continue to decline to trough at September 2011 at 30% below the March 2008 peak. This represents a median price of $294,000. The median price forms a solid base there over several quarters, and with the increase in demand from first home buyers, prices begin to rise in the late 2012/early 2013. Price rises are roughly inline with inflation from 2013 out to the end of the modeling period at March 2016 when the median price is $334, 224.

In the second scenario, house prices continue to decline and once again trough at September 2011 at 30% below the March 2008 peak. However, with the property investor taxation concessions still in place and promoting speculation in housing, investors begin to position themselves to take advantage of the surge in demand from the FHSA participants gaining access to their funds. This surge in demand initially from investors results in house prices quickly moving off their trough in late 2011/early 2012 and accelerating upward through mid 2012. By late 2012, when the first FHSA holders hit the market, house prices are already $66,750 above their trough prices. Some FHSA holders decide to buy, others decide not to, but the feedback loop has been reignited to a slight degree by the price gains, so more speculators come into the market further driving up prices. However, the ability of spruikers to build moment in the market is hampered by the coexistence of negative feedback loops from the most recent price declines. In other words, spruikers will not be able to perpetuate the myth that "house prices never fall". Through mid 2013 it becomes apparent that first home buyers are still not entering the market due to poor affordability, so the mini price boom is short lived and it peaks at September 2013 at a median price of $375,548. Affordability continues to be a major issue for first home buyers; some make use of FHSAs, many do not. The mini price boom deflates out to March 2016 to finish at the same median price of $334,224.

Given the size of the house price bubble, the degree of indebtedness by Australians (as elegantly covered in Keen 2007), and the degree of credit market disruption caused by the American subprime crisis, **I would consider that the risks to these forecasts are to the downside**, i.e. house price falls are more likely than not to be greater than presented in these forecasts.

But what about the fundamentals – Undersupply and Immigration?

Firstly, lets look at how these forecasts fit with longer term price movements of Brisbane house prices.

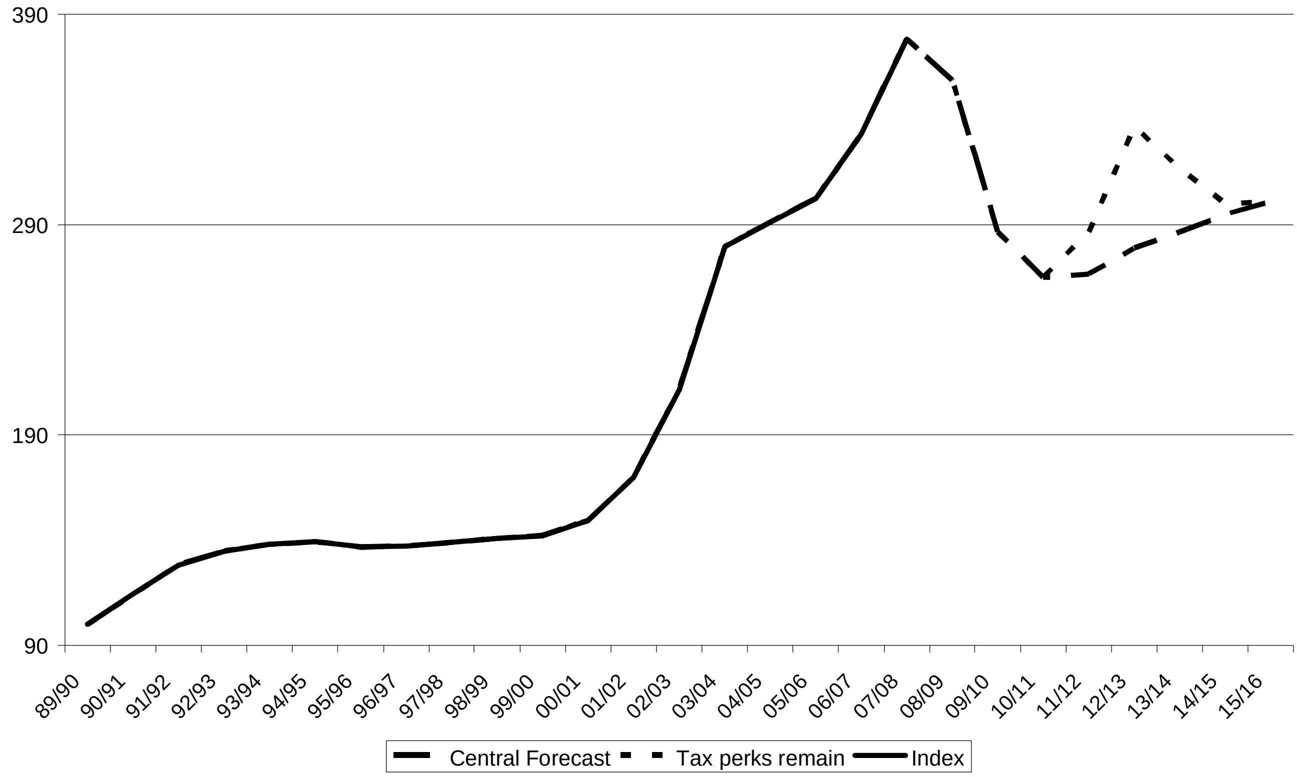


Figure 4. Brisbane median house price index: actual 1989/90-2007/08 (data source: ABS), forecast 2008/09 to 2015/16. 89/90 = 100.

Although the many proponents of property investing will suggest that these forecasts massively underestimate likely future Brisbane house price gains, and investors would rightly be shocked because clearly movements are not what they expected and were told to expect, in the context of long term price movements the forecasts are patently realistic. It is the skyrocketing prices from 2001/02 that appears unrealistic! I don't think anybody in the mid- to late-1990s would have forecast what was about to happen to house prices – then again, who was to know that Greenspan would enact his "put option" and supply liquidity to the world!!

Of course property spruikers and investors will argue against these forecasts based on fundamentals – as all proponents of any particular asset class do to justify their views. If markets were completely rational and always priced on fundamentals, that would be perfectly valid. But it is exceedingly clear that, especially over the last several decades as the globe has been awash with liquidity, markets rarely trade strictly on fundamentals. In fact, it is frequently argued that markets are very rarely priced accurately with respect to fundamentals – and these rare occasions simply mark a fraction of a moment in time as markets swing from overpriced to underpriced and vice-versa. What makes prices flip between the two is market participant psychology – the tendency of people to be optimistic or pessimistic, rolled together with emotions described at their extremes as greed and fear.

So the question needs to be asked: why should markets, from this point in time, move in line with factors which definitely do determine our future need for housing – household formation (dependant on various demographic factors such as population growth rate, both natural and from migration, etc) relative to existing housing? I do not argue that immigration to Queensland is not strong – but it has been for a long time. Ross Barker, director of the Queensland Department of Infrastructure and Planning stated "in terms of growth rates, Queensland has been the fastest of the states for most of the period between 1991 and 2007" (7). He added "overseas migration is now much more significant than interstate migration".

Clearly, house price movements throughout the 1990s did not reflect this fundamental because house prices declined in real terms. Moreover, that current migration levels are more dependent now on overseas migration, and from my understanding, specifically skilled migration under the 457 **temporary** visa scheme, suggests that this form of migration will be very quick to adjust to economic circumstances. Furthermore, as the migrants in question are highly mobile and skilled, in an economic downturn they may well leave to go to better performing economies. And finally, in regards to household formation by Australian citizens, the demographics underlying the increase in household formation may well change abruptly – there is already much discussion of children staying in the family home till later stages in life, but this is probably not all that new a phenomenon, and a deterioration in economic conditions could also lead to lower household formation through "bunching" up. (Certainly there are anecdotal reports of lots of students living together in one house, not unlike some friends I knew at uni in the late 80s!)

So we come back to this question again. When Brisbane house prices over the last 4 decades have shown to strongly follow a boom-bust pattern, and when many international organisations point to Australia as being in the grip of a house price boom, eg. the International Monetary Fund says that Australian houses are overvalued by 25% (See this article [http://www.abc.net.au/pm/content/2008/s2208561.htm] for coverage), is it really reasonable to expect that suddenly at the peak of the biggest house price bubble Brisbane has ever experienced future house price movements will be dictated by fundamentals? Of course the answer is No!

That is what makes it all the more disgraceful that such a well known and trusted Australian bank as the ANZ recently lent its name to an article in a national newspaper entitled "Home Prices to Explode" [http://www.news.com.au/business/money/story/0,25479,23961580-5013951,00.html]. As stated earlier, various industries have much financial interest in there being continued strength in Australia's housing markets. That one of Australia's biggest banks engaged in such an obvious attempt to influence market sentiment suggests two things: a) data at the banks' disposal must confirm that the housing bubble has popped, and in a dramatic fashion; and b) this bank is in a particularly precarious position and has significant concerns over the health of its loan book with the prospect of significant bad loans and writedowns, and thus its profitability is under threat. I would not be an investor in the ANZ going forward!(8)

Many property investors and speculators expecting capital gains from March 2008 prices will be extremely disappointed. Moreover, affordability issues will also impact their ability to raise rents – faced with the prospect of vacancies as rental increases ripple outward from the CBD, causing tenants to move progressively outward and those already in outer suburbs to become homeless – a ceiling to rental increases will be reached when owners decide, through financial realities of their own, they would rather have a stable tenant than attempt to continue to extract large rental increases.

I would suggest that my forecasts may be painted by some vested interests as pro-first home buyer. However, it is significant to note that even my central forecast is not especially good for first home buyers. In March 2001, the ratio of the Brisbane median house price to Brisbane average earnings was 3.95. At March 2008 it was 7.67! Under both forecasts, if Brisbane wages increase at the rate of 4% pa, at the end of the forecast period (March 2016) the ratio will be 4.43, 10% higher than in 2001! And remember, most international studies consider that housing is only affordable when the ratio is below 3!! Clearly, young Brisbane families will continue to have to make difficult decisions about family and their desires of home ownership.

Over the very long term, beyond the forecast period, I do believe that affordability will continue to improve for first home buyers as baby boomers sell down their assets through retirement. The continual supply of existing housing on the market should have a downward impact on Brisbane house prices over the next several decades.

Conclusion

This study and its forecasts show that poor Federal government policy has been, and will continue for a long period to be, damaging to the needs and aspirations of everyday Australians, and dare I say it, “working families”. That very much includes the less sophisticated investors that joined the boom late, thereby transferring their current and future wealth to the earlier “smart money” investors.

And that is precisely why the current Australian federal government must finally take action and get rid of these ineffective taxation policies which promote, and provide an opportunity for spruikers to aggressively promote, Australian houses as speculative assets. They are our homes not casino chips!

Some Favourite Quotes

Adam Smith (from PJ O'Rourke, 2007, "On The Wealth of Nations")

"A dwelling house, as such, contributes nothing to the revenue of its inhabitant…….. It cannot yield any to the public, nor serve any function of a capital, and the revenue of the whole body of people can never be in the smallest degree increased by it"

Warren Buffet (Berkshire Hathaway's 1997 Chairman's Letter)
[http://www.berkshirehathaway.com/letters/1997.html]

"A short quiz: If you plan to eat hamburgers throughout your life and are not a cattle producer, should you wish for higher or lower prices for beef? Likewise, if you are going to buy a car from time to time but are not an auto manufacturer, should you prefer higher or lower car prices? These questions, of course, answer themselves.

But now for the final exam: If you expect to be a net saver during the next five years, should you hope for a higher or lower stock market during that period? Many investors get this one wrong. Even though they are going to be net buyers of stocks for many years to come, they are elated when stock prices rise and depressed when they fall. In effect, they rejoice because prices have risen for the "hamburgers" they will soon be buying. This reaction makes no sense. Only those who will be sellers of equities in the near future should be happy at seeing stocks rise. Prospective purchasers should much prefer sinking prices."

(Note by Brett – the same goes for property – whether for an investment or for your home.)

Some Recent Property Specific Quotes

Warren Buffet on CNBC Squawk Box (talking about US housing market on CNBC Squawk Box on March 3, 2008)

"And if a house has doubled in price, and somebody lends 95 percent of the price that's doubled in a couple of years, there's a good chance they're going to lose money….. for a while people thought houses could do nothing but go up, so they paid no attention to any other factor..... the person who sold the house [during the bubble] got a bubble-type price….. every time anybody tells about somebody losing a lot of money by selling a house [after the bubble burst], there's somebody else that's buying it at a more attractive price than they would've paid a year or two ago."

Wilbur Ross on CNBC Squawk Box on March 7, 2008

"I think the credit crunch is not only getting worse in the US but it is spreading overseas. I was in England about two weeks ago, and my take of the housing market there is that it is in at least as bad a shambles as what we have in the United States. They had an activity there called "build to let" where little people, not real realestate professionals, but average citizens were building houses, highly leveraged, on speck, with the idea of renting them out. And I don't think that realestate is a very good game to play "Amateur Hour". And it's now coming back to haunt them. So I see the credit crunch spreading to England. Housing prices have been very badly hit in Ireland. Very badly hit in Spain. Even as far away as Australia. So I think "credit crunch" may be one of our big export products near term."

Notes

(1) The term bubble is used as per accepted convention in most national markets, particularly the US, along the lines described by Shiller (2005).

(2) Steve Keen's Debtwatch No. 20 March 2008: Double or nothing?
http://www.debtdeflation.com/blogs/2008/03/03/steve-keens-debtwatch-no-20-march-2008-double-or-nothing/

(3) Figures quoted here are from, or have been calculated from, data from the Reserve Bank of Australia, the Australian Bureau of Statistics, and from Case-Shiller. The specific websites I used are – www.abs.gov.au – www.rba.gov.au/calculator/calc.go -
http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice_History_062418.xls

(4) http://www.news.com.au/couriermail/story/0,23739,23968923-5011140,00.html

(5) http://www.news.com.au/couriermail/story/0,23739,23954212-953,00.html

(6) Ludlow (2008)

(7) Mr Barker's comments were made at the Australian Population Association's 14th biennial conference and were reported in the Australian Financial Review on 3 July 2008, "WA steals march on Queensland", P10.

(8) As an aside, I always find it humorous how industry's suggested response following financial collapses – such as ACR, Fincorp, etc – always involves "investor education". Really! As if industry really wants us all to be wise to their tricks!!

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[Professer Shiller's website about the book, data and additional information is available at http://www.irrationalexuberance.com/index.htm]

Appendix 6 – A personal experience of renting in central Europe

Many Australians have never lived for a period outside of the country. As such, Australians find it difficult to imagine what it like to rent in another country with another system, especially where the majority of accommodation is owned by large scale investors. The following is a personal insight from my experience of renting in central Europe – in France and Germany – for several years.

On moving into an apartment it is bare – there aren't even light fittings – just wires sticking out of the ceiling. I believe it is a requirement that residences have a stove. Most people refurbish the apartment or house before relocating in order to make it their home exactly the way they would like. Essentially, the renter can do as they like so long as they do not alter the structure of the building. They might put up a new wall to subdivide a room, or even put in a new kitchen. In Germany around 70% of people rent. And people have no qualms about spending money when they move in because: 1) it genuinely makes the residence <u>their home</u>; 2) they usually take out very long leases of 5, 10 or even 20 years; and 3) they do not have all of the other costs of home ownership. Most Australian home owners would refurbish about as frequently as central Europeans shift rented apartments.

It is also important to note that it is not absolutely necessary to spend money refurbishing when you move in if you do not wish to or if you can not afford it at the time. The accommodation must be in a liveable state, although it is usually rather bare.

This does not preclude small scale investors from being involved in the market. In Germany we actually lived in a flat attached to a large privately owned residence. However, the dominance of large scale investors in the market has the effect of keeping rental increases more stable and in tune with long term trends rather than short term issues.