Common sense 101: Some really simple solutions to the housing affordability crisis

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Ian McAuley has written two articles on the problem of housing affordability and the related risk aced by those who have high housing debt. One reader has asked him to respond with suggested solutions. Over to Ian….

Responding to two articles I wrote on housing policy (Part 1 on financiers, Part 2 on borrowers), Kathy Hyne wrote, "I hope there is a part 3 on mitigation".

There are two related problems – non-affordability for those who find themselves locked out of the market, and financial stress for those who have become heavily indebted in an over-priced market (while my article on borrowers is about individuals, Greg Budworth has an excellent article in New Matilda this week on affordability that goes into its social aspects).

To an extent the interests of the two groups – those who cannot afford housing and those who are over-committed – are at odds: what is done to bring down housing prices will probably leave others exposed to financial risk, particularly those who have high debt and little equity.

When prices fall debt stays constant, resulting in a disproportionate ("levered") effect on equity, which can easily go negative. For example: if you owe $800K on a $1 million property, you have $200K equity; if its value falls by 10 per cent your equity falls to $100K (the debt doesn't fall) meaning it halves; and once its value falls again by a similar amount, your equity is wiped out.

That's the essence of the political problem facing the government, because many of the Coalition's so-called "aspirational" voters have taken the bait of low nominal interest rates, permissive bank lending practices and tax breaks to buy investment properties.

Apart from their real estate they are not necessarily wealthy: rather many are taking advantage of what they see as a chance to get ahead materially in a country described by Cameron Murray and Paul Fritijers in their work Game of Mates: How favours bleed the nation, as "a class-society, with an elite that robs the rest who are scrambling to salvage some self-esteem by secretly hoping to join that elite".

Even though their self-image may be one of rugged self-reliant individualism, the reality is that they have benefited from government-dispensed favours, and they are pressuring the Liberal Party to protect them from their own gullibility.

Leaving aside the Coalition's problems with its pampered supporters (those problems go way beyond housing), I suggest that by any reasonable standard, priority should be given to making housing affordable, particularly for first-home buyers. Their interests should take precedence over those of property speculators.

To get speculative money out of the system, the obvious solution is to wind back the tax concessions that privilege speculators. Capital gains tax should apply to 100 per cent of the capital gain, with provision for indexation – the system before Howard's changes in 1999. Losses in housing should be quarantined, and should not be permitted to be offset against other income for tax purposes. This refers to the practice known as "negative gearing".

For a short period, from 1985 to 1987, the Hawke-Keating Government prohibited negative gearing, before it yielded to pressure from speculators and a hysterical scare campaign mounted by the Liberal Party. I also suggest that deductibility of interest payments should be limited to the real (inflation adjusted) component of interest, to avoid double-counting of deductions.

Also on the table for consideration should be removal of capital gains tax exemption for owner-occupied housing and the re-introduction of some form of inheritance and gift taxes. Such changes, if designed and implemented well, with provision for deferred payment, could include measures to allow older people to downsize without suffering any immediate penalty.

On the supply side, investment in public housing should be a clear priority, and such housing should not only be at the bottom of the market, because if it can stretch towards the middle of the market it will help bring down the price of all housing. Addressing the same need Greg Budworth has suggested an Affordable Housing Commission.

Then there are policies that go beyond "housing" toward what may be broadly called "settlement policies", integrating policies on infrastructure, immigration and land use.

A settlement policy is broader than what is known as "decentralisation", which implies some hub-and-spoke hierarchy of locations. Rather, it is about ensuring that the amenities that have made our state capitals attractive places are not confined to a small circle around their CBDs.

These should not be the only places where people want to live and do business. Public goods that contribute to people's well-being should be well-distributed. These include schools, hospitals, parks, universities, and recreation and cultural facilities. Transport infrastructure connecting communities should also be well-distributed.

Even more broadly influencing housing affordability are policies that affect income and wealth distribution. In relation to housing, this is not only about distribution between broad income and wealth groups, but also about distribution between old and young people. We presently have a set of policies – university fees and their repayment, health insurance subsidies, and tax concessions for retirees – that effectively re-distribute income from the young to the old. We need policies to move the distribution in the opposite direction.

These are policies for the medium to long term. Any policies that act in the short term to bring down housing prices will leave people exposed. And if public policy doesn't deflate the bubble, the market will do it, as it has already done in Perth and Darwin, where real prices of established houses are 14 per cent below their recent peak.

The irrational dynamic that has prompted investors to buy in a rising market will probably prompt them to sell in a falling market – these feedback loops work in both directions.

Much will depend on how the banks react to a widespread fall in housing prices, particularly if inflation stays low and fails to shrink the real value of their loan portfolio. A detached observer may say that the only thing that will happen is a write-down of asset values: it's not as if the houses and apartments will have been destroyed in a fire or cyclone.

Banks should keep their cool and not panic, but there is a good case for them to foreclose on investment properties which will then go back on to the market. Foreclosing on people's residences is a different matter, however. For people's homes it would be better if the banks were to re-negotiate payment schedules. A slow deflation is much more in the banks' interests than a crash.

Either way, however, there will be pain for over-committed borrowers and for those who have lent unwisely. Pain may be the cost of learning – learning not to buy into an over-priced market, learning that there are no easy paths to financial prosperity, learning that there is a difference between real wealth and inflated asset values, and learning not to trust real-estate spruikers or Liberal Party politicians who have so cynically encouraged their "aspirational" supporters to get into deep trouble.

Once we have come through this difficult adjustment we must come to a basic social agreement about housing. That agreement is that we invest in housing for its value in providing shelter and social connection. To draw on a distinction Aristotle made 2,350 years ago, the value of housing should be its use value. It is not some commodity like gold or pork belly futures which are traded on the basis of their exchange value.

If we have such an understanding people will be more accepting of policies designed to nip housing speculation in the bud.

And the Liberal Party, if it still exists after the bubble deflates, can go about the hard work of developing policies that contribute to real and shared wealth, rather than promoting a frenzy of asset speculation.