HOUSING FINANCE AND THE CAMPBELL REPORT:
A REVIEW OF EFFICIENCY AND SUPPLY ASPECTS

Robert Albon and John Piggott

Discussion Paper No. 51
September 1982
HOUSING FINANCE AND THE CAMPBELL REPORT:
A REVIEW OF EFFICIENCY AND SUPPLY ASPECTS

Robert Albon and John Piggott

Discussion Paper No. 51

September 1982

* Revised version of a paper presented at the Conference on the Campbell Report, Australian Graduate School of Management, June 18-19, 1982. We are grateful to Noel Drane and Bob Gregory (discussants) and other conference participants for their comments. We are also indebted to Frank Milne, Jonathon Fincus, Tom Valentine, Neil Vousden and Judy Yates for discussion and comments on an earlier draft.

ISBN: 0 949838 51 9
ISSN: 0725-430X
HOUSING FINANCE AND THE CAMPBELL REPORT:
A REVIEW OF EFFICIENCY AND SUPPLY ASPECTS
Discussion Paper No. 51

TABLE OF CONTENTS

Abstract.................................................................................................................. 1

I. Introduction......................................................................................................... 1

II. The Efficiency Effects of Housing Finance Deregulation............................ 3
   1. Introduction.................................................................................................. 3
   2. Taxation Interactions................................................................................... 5
   3. The Effect of Inflation.................................................................................. 9

III. The Availability and Stability of Housing Finance After Deregulation.... 11

IV. The Distributional Effects of Deregulation.................................................... 16

V. Alternative Compensation Policies................................................................. 18

VI. Conclusion...................................................................................................... 20

Footnotes............................................................................................................... 22

Bibliography.......................................................................................................... 26

TABLES AND FIGURES

Table 1 The Housing Finance and Housing Markets for Owner-Occupation in the Context of the National Economy, 1980 2

Figure 1 The Welfare Cost of the Owner-Occupier Tax Break and Interest Rate Regulation on Owner-Occupier Housing Finance 6
ABSTRACT

The Campbell Report defended its advocacy of owner-occupier housing finance deregulation on a number of grounds. Inter alia, these included efficiency improvements, and greater availability and stability of funds. This paper suggests that efficiency gains will be small, especially when compared with the welfare cost of the owner-occupier tax break. It also argues that there will be no change in the availability or stability of overall owner-occupier housing finance. The authors conclude that the best argument in support of deregulation is that the regulations currently in force in the owner-occupier housing finance market in Australia do not achieve their stated goal of making home ownership easier for the less well-off.
I. INTRODUCTION

The purpose of this paper is to analyse the economic consequences of deregulating the housing finance market in Australia, with special reference to the arguments of the Report of the Australian Financial System Inquiry (1981). The Campbell Commission has argued for the deregulation of lending for housing, concluding that "there is no justification for retaining interest-rate controls as an instrument of housing or welfare policy" (p.647). We have interpreted the Committee as being mainly concerned with the efficiency, distributional, availability and stability of effects of regulatory intervention in the housing finance market. In this paper we stress efficiency, availability and stability aspects, although distributional issues are also discussed briefly.

In the belief that policy issues are most sensibly debated if there is some agreement about the facts, we have presented in Table 1 some estimates of magnitudes relevant to the housing finance debate. While none of these numbers is beyond dispute, we have no reason to believe that any are seriously misleading. Together with the data presented in Albon and Piggott (1982), they lead to the following impressions:

(i) The market for housing finance is quite small relative to the total finance market, comprising only about 20 per cent of the value of all financial assets outstanding.

(ii) The $27 billion outstanding as housing loans from institutional lenders is dominated by loans from savings banks (39 per cent) and permanent building societies (31 per cent).
TABLE 1

The Housing Finance and Housing Markets for Owner-Occupation

In the Context of the National Economy, 1980

THE MARKET FOR FINANCIAL ASSETS

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commonwealth Government Securities</td>
<td>$32.8 billion</td>
</tr>
<tr>
<td>Local- and Semi-Government Securities</td>
<td>$15.8</td>
</tr>
<tr>
<td>Loans by Financial Institutions to:</td>
<td></td>
</tr>
<tr>
<td>- Households</td>
<td>$43.5</td>
</tr>
<tr>
<td>- Non-Finance Corporations</td>
<td>$18.2</td>
</tr>
<tr>
<td>Share Capital of Non-Finance Corporations</td>
<td>$17.0</td>
</tr>
</tbody>
</table>

THE MARKET FOR HOUSING:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of Housing Stock (including land)</td>
<td>$135.1 (1979 estimate)</td>
</tr>
<tr>
<td>Value of Owner-occupied Stock</td>
<td>$97.2</td>
</tr>
</tbody>
</table>

NOTES

1. These estimates are drawn from Pellarini (1978). They do not pretend to give a complete picture of the market for financial assets.

2. See Roger (1979). This may well be an under-estimate.

3. Calculated as 0.72 of Roger's estimate. The figure of 0.72 for the proportion of owner-occupancy is from "Survey of Housing Occupancy and Costs, Australia, June 1980" (ABS 8724.0, 13.3.81).
(iii) As of December 1981, the weighted average interest rate on these loans was about 14 per cent and about 90 per cent of loans outstanding were negotiated at regulated interest rates.

(iv) The proportion of equity held in owner-occupied housing is about 75 per cent.

With this background in mind, we analyze in section II the efficiency effects of regulation, and in section III the supply stability and availability of funds. Section IV discusses briefly some distributional issues, while in section V, we conclude with some observations on mortgage interest deductibility as a possible compensation policy in an inflationary environment.

II THE EFFICIENCY EFFECTS OF HOUSING FINANCE DeregULATION

1. Introduction

It is useful to begin with a general point. Economic policy prescription requires a normative framework, and reports produced to inform policymakers should therefore also make explicit the value judgments embodied in their recommendations. The Committee's emphasis on "efficiency" may be seen as its statement of normative position, and its broad-ranging suggestions for deregulation, its reliance on the market, and its advocacy of competitive market structures, may then be interpreted as acceptance of the relevance of the theoretical link between a competitive equilibrium and Pareto efficiency. Certainly, the Committee's criteria for assessing "efficiency" (1.9) give support to such an interpretation.
Strictly, this link is only proven under special and restrictive assumptions, but it is reasonable to accept the Report's normative stance as both consistent and fruitful.

The Committee has by and large confined its attention to distortions operating on financial flows. While it is reasonable to expect some impact of such interventions on real flows, the Committee has not explored the relationship. If the purchase of a particular financial asset is tied to the future consumption of a particular commodity, then when trade in the financial asset takes place, such a distortion will exist. It is these which are important in evaluating the efficiency, or welfare, costs of interventions.  

A second consequence of the Committee's confining its attention to financial flow distortions is that its recommendations take no account of distortions in the Australian economy, unless they operate directly upon transactions in financial assets. The possibility of their interaction with other distortions is not systematically considered on a case by case basis. The absence of any reference to such interactions leaves the reader uncertain as to the likely long run efficiency effects of implementing the Committee's recommendations. We believe that this point should be borne in mind in considering all aspects of the Report. In the case of housing finance, the point is well illustrated by the interactions of regulation with taxation and inflation. It is to these matters that we now turn.
2. Taxation Interactions

It is well known that the subsidy conferred upon owner-occupier housing by excluding the housing equity imputed income from the personal income tax base is distortionary, and in equilibrium leads to a greater consumption of such housing services than would otherwise be the case. In considering the interaction between this distortion and that induced by regulated interest rates, it is useful to begin by assuming no inflation, and no rationing.

The welfare cost of regulating the housing interest rate to be less by a proportion \( m \) than the market rate, in the absence of any other distortion, is approximately given by

\[
I^R = \frac{1}{2} \frac{n^2}{\pi} \leq PQ,
\]

\[
\nu = \frac{n(1 - \lambda)}{1 - n(1 - \lambda)}
\]

(1)

where \( \lambda \) gives the proportion of equity held by the owner-occupier, \( \varepsilon \) is the own-price elasticity of demand and \( PQ \) gives the value of the imputed income from owner-occupier housing, net of maintenance, rates, insurance, and depreciation. The above expression is one form of the formula for welfare cost due to Harberger (1964). Similarly, the welfare cost of the owner-occupier tax break is given by

\[
I^T = \frac{1}{2} \frac{\varepsilon^2}{\pi^2} \leq PQ,
\]

\[
\varepsilon = \frac{\lambda t}{1 - \lambda t}
\]

(2)

where \( t \) is the marginal personal tax rate. These expressions, however, underestimate the welfare cost of the combined policies, which is given by

\[
I = \frac{1}{2} \left[ \frac{n^2}{\pi} + \frac{\varepsilon^2}{\pi^2} \right] \leq PQ > I^R + I^T
\]

(3)
The Welfare Cost of the Owner-occupier Tax Break and Interest rate Regulation on Owner-occupier Housing Finance

\[ P_0 : \text{market price of housing} \]
\[ P_1 = P_0 (1-\lambda t) \]
\[ P_2 = P_1 (1-(1-\lambda)m) \]
\[ P_0 - P_1 = P_0 \lambda t \]
\[ P_1 - P_2 = P_1 (1-\lambda)m \]
\[ \frac{P_1 - P_2}{P_1} = (1-\lambda)m \]
\( L^R \) underestimates the welfare cost of the regulation, given the pre-existing owner-occupier tax break, by an amount equal to \( \left( \frac{x}{x} + \frac{y}{y} \right) \text{CPQ} \). In terms of Figure 1, \( L^T \) is equal to the area of triangle \( a \), \( L^R \) is equal to the area of the triangle \( b \), and \( L \) is equal to the sum of the three areas \( a + b + c \).

So far it appears that interest rate deregulation may lead to a significant efficiency improvement in the allocation of resources.

Now assume that low interest loans are rationed, so that the total quantity of housing services that can be bought with subsidised loans is less than or equal to \( q_1 \) in Figure 1.\(^4\) No efficiency gains are secured by deregulation in this environment, other than the elimination of rent seeking behaviour by potential borrowers.\(^5\) Efficiency gains could be secured by the removal of the owner-occupier tax break, given a low interest ration constraint strictly less than \( q_1 \), or by the simultaneous elimination of both subsidies.

The extent of rationing is not known. However, the Committee implies in a number of places that low interest loans are rationed. Given this belief, we have here an example of how, by confining its attention to direct interventions in financial markets, the Committee has sometimes missed important efficiency implications of related policies.\(^6\)

It may be useful to speculate on the magnitudes of these welfare costs. The only published estimate of the annual welfare cost of the owner-occupier tax distortion in Australia is that of Reece (1975), who used data from a sample of Sydney households to calculate the extent of the subsidy. He valued the annual welfare cost at 0.06% of GDP.
Reece's estimate is surprisingly low. Using national accounts estimates for 1978-79 to calculate $P_0$, we find it equal to $4.8$ billion.

The information included in the introduction implies that $\lambda$ is approximately equal to .75. Assuming $c = 1.0$ and $t = .32$, (the basic marginal tax rate), the value of the welfare cost is $246$ million or $0.25\%$ of GDP, using equation (2). This estimate, rough as it is, is likely to be conservative.

Firstly, it takes no account of the compounding distortion of commodity taxes on non-housing purchases. Secondly, it uses the basic personal income tax rate as an estimate of the subsidy. It seems plausible that, the retired apart, housing equity might be held disproportionately by those facing higher marginal rates. Thirdly, the choice of $c = 1$ is conservative. Absolute elasticities are often taken to be as high as 1.5. Alternative plausible values of parameters can give much higher values for the welfare cost. For example, assuming $t = 0.4$ and $c = 1.5$ gives an estimate of $666$ million, $0.66\%$ of GDP.

In the absence of rationing, the overall welfare cost, $L$, of the owner-occupier tax break and interest rate regulation can be calculated from (3). The value of $\mu$, taken from estimates of regulated and market rates reported in Albon and Piggott (1982), assuming an inflation rate of $10\%$, is $0.43$. Assuming $t = 0.32$, and $c = 1.0$, we find the welfare cost of the combined policies, $L$, is calculated to be $465$ million, or $0.46\%$ of GDP. With $t = 0.4$, and $c = 1.5$, $L$ is equal to $1,089$ million, or $1.09\%$ of GDP.

If the welfare cost of regulation is estimated without recognising the existence of the owner-occupier tax break the corresponding calculations yield $74$ million ($0.07\%$ of GDP) and $112$ million ($0.11\%$ of GDP). From these calculations therefore, the owner-occupier tax break is by far the more important contributor to distortions in the housing market, even if it is assumed that cheap loans are not rationed. This conclusion is interesting in the light of Prest's (1982) observation that the Campbell Report contains...
9.

"no more than an isolated reference to the non-taxability of imputed income from owner-occupied housing" and that while the Committee "might well argue that its concern was with housing finance rather than housing as such,... it might be that non-taxability of imputed income is more important than cheap finance as a stimulus to house purchase" (p.90).

To make the personal income tax treatment of owner-occupied housing consistent with that of other income, mortgage interest payments should be made tax deductible, and imputed income should be taxed. This is a policy option considered further in section V.

3. The Effect of Inflation

The effects of the interaction of uniform anticipated inflation and taxation on the costs of home-ownership under an Australian-type tax regime have been explored by Anstie (1981). She bases her analysis on the tax-modified Fisher formula developed by Darby (1975) and Feldstein (1976). Given the taxation of nominal interest payments, the deductibility of nominal interest receipts, and a single tax rate \( t \), these authors show that the nominal rate of interest is given by

\[
i = \frac{(1+i) - r + \frac{\hat{\pi}}{1-t}}{(1-c)} = \frac{r + \frac{\hat{\pi}}{1-t}}{1-t}
\]

(4)

where \( \hat{\pi} \) is the uniform and anticipated rate of inflation, and \( r \) is the net-of-tax real rate of return. The nominal rate of interest thus increases by more than the rate of inflation. With a (long-term) anticipated inflation rate of 8%, a tax rate of 40%, and a real after tax return of 2%, the implied nominal rate of interest is about 17%.

Provided all nominal interest payments are taxable, and all nominal receipts are deductible, no real effects are implied by the tax-modified Fisher formula. The real prices facing borrower and lender are the same,
and the government collects no net revenue from the transaction. However, if, as is the case in Australia, owner-occupied mortgage interest payments are not tax-deductible, real effects will result. We can think of the additional interest paid as a form of inflation tax on owner-occupied housing services financed by debt. The effective tax rate, on the gross of tax real rate of return r/(1-t), is πr/r. Given the values in the above illustration, the tax rate (on a net base) is 160%. On a gross basis, this is equivalent to a 62% tax rate.

With uniform and anticipated inflation, and under current Australian tax law, it is possible that this inflation tax will reverse the traditional owner-occupied tax subsidy. This point is explored in detail in Astle (1981), who casts the question in terms of the decision of whether to own or rent.

These calculations assume that housing interest rates are not regulated. With current regulatory policies, the impact of the tax-modified Fisher effect is suppressed. It is possible, however, that the Committee's lack of consideration of its effect on nominal borrowing rates contributed to its views on the consequences of deregulation for housing interest rates. Whatever the truth of this speculation, the Albon-Piggott (1982) prediction of a 3 percentage point rise in the weighted average rate is much less surprising when seen in the light of equation (4). Once again, the Committee's arguments must be qualified because of their failure to take existing related policies into account.
III. THE AVAILABILITY AND STABILITY OF HOUSING FINANCE AFTER Deregulation

The Campbell Committee has suggested that after deregulation:

(i) funds would be available at rates below those currently prevailing in the uncontrolled segment of the market, (e.g. 37.45, 37.52 and 37.54);
(ii) there would be a greater availability of funds (37.101);
and (iii) the "stability" over time of housing finance flows would be increased (37.26).

As noted above, we take issue with the Committee's interest rate prediction. It is our expectation that in a deregulated environment all housing financiers will lend at rates roughly equivalent to those currently prevailing in the uncontrolled segment of the market, i.e. rates of around 17-18 per cent with some variations due to risk. The weighted average interest rate cannot fail to rise substantially from its December 1981 level of about 13.5-14.0 per cent.

It is not clear whether deregulation will lead to a greater availability of total housing finance. If the lending and borrowing rates of controlled institutions are freed of restrictions, the availability of funds from these institutions may increase. But this increase may be at the expense of the unregulated lenders such as finance companies. Indeed, if our interest rate forecast is correct, this conclusion seems to follow.

The concept of "availability" only has relevance when related to the cost of borrowing.

A further consideration is that housing finance flows may not become more stable in a competitive market situation. The Report argues that "housing financiers' inflows would be more stable if their interest rates were allowed to move in line with market forces" (37.26). The arguments in favour of this conclusion are persuasive if it is the case that all housing financiers were initially controlled and then deregulated. Where a
"free market coexists alongside a 'controlled market'" (37.44) it is possible that the free institutions could act as a counter-cyclical force offsetting the instability of the regulated lenders. For example, if banks' lending rates (and thus, deposit rates) are held down while market rates of interest are rising, unregulated institutions/lenders could draw depositors and borrowers away, thus offsetting the fall in lending/borrowing of the banks. Unfortunately there is only sketchy data on the activities of some uncontrolled financiers (especially solicitors and mortgage brokers), precluding the possibility of sophisticated empirical testing.

It is of interest to model how the banks respond to interest rate controls on their housing loans and (until December 1980) controls on their deposits. Building societies are of less interest because of the diversity (across states) and lack of clarity of the regulations they face. Interestingly, a cursory inspection of the new lending for owner-occupancy figures indicates that the permanent building societies' lending tends to move in opposite directions to that of the savings banks in recent years.

Modelling the banks' response to interest rate controls is easiest where only lending rates are subject to a ceiling. However, deposit rates were also subject to strict controls until December 1980 when these were deregulated. There is insufficient data to use time-series regression analysis to study exclusively the period since deposit rate deregulation. Econometric analysis of a longer period is therefore necessary but the changes in deposit rate controls during the estimation period introduce conceptual problems in formulating the equation.
In conducting a simple econometric analysis of the savings banks’
loans for housing easily available data for the period (1975-80) to
1981(D) was collected largely from the Reserve Bank’s Statistical Bulletin.
The procedures used are in the tradition of analyses by Sharpe (1974),
Johnston and Spanos (1976), Johnston (1978) and Cameron (1978) except
that new lending rather than loans outstanding is used as the dependent
variable.

No "identification problem" is anticipated because the interest rate
controls have been sufficiently binding to ensure the observation of
supply points. Perhaps Government lending guidelines (qualitative
restrictions or sanction) have forced banks to less desired positions. The
importance of qualitative controls has recently been exemplified by the deal
reached between the banks and the Government to lend more as part of the
March 1982 "housing policy package".

Where both lending and deposit rates are controlled, simple demand
and supply analysis suggests that they cannot be included together in the
equation explaining advances for housing if it is hoped to gauge their
separate effects. The signs on each interest rate cannot be predicted
in a situation where both are controlled. In order to assess the
effects of restrictions on the lending rate, an equation containing
total deposits as an explanatory variable is used — any effect of the deposit
rate controls on sources of funds is indirectly covered in this way.

It must be further remembered that most savings banks are constrained
to hold either mortgages or government securities, suggesting that a
government bond rate should be included in the equation. Perhaps the best
way to enter this variable is in differential form and a lagged response
should be tested.

After some experimentation with the variables mentioned above, the
following preferred equation was estimated:
\[ H_l = -109.33 + 0.039 \text{TG}_{t-1} - 19.70 (\text{BR}_{t-1} - \text{HR}_{t-1}) + 15.38 \text{NSD} \]

\[ \begin{align*}
\rho_1 &= -0.63 \\
R^2 &= 0.81 \\
\text{SE} &= 19.14
\end{align*} \]

(\(-3.85^{*}\))

N.B. Figures in parentheses are t-statistics. One asterisk indicates significance at the 5% level, two asterisks indicate significance at the 1% level.

where:

- \( H_l \) = savings banks lending for housing in the period (\$m deflated by CPI adjusted to base 1975(1) = 1)
- \( \text{TG} \) = total deposits of the savings banks (\$m deflated by CPI)
- \( \text{BR} \) = government bond rate (rate on two year non-rebateable bonds)
- \( \text{HR} \) = maximum interest rate on housing loans

This equation is satisfactory from a statistical point of view. The overall fit is good, autocorrelation has been corrected by a maximum likelihood procedure and the seasonality has been removed by inclusion of a March seasonal dummy (MSD). As expected, new savings bank lending for housing is positively related to the total deposits in the previous period\(^1\) and negatively related to the differential between the two-year bond rate and the maximum allowable lending rate in the preceding quarter. A variable reflecting qualitative lending directions was insignificant in all regressions in which it was included.

The above equation suggests that, ceteris paribus, increasing the ceiling rate on savings banks' mortgages relative to the rate on two-year non-rebateable bonds would have raised savings banks lending for housing. A one percentage point narrowing of the differential
would raise quarterly lending by about $20m (in 1975 (H) values) or
approximately 5 per cent on average.

To test for the effect of deposit interest rate controls the
following equation was estimated over the period 1976(J) to 1981(D):

$$TD_t = 12,819.0 - 67.76 (MR_t - SBR_t)$$

$$(108.09^{**}) (-2.16^{*})$$

$$\rho_1 = -0.49 \quad R^2 = .45 \quad SE = 147.75$$

$$(2.57^{**})$$

MR\(_t\) is the Australian Merchant Bankers' Association rate on 180-day bills
and SBR\(_t\) is the maximum rate on savings banks' investment accounts (which
was a controlled rate until 1980(D)). The equation indicates that total
deposits in savings banks are negatively related to the differential between
these rates and that raising the rate on investment accounts relative to the
AMBA rate would have raised deposits\(^1\). On average deposits would have increased
by about $68m or about 0.5 per cent for a one percentage point lowering of the
differential.

These estimated equations together suggest that interest rate
controls on both savings bank house lending and on investment accounts have
had the effect of reducing savings banks' lending for housing. This suggests
that deregulation, to the extent that it entailed a rise in the savings banks'
lending rates, would increase lending from these institutions, and tends to
support the Committee's prediction that deregulation would result in greater
availability of finance from previously-controlled institutions. The empirical
results do not have any implications for the aggregate availability of
finance for housing post-deregulation.
IV. THE DISTRIBUTIONAL EFFECTS OF DEREGULATION

The public debate in the wake of the Campbell Report has emphasised the distributional impact of deregulation. Much light has been thrown on this issue through the studies by Judith Yates (1981a, 1981b and 1981c) and we have little to add to her conclusions.

In another paper (Almon and Piggott, 1982) we have attempted to predict the effect on the housing interest rate as a result of deregulation. This question has obvious importance for the assessment of distributional implications. Indeed our forecast of an increase of at least three percentage points implies a larger distributional effect than that apparently expected by the Campbell Committee and, it seems, other commentators.

Stroud (1981) and Closter (1982) have directed attention to the possible effects of deregulation on lending practices and rules, arguing that housing financiers will have less disincentive to become more innovative in their lending. The credit foncier loan arrangement may give way to a variety of types including those which maintain repayments as a constant proportion of real income. Such changes could counteract some of the effects of higher interest rates.

Another possible countering influence is the interest rate capitalisation effect. If housing prices were to fall as a result of deregulation the burden on new home-buyers would be reduced. While far from being a major aspect of its case, the Campbell Committee has suggested that "lower-than-market rates may have simply become capitalised into housing prices...(and that) deregulation of interest rates may ease the upward pressure on the cost of housing" (fn. 24, p.643). Stroud (1981) also examined the possibility of a capitalisation effect and has tentatively suggested that interest rate deregulation would result in house prices falling "to rise as rapidly as they would have otherwise" (p.14).
If, as the evidence suggests, the supply of housing services is highly elastic (see Albon (1981) Ch. 4), then any capitalisation effect will in aggregate be very small, although there may be substantial changes in rents accruing to particular sites. In the simplest formulation, we can imagine a "circular" city with a central business district. If removal of an interest rate ceiling were to lead to a fall in the demand for housing and a downward shift in the rent profile across the city, this would imply a decline in all property values except those at the fringe of the city. More realistically, deregulation might lead to a decline in the growth rate of Australian cities and, thus, to an arrest of the rate at which the rent profile shifts.

It is difficult to perceive of this effect being very large as the empirical literature suggests that site values are very insensitive to subsidisation. As Muth (1971) notes, "[I]n the long run...it is unlikely that rentals will be affected...even with a fixed quantity of residential land provided the supply of structures is highly elastic, because land's share in the production of housing is small" (p.251). This also depends on the empirically-supported assumption of a high elasticity of substitution between land and structures.

In the light of the considerations in the last section one further point should be made. A capitalisation effect is dependent on deregulation affecting the demand for housing. A capitalisation effect exerting a downward influence on the price of housing would require that deregulation reduced the demand for housing. However, it is far from clear whether the Campbell Committee would expect a reduction in the demand for housing to flow from the adoption of its recommendations. The Report could easily be construed as predicting an increase.
V. ALTERNATIVE COMPENSATION POLICIES

The Campbell Committee takes the position that if governments "wish to assist certain groups in a manner specifically directed to the facilitation of home ownership (or house rental)...this assistance should be dispensed fiscally rather than through regulation of interest rates or credit controls" (p.652). It seems to be widely accepted that for deregulation of housing interest rates to be a practicable proposition, some form of compensation for the losers from deregulation is required. This attitude may underlie the Government's March 1982 housing package, which comprised:

(i) a one percentage point increase in the controlled savings bank rate of mortgages;

(ii) a relaxation of savings bank portfolio restrictions;

(iii) limited tax deductibility of mortgage interest payments;

(iv) modifications to the home savings grant;

(v) an agreement by the banks to increase funds available for mortgages by $400m,\(^{18}\) and

(vi) an agreement by banks not to increase the monthly repayments of mortgages for recent borrowers for a two year period.

This package has been seen by some as a first step to full implementation of Campbell's recommendations. The extent to which it can be so interpreted may be questioned. While the interest rate ceiling has been lifted and portfolio restrictions eased, the interest rate increase has been insufficient to maintain its relativity with uncontrolled rates established over recent years and qualitative restrictions seen to have replaced quantitative ones. According to the "Financial Review" (19-3-82), "the Government has avoided embracing the broad thrust of the Campbell Report by extending the area of arbitrary 'suspension' on the banks".
If full deregulation were to proceed, no implementable compensation policy could even approach the ideal of exact compensation. To simply identify the losers from deregulation would be extremely difficult. To quantify the losses accurately would be impossible. It is therefore more likely that the government will offer some general concession in the area of housing finance. If the goal of exact compensation is abandoned, then the compensation policy may take the form of a broader-based assistance scheme to low income groups, either for home purchase or for the purchase of housing services generally.

In this somewhat loose context, we discuss the nature and economic effects of one such policy in some detail: tax deductibility of mortgage interest payments. We assume throughout that housing interest rates have been deregulated.

Tax deductibility of mortgage interest payments has been given much attention in recent public debate on compensation schemes. The Campbell Report raises the matter of interest deductibility, or rebatability, rejects it as a blanket policy, but suggests its use for "limited assistance specifically to low income groups" (37.109). Partial deductibility (though not confined to low income groups) has been incorporated in the March 1982 housing package outlined above. It is therefore important to consider the implications of this policy option carefully.

In the absence of inflation, the economic effects are straightforward. The efficiency cost calculations of section II must be modified to apply the owner-occupier tax break to all imputed income, rather than only equity imputed income. Using the same basis for calculation as that described in section II, the welfare cost of the owner-occupier tax break increases by 116% for \( t = .32 \), and by 143% for \( t = 0.4 \). If, as the evidence and intuition suggests, the owner-occupier/rental tenure ratio is lower for the poor than on average, the measure is regressive as well, since only owner-occupiers will benefit from the change.
20.

Now assume a uniform anticipated inflation, and assume further that the tax-modified Fisher effect operates fully. As was explained in section II, Australia's current tax laws will lead to an erosion of the current equity-only tax break, for those owner occupiers with mortgages, if the housing interest rate is deregulated. Recall the tax-modified Fisher formula:

\[ 1 - \frac{\pi}{(1-t)} = \frac{\pi}{(1-t)} + \frac{\pi}{(1-t)} \]  

(5)

If the Government wishes to restore the no-inflation status quo, it should allow tax deductibility of \( \frac{\pi}{(1-t)} \) and \( \frac{\pi}{(1-t)} \) remaining non-deductible, as it was in the no-inflation case. This would be approximately equivalent to the regulated situation at the end of 1981, since the current (end of 1981) average regulated interest rate for owner-occupied housing (about 14%) is roughly equal to the sum of the inflation rate (9%) and the no-inflation gross real interest rate (5%). In that sense such a policy would be compensating.10

If full interest deductibility were to be adopted, the result would be over-compensation, with the difference being made up by increased tax rates elsewhere in the economy, and/or a reduction in government spending.11

VI. CONCLUSION

In advocating the deregulation of housing finance provision, the Campbell Committee argued that this policy initiative would:

(i) not appreciably increase the cost of owner-occupier housing finance;
(ii) increase "efficiency";
(iii) increase the "availability" of owner-occupier housing finance at least from previously controlled institutions;
(iv) probably lead to a capitalisation effect, thus decreasing the cost of housing services;
(v) make housing finance flows more stable;
(vi) lead to more innovative lending practices.

In an earlier paper, we argued that the weighted average interest rate on owner-occupier housing finance would increase substantially as a result of deregulation. In this paper we have argued that deregulation:

(i) would lead to small efficiency gains, especially when compared with the efficiency cost of the owner-occupier tax break;
(ii) would not lead to greater total availability of owner-occupier housing finance;
(iii) would not in the long run lead to a change in the price of housing services;
(iv) would not necessarily lead to greater stability overall; and
(v) may well result in the break-down of the credit foncier system of lending and its replacement with more sensible alternatives.

Finally, we would like to stress that our differences with the Committee over the effects of housing finance deregulation do not lead us to conclude that this policy initiative does not have merit. In our view, however, the strongest argument for deregulation does not lie in favourable efficiency, stability, or availability consequences. Rather, it is that interest rate controls have not achieved the distributional objective of actually subsidising those for whom assistance was allegedly intended.
FOOTNOTES

1. These arguments relating to housing finance are presented in Part I of Chapter 37 of the Report.

2. In the conference version, a formal analysis of the circumstances under which financial distortions would transmit directly to real flows was presented.

3. This is a statement of the conclusion of the "theory of second-best" which states that the removal of one impediment to Pareto efficiency may not improve efficiency if other impediments remain in the system. There are many circumstances in which the theory is inapplicable, as explained in Albon and Cheek (1981).

4. Of course, the purchase of housing services themselves are not quantity-constrained.

5. Potential borrowers will expend resources in seeking out and securing below-market interest loans. This is a form of rent-seeking that would not occur if all loans were transacted at market rates.

6. The Committee's terms of reference precluded detailed examination of taxation issues although it managed to treat some taxation matters. We understand the difficulties that faced the Committee in this regard but feel that housing finance was one area where the implications of the tax system could usefully have been examined in more depth.

7. One reason for Reece's low estimate of 0.06% is that it is based on an assumed value of $\lambda$ of 0.5. Reece also reports per household estimates for $\lambda = 0.25$ and 0.75.

8. Welfare costs as a percentage of GDP may be converted to percentages of (net) expenditures on housing services by multiplying them by 20.9.

9. See Laidler (1969) and Tran van Hoa (1968). Reece's 0.06% result comes from a result in which it was assumed that $\xi = 1.25$.

10. For an analysis of the welfare costs of the tax-inflation interaction in the context of owner-occupier mortgage interest deductibility and a capital gains tax, see Figgott and Whalley (1980).
11. An examination of quarterly lending data (expressed in 1975 ($\pi$) prices) for the period 1975 (S) - 1981 (D) suggests that the fluctuation in savings bank lending was slightly less than that for non-savings bank institutional lending but that total institutional lending was more stable than savings bank lending. For savings bank lending the coefficient of variation was 10.08% compared with figures of 10.38% and 8.69% for non-savings bank lending and total institutional lending, respectively. These figures lend support to the "offset hypothesis" which would suggest that the variation of the lending of the highly controlled institution would be greater than that of the total.

12. The possibility of capital gains/losses on government securities will also be important to the banks' choice. A crude way of allowing for this effect would be to include a variable measuring ex post changes in capital value. This approach has been used by Allan and Valentine (1978).

13. Unfortunately, this specification has the unsatisfactory consequence that even if deposits remained constant, new lending would continue at the same rate. However, this does not necessarily imply that loans outstanding would increase as existing loans are constantly being repaid. Indeed the increase in debt outstanding over the data period was small relative to new lending. Alternative specifications of the equation, which replaced total deposits with the change in deposits or the change in deposits plus loan repayments, were statistically unsatisfactory.

14. Valentine and Williamson (1981) have estimated an equation to explain savings bank deposits but "failed to detect any interest rate effect" (p.208) while savings banks plus permanent building society deposits "exhibit significant [negative] sensitivity to the rate on finance company debentures" (p.206).

15. An Economics IV Honours student at ANU, Paul Cummins, is currently working on a thesis examining the implications of regulation and deregulation for the banks' lending practices.

16. We have had some difficulty understanding the Committee's argument that the capitalisation effect depends directly on the interest rate per se, i.e. that raising the interest rate would directly exert a downward influence on house prices (see fn. 24, p.643). Our contention is that the effects of the regulation/deregulation must be traced through
to the demand for housing and that a capitalisation effect will occur only in certain circumstances relating to the production of housing services.

17. In aggregate, deregulation is highly unlikely to create any net losses and will, we would expect, produce some net gains. The household sector will gain as a whole as it is a net creditor. The only losers will come from the group paying off their own homes. This group comprises only about one-third of all householders and less than one-half of owner-occupiers. ("Survey of Housing Occupancy and Costs, Australia, August 1980", ABS No. 8724.0, 13.3.81). The number of losers will, then, be something less than one-third of householders.

18. The Government reportedly induced the banks to lend an extra $400m for housing over a 12 month period ("Financial Review", 19.3.82). Our understanding is that the banks were asked to "project" their lending for the period 1982 (J) to 1983 (M) on the basis of the pre-March 1982 regulations. Given the changes to the interest rate ceiling and the relaxation of the portfolio constraints the banks agreed to lend an amount of $400m over-and-above the projected lending for the period. Of course, a lot depends on the banks' forecast. The results of our regression analysis suggest that, ceteris paribus, an increase in the lending rate of nearly three percentage points would have been required to get the banks to voluntarily increase their real lending by $400m (i.e. $56m per quarter in 1975 (M) dollars would require a rise in \((BR_{t-1} - HR_{t-1})\) of 56/19.7 = 2.84). A nominal increase of $400m given lending in 1981 of $2759m and inflation of 10 per cent, would have required a relative lending rate increase of only 1 percentage point.

19. Full interest deductibility obtains in both the U.S. and the U.K. The Government considered this option (in a rebutability variant) in making up its March 1982 package, but rejected it on the grounds of revenue cost - about $1 billion.

20. A more desirable option than either of these would be to index interest liability and deductibility under the Australian tax law. The nominal interest rate would then be given by the "simple" Fisher formula:
\[ i = \hat{r} + \pi^G. \] Given the rates used in the text for December 1981, this would result in a nominal interest rate equal to the regulated rate, and would thus be equivalent to allowing deductibility of \( \hat{r}/(1-t) \)

percentage points of interest. The effect however would include consumer debt and other non-deductible interest payments. A world capital market dominated by economies where such indexation does not exist may complicate such a policy.
BIBLIOGRAPHY


Cameron, A.C. (1978), "The Portfolio Behaviour of Two Australian Savings Banks and Possible Links with their Affiliated Trading Banks", Seventh Conference of Economists, Macquarie University, August-September.


Tran van Hoa (1968), "Inter-regional Elasticities and Aggregation Bias: A Study of Consumer Demand in Australia", *Australian Economic Papers*, 7 December, 206-226.

