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Housing market will face crack of the whip

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Sticks are sometimes better than carrots at persuading others to do what you'd like them to do. Al Capone probably put it best when he said, "You can go a long way with a smile. You can go a lot farther with a smile and a gun."

Economic policymakers have at their disposal a variety of carrots and sticks that can be brought to bear to try to dampen property booms and busts. In countries like America and the UK that have their own central banks, the authorities can hike interest rates if the housing market is overheating and cut rates if the market threatens to spiral downward.

Of course, interest rates are not part of Irish policymakers' arsenal. The price of money here is set by the European Central Bank—and the ECB does not respond to developments in Ireland's housing market. While our housing bubble was inflating over recent years, interest rates were at historical lows.

Worse still, consumer price inflation in Ireland was among the highest in the euro area, so real (that is, inflation-adjusted) interest rates were even lower. With inflation at four per cent in 2003, for instance, and money on deposit earning less than one per cent, investing in property was a no-brainer. Arguably, interest rates were more inappropriate for us than for any other euro area economy.

There were, however, others weapons available to try to tame the housing market and policymakers in Ireland used them to varying degrees. The authorities tried to deflate expectations about future increases in house prices by issuing warnings about the unsustainability of the housing boom. But that advice seemed to fall on deaf ears.

Other measures, such as changes in tax breaks for housing, are harder to ignore. Despite some flip-flopping on policy in the late 1990s and early 2000s, tax breaks for buy-to-let investors are less generous today than they were a decade ago. That said, it was only in the last year or so that the phasing out began of so-called 'Section 23' tax relief on rental properties in designated areas.

For owner-occupiers, the subsidy to homeownership from mortgage interest relief has declined gradually as the standard rate of tax (the rate at which mortgage relief is given) was lowered. In addition, the ceiling on mortgage interest relief has failed to keep pace with house prices, despites increases in the ceiling over recent budgets.

Nonetheless, subsidies to homeownership in Ireland remain among the most generous in the developed world. The OECD, the Paris-based think tank, points out that we are one of only a handful of countries that gives mortgage interest relief. We don't have a property tax—it was scrapped in the mid-1990s. Our homes are exempt from capital gains tax. We don't pay tax on so-called 'imputed income' (that is, the rent that we implicitly pay ourselves for living in our homes) from owner-occupied housing.

As our housing boom gives way to a bust, an obvious question arises: could changes in tax reliefs on housing have prevented the overheating? To be sure, tax breaks are a blunt tool compared with interest rates. But that doesn't mean that they are completely impotent. You can chop down a tree even with a blunt axe---you just need to swing real hard.

The ECB slashed interest rates from 4.75 per cent in mid-2001 to two per cent by mid-2003. But Irish house prices were soaring again at a double-digit pace by late 2002, having slowed earlier that year. In retrospect, it now seems that what was called for back around 2002 was an aggressive reduction in tax breaks on housing to offset the stimulus coming from ECB interest rate cuts.

Mortgage interest relief could have been eliminated. A tax on interest payments for flexible-rate mortgages might also have kept the housing market in check. Additionally, the introduction of a small property tax and capital gains tax on owner-occupied homes might have helped to nip the boom in the bud. These measures could have been reversed when the ECB pushed interest rates back up.

Another weapon that could have been deployed more forcefully is restrictions on lending, especially in the credit-fuelled boom years from 2004 to 2006. Mortgage loans are easier to obtain in Ireland than in most other European countries. The average loan-to-value ratio on new mortgages here is high compared with other countries. To be sure, the authorities required banks to assign higher risk weights to mortgage loans with high loan-to-value ratios. But with the benefit of hindsight perhaps more forceful measures to curb the explosive growth in lending were needed.

On the positive side, we can learn from this experience and will know better in the future. Gentle prodding by tinkering with tax reliefs and risk weights weren't enough. When the excesses of the recent boom have finally been worked off, expect to see the introduction of a more forceful set of policies to manage the housing market. Carrots and sticks, a smile and a gun.

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