

Crunch time for negative gearing



It's become the 'never ever' tax reform for both major parties in Australia, but – as Saul Eslake outlines – it's time for negative gearing to stop distorting the market and the equity of the tax system.

Apart from their education and health, there are few things that have a greater impact on people's material standard of living, or their ability to participate in employment than their ability to afford a decent place to live.

Hence governments of all political persuasions typically accord a high rhetorical priority to improving 'housing affordability', both for those seeking to own their own home and for those unable to achieve home ownership and needing (or preferring) to rent.

Unfortunately, the importance that governments have given to 'housing affordability' in their statements of intent has rarely been matched by policy actions that have achieved much by way of tangible progress towards that objective. Indeed, many government policies have actually had the opposite effect – they have made housing less, rather than more, affordable. And yet successive governments have been reluctant to modify or abandon those policies, or to replace them with policies that would actually contribute towards the achievement of the 'housing affordability' objectives which they supposedly hold dear.

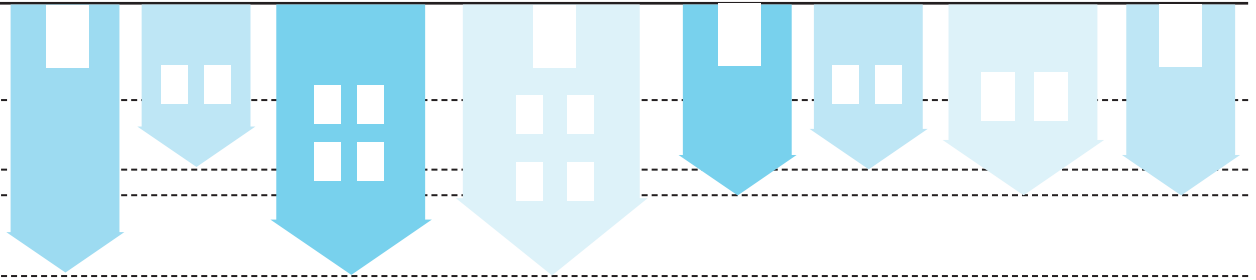
One of the most striking examples of this is the policy of giving cash grants (and other forms of financial assistance, such as stamp duty concessions or exemptions) to first-home buyers, in the belief that this will result in higher levels of home ownership. Governments of both political persuasions have been doing this for almost 50 years. Yet the home ownership rate has never been higher than it was at the time of the 1961 Census, two years before the first of these schemes was introduced by the Menzies Government. All that the billions of dollars which the Commonwealth and State Governments have spent in this way has done has been to inflate the price of housing, making

it less, rather than more, affordable to those unable to raise large deposits or service large mortgages. Indeed, it's hard to think of any government policy that has been pursued for so long, in the face of such incontrovertible evidence that it doesn't work, as this.

Another policy which – notwithstanding the stated rationale for it – has made 'housing affordability' worse rather than better, is the set of arrangements commonly known as 'negative gearing' under which investors are able to offset any excess of financing and other costs associated with acquiring and holding an investment (be it in property, shares, taxi licence plates or any other income-producing asset) over the income produced by that asset in any given year against any other taxable income which they may have. Thus, if a landlord's interest and other costs associated with owning an investment property exceed the net rental income produced by that property, he or she can offset the resulting 'loss' against his or her other income for tax purposes.

Very few other Western countries' tax systems are as generous to investors as Australia's is in this respect. In the United States, for example, investors can only deduct interest incurred on borrowings undertaken to purchase property or shares up to the amount of income (dividends or rent) earned in any given financial year; any excess of interest expense over income must be 'carried forward' as a deduction against the capital gains tax payable when the asset is eventually sold.

The benefits of 'negative gearing' to investors were substantially enhanced by the Howard Government's 1999 decision (supported by the then Labor Opposition) to tax capital gains on assets held for more than 12 months at half the rate applicable to other forms of income (such as wages and salaries), replacing the arrangement which had been in place since 1986 under which capital gains were taxed at a taxpayer's full marginal rate after allowing for the impact of inflation.



This decision converted 'negative gearing' from being an arrangement which merely allowed for the deferral of tax (to the time when the asset was sold) to one which allows for a reduction in tax payable as well as its deferral.

In effect, it allows for wage and salary income taxable at what is usually the top, or second highest, marginal rate in the year in which it is earned to be converted into capital gains, taxable at half the rate which would otherwise have been payable, at some point in the future.

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Not surprisingly, the number of taxpayers taking advantage of this much more generous treatment has increased significantly over the past decade.

In 1998-99, when capital gains were last taxed at the same rate as other types of income (less an allowance for inflation), Australia had 1.3 million tax-paying landlords who in total made a taxable profit of almost \$700 million. By 2008-09, the latest year for which statistics are presently available, the number of tax-paying landlords had risen to just under 1.7 million: but they collectively lost \$6.5 billion, largely because the amount they paid out in interest rose almost fourfold (from just over \$5 billion to almost \$20 billion over this period), while the amount they collected in rent 'only' slightly more than doubled (from \$11 billion to \$26 billion), as did other (non-interest) expenses. If all of the 1.1 million landlords who in total reported net

losses in 2008-09 were in the 38 per cent income tax bracket, their ability to offset those losses against their other taxable income would have cost over \$4.3 billion in revenue foregone; if (say) one fifth of them had been in the top tax bracket then the cost to revenue would have been over \$4.6 billion.

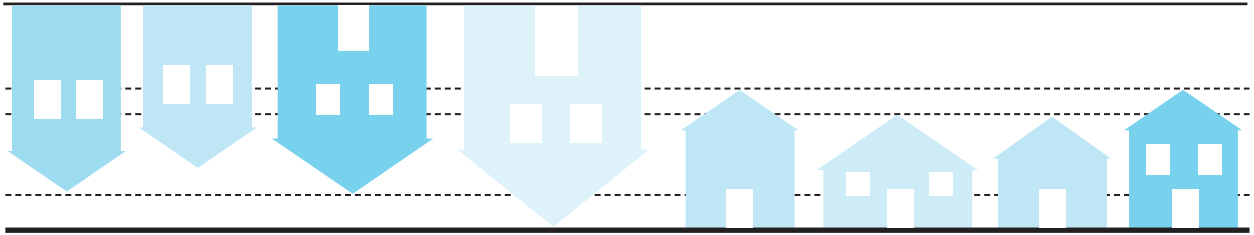
This is a pretty large subsidy from people who are working and saving to people who are borrowing and speculating (since those landlords who are making 'running losses' on their property investments expect to more than make up those losses through capital gains when they eventually sell them).

And it's hard to think of any worthwhile public policy purpose which is served by it. It certainly does nothing to increase the supply of housing, since the vast majority of landlords buy established properties: 92 per cent of all borrowing by residential property investors over the past decade has been for the purchase of established dwellings, as against 82 per cent of all borrowing by owner-occupiers.

Precisely for that reason, the availability of 'negative gearing' contributes to upward pressure on the prices of established dwellings, and thus diminishes housing affordability for would-be home buyers.

There's absolutely no evidence to support the assertion made by proponents of the continued existence of 'negative gearing' that it results in more rental housing being available than would be the case were it to be abolished (even though the Henry Review appears to have swallowed this assertion).

Most other 'advanced' economies don't have 'negative gearing': yet most other countries have higher rental vacancy rates than Australia does. In the United States, which doesn't allow 'negative gearing', the rental vacancy rate has in the last 50 years only once been below 5 per cent (and that was in the March quarter of 1979); in the ten years prior to the onset of the most recent recession, it has averaged 9.1 per



cent. Yet here in Australia, which does allow 'negative gearing', the rental vacancy rate has never (at least in the last 30 years) been above 5 per cent, and in the period since 'negative gearing' became more attractive (as a result of the halving of the capital gains tax rate) has fallen from over 3 per cent to less than 2 per cent.

Nor is there any evidence that 'negative gearing' results in lower rents than would be the case in its absence. During the period since the attractiveness of 'negative gearing' to investors was increased (by halving the tax rate on capital gains), and during which the extent of 'negatively geared' property investment rose sharply as noted above, rents rose at a rate 0.8 per cent per annum faster than the CPI (consumer price index) as a whole; whereas over the preceding decade, rents rose at exactly the same rate as the CPI.

Supporters of 'negative gearing' argue that its abolition would lead to a 'landlord's strike', driving up rents and exacerbating the existing shortage of affordable rental housing. They point to 'what happened' when the Hawke Government abolished negative gearing (only for property investment) in 1986, claiming that it led to a surge in rents, which prompted the reintroduction of negative gearing in 1988.

This assertion has attained the status of an urban myth. However it's actually not true. If the abolition of 'negative gearing' had led to a 'landlord's strike', as proponents of 'negative gearing' usually assert, then rents should have risen everywhere (since 'negative gearing' had been available everywhere). In fact, rents (as measured in the CPI) actually only rose rapidly (at double-digit rates) in Sydney and Perth. And that was because in those two cities, rental vacancy rates were unusually low (in Sydney's case, barely above 1 per cent) before negative gearing was abolished. In other State capitals (where vacancy rates were higher), growth in rentals was either unchanged or, in Melbourne, actually slowed.

But suppose, notwithstanding this history, that a large number of landlords were to respond to the abolition of 'negative gearing' by selling their properties. That would push down the prices of investment properties, making them more affordable to would-be home buyers, allowing more of them to become homeowners, and thereby reducing the demand for rental properties in almost exactly the same proportion as the reduction in the supply of them.

It's actually quite difficult to think of anything that would do more to improve affordability conditions for would-be homebuyers than the abolition of 'negative gearing'.

I'm not advocating that 'negative gearing' be abolished for property investments only, as happened between 1986 and 1988. That would be unfair to property investors, vis-à-vis other investors in shares and other assets. I'd settle for the recommendation of the Henry Review, which was that only 40 per cent of interest (and other expenses) associated with investments be allowed as a deduction, and that capital gains (and other forms of investment income, including interest on deposits) be taxed at 60 per cent (rather than 50 per cent as at present) of the rates applicable to the same amounts of wage and salary income.

Sadly, however, these recommendations were among the 19 that the Treasurer explicitly ruled out when releasing the Henry Review in May 2010, and again when announcing the details of the Tax Forum to be held in October.

That makes it hard to believe that this Government (or indeed any alternative government) is really serious about increasing the incentives to work and save – or at least, about doing so without risking the votes of those who borrow and speculate, in effect subsidized by those who don't, or can't.

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