A tax system that penalizes working & saving, and rewards borrowing & speculating

(Article by Saul Eslake, Director of the Productivity Growth Program at the Grattan Institute, published in the business pages of the Melbourne Age *newspaper, and in the online edition of the* Sydney Morning Herald*, on Wednesday 30th March 2011)*

Imagine that you have just become Treasurer or Finance Minister in the government of a newly independent nation, and that for some reason you wanted to create a tax system that encouraged the accumulation of wealth through borrowing and speculating, as opposed to working and saving. You hire a consultant, who, based on your previous experience, you fully expect to hand you both a voluminous report and a large bill after a period of extensive research, consultation with interested stakeholders and all the other things that consultants do. But, to your astonishment, the consultant comes back the very next day and simply hands you a copy of the Australian Income Tax Assessment Act, and tells you to forget the bill.

Why it is that the Treasurer of some hypothetical government in a far-away country might actually want a tax system that encouraged borrowing and speculating, and penalized working and saving, is of course rather hard to imagine.

Yet that is precisely what Australia's income tax system does. It imposes the highest rates on wage and salary income – that is, income from working – and on income from the most common forms of saving (bank, building society and credit union deposits). By contrast, Australia's tax system taxes income from investments (other than deposits) at substantially lower rates than identical amounts of income when derived from working. And if those investments are funded wholly or partially by debt, it provides a subsidy which serves to reduce the amount of tax payable on the income from those investments even further.

For most people on relatively high wage or salary incomes, tax rates aren't as high as they used to be, as a result of the substantial increases in the thresholds at which the top rate becomes payable that were implemented during the last term of the Howard Government. However, for people lower down the income scale, the interaction of the income tax system with the income tests on various forms of social security payments can result in them facing effective marginal tax rates considerably above those paid by those earning the highest incomes. These high effective marginal tax rates can, and according to at least some research do, adversely affect the willingness of some people, especially women with children, to enter paid employment.

By contrast, the Australian income tax system provides substantial incentives for people to borrow in order to acquire property, shares or other assets whose value they expect to increase over time. Unlike in most other countries, it's always been possible in Australia to deduct any excess of interest payments on loans taken out to fund an investment over the income produced by that investment in order to reduce the tax payable on wage or salary income. Since the Howard Government's decision, in 1999, to tax capital gains at half the rate applicable to the same amount of wage and salary income, a decision which was supported by the then Opposition, 'negative gearing' has become a means not only of deferring tax, but also permanently reducing it.

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 $700mn. By 2007-08, the latest year for which statistics are presently available, the number of tax-paying landlords had risen to 1.7mn: but they collectively lost more than $8.6bn, largely because the amount they paid out in interest rose more than fourfold (from just over $5bn to more than $20bn over

this period), while the amount they collected in rent 'only' slightly more than doubled (from $11bn to $24bn), as did other (non-interest) expenses. If all of the 1.2mn landlords who in total reported net losses in 2007-08 were in the 38% income tax bracket, their ability to offset those losses against their other taxable income would have cost over $4.8bn 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 $5bn.

This is a pretty big 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 this subsidy. It certainly does nothing to increase the supply of housing, since the vast majority of landlords buy established properties. Precisely for that reason, it contributes to upward pressure on the prices of established dwellings, thereby diminishing housing affordability for would-be home buyers.

It's also hard to reconcile this subsidy with the Government's stated aim of increasing participation in the workforce, especially when abolishing it could help pay for reducing some of the high effective marginal tax rates faced by those contemplating moving from taxpayer-funded benefits into paid employment.

The revenue foregone through negative gearing could alternatively be used to build nearly 20,000 new 'affordable' homes each year. Over a decade, that would make substantial (though still incomplete) inroads into the massive shortage of affordable housing that Australia now has.

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[1]. 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. Rents (as measured in the consumer price index) did rise rapidly (at double-digit annual rates) in Sydney and Perth. But that was because in those two cities, rental vacancy rates were unusually low (in Sydney's case, barely above 1%) 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.

Suppose, however, 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, thereby reducing the demand for rental properties in almost exactly the same proportion as the reduction in the supply of them.

And that, of course, is the reason why 'negative gearing' will forever remain untouched – because (like grants to first home owners) the people who would experience declines in the value of their properties were it ever to be removed are far more likely to vote against a government which removed it (or an opposition party which promised to do it) than there are people who would benefit from lower property prices and would change their votes accordingly. It's something to remember next time you hear a politician saying he or she is committed to improving housing affordability, or increasing participation in the work force, or both.

---

[1] Note, I am not advocating that 'negative gearing' be abolished for property investment only (as occurred between 1986 and 1988), but rather for *all* types of investment.