The case against 'negative gearing'

(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 Monday 25th April 2011)*

For almost a quarter of a century, successive Australian governments have, with varying degrees of enthusiasm, sought to promote higher levels of participation in employment, and higher levels of personal saving. These are both eminently worthy objectives, ones which public policy *should* seek to promote.

It's therefore somewhat surprising that successive Australian governments have not merely been content to maintain a tax system which taxes income from working and saving at *higher* rates than those at which it taxes income from borrowing and speculating (in assets whose values increase over time, often through no effort on the part of those who acquire them); but have either *increased* the extent to which income from borrowing and speculating is treated more favourably by the tax system than income from working and saving (as the Howard Government did when it halved the rate of capital gains tax in 1999), or explicitly *rejected* sensible proposals that this more favourable treatment of income from working and saving than of income from borrowing and speculating should be lessened (as Wayne Swan did in May last year when ruling out recommendations to that effect made by the Henry Review).

Under the Australian taxation system, income from working – that is, wages and salaries – are taxed at higher marginal rates than any other kind of income derived by individuals: 31.5% for most Australians with full-time jobs (earning between $37,000 and $80,000 a year), 38.5% for those earning over $80,000 a year and 46.5% for those earning over $180,000 a year. Income from deposits in banks, building societies and credit unions (the form in which one quarter of household financial assets are held) is taxed at the same marginal rates. For those contemplating entering, or re-entering, paid employment (for example, after a period of caring for children or aged parents), and depending on their family circumstances, the interaction between the gradual withdrawal of social security benefits and the impact of tax on income from work can result in effective marginal tax rates of close to, or even over, 60%, on what are quite modest levels of income.

The Henry Review concluded that 'some people [are] likely to reduce their level of work as a result' of these very high effective marginal tax rates. This may be one reason why the workforce participation rates of women with children, and older people, are lower in Australia than in other OECD countries.

By contrast, income from most forms of investment, other than interest-bearing deposits, is typically taxed at lower rates than similar amounts of income derived from working. Income from saving through superannuation funds, and from 'geared' investments (that is, the purchase of assets funded by borrowing) is especially lightly taxed. The Henry Review calculated that, for a top-rate taxpayer, the *real* effective marginal tax rates (that is, after taking account of inflation assumed to average 2.5% per annum, and the time at which tax is payable) on income earned from superannuation savings or highly-geared property investments are actually negative; while the real effective marginal tax rate on interest income from deposits can be as high as 80%.

As the Henry Review noted, 'retirement savings are generally lightly taxed around the world', for the good reasons that these savings are usually not as readily accessible as other forms of saving prior to reaching retirement age, and that encouraging self-provision for retirement reduces the cost to other taxpayers of providing age pensions.

Whether the taxation treatment of superannuation saving *needs* to be as generous as it now is in Australia in order to achieve those objectives is a moot point: in particular, it's hard to think of any compelling economic or social policy reason why income paid out of superannuation funds to people aged over 60 should be completely free of any income tax at all.

By contrast, very few other 'advanced' economies are as generous in their tax treatment of geared investments as Australia is.

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 (as in a 'negatively geared' investment) must be 'carried forward' as a deduction against the capital gains tax payable when the asset is eventually sold. In Australia, by contrast, where interest on borrowings undertaken to finance the purchase of a property or shares exceeds the rent or dividend income generated by those investments, that excess can be deducted against a taxpayer's other income (such as wages and salaries) thereby reducing the amount of tax otherwise payable on that other income.

The Howard Government's decision, in 1999, to tax capital gains at half the rate applicable to wage and salary income, converted 'negative gearing' from a vehicle allowing taxpayers to *defer* tax on their wage and salary income (until they sold the property or shares which they had purchased with borrowed money), into one allowing taxpayers to *reduce* their taxation obligations (by, in effect, converting wage and salary income into capital gains taxed at half the normal rate) as well as deferring them.

As a result, 'negative gearing' has become much more widespread over the past decade, and much more costly in terms of the revenue thereby foregone.

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 2008-09, the latest year for which statistics are presently available, the number of tax-paying landlords had risen to just under 1.7mn: but they collectively lost $6.5bn, largely because the amount they paid out in interest rose almost fourfold (from just over $5bn to almost $20bn over this period), while the amount they collected in rent 'only' slightly more than doubled (from $11bn to $26bn), as did other (non-interest) expenses. If all of the 1.1mn landlords who in total reported net losses in 2008-09 were in the 38% income tax bracket, their ability to offset those losses against their other taxable income would have cost over $4.3bn 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 $4.6bn.

[The revenue foregone through 'negative gearing' was lower in 2008-09 than it was in 2007-08, because number of taxpayers reporting rental income fell by around 51,000 (presumably as a result of the global financial crisis prompting some landlords to sell their properties), and because the substantial decline in interest rates after the onset of the financial crisis meant that fewer landlords paid more in interest than they received in net rent. The figures in the previous paragraph also exclude revenue foregone through negatively gearing of share portfolios or other investments, on which no details are available].

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% of all borrowing by residential property investors over the past decade has been for the purchase of established dwellings, as against 82% 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.

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 consumer price index) 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%) 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.

Notwithstanding this history, suppose 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 home-owners, 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'. It would certainly do more than continuing to give large amounts of cash to would-be first-time homebuyers through grants or stamp duty concessions, which historically have served only to increase the prices of existing dwellings and ended up in the pockets of vendors.

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% (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%. 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%, 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% to less than 2%. During that same period, rents rose at rate 0.8 percentage points per annum faster than the CPI as a whole; whereas over the preceding decade, rents rose at exactly the same rate as the CPI.

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. Personally, I think 'negative gearing' should be abolished for *all* investors, so that interest expenses would only be deductible in any given year up to the amount of investment income earned in that year, with any excess 'carried forward' against the ultimate capital gains tax liability, rather than being used to reduce the tax payable on wage and salary or other income (as is the case in the United States and most other 'advanced' economies).

But I'd settle for the recommendation of the Henry Review, which was that only 40% 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% (rather than 50% as at present) of the rates applicable to the same amounts of wage and salary income.

This recommendation would *not* amount to the abolition of 'negative gearing'; it would just make it less generous than it is at the moment. It would be likely, as the Henry Review suggested, 'to change investor demand toward housing with higher rental yields and longer investment horizons [and] may result in a more stable housing market, as the current incentive for investors to chase large capital gains in housing would be reduced'.

I could even accept the Henry Review's recommendation that 'these reforms should only be adopted following reforms to the supply of housing and reforms to housing assistance' which it makes elsewhere, even though (as I've argued earlier) I disagree with the Henry Review's concern that these reforms 'may *in the short term* reduce residential property investment' (emphasis added).

Sadly, however, these recommendations were among the 19 that the Treasurer explicitly ruled out when releasing the Henry Review in May last year. 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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