THE AUSTRALIAN

Lower income renters would pay the price of change

HENRY ERGAS THE AUSTRALIAN JANUARY 27, 2014 12:00AM

HISTORY may not teach us much, but it does show that you can't keep a bad idea down. And this bad idea resurfaces with a regularity that, if it applied to ageing human bodies, would deprive prune growers of their livelihoods.

At issue are claims made last week by economist Saul Eslake that negative gearing provides a "large subsidy from people who are working and saving to people who are borrowing and speculating". Recurring every time property markets arise from their slumbers, this contention is not one to be tossed aside lightly: rather, it should be thrown with great force.

That is not to suggest there is an elevated risk of negative gearing disappearing. Natural selection has, after all, endowed Australian politicians with some instinct for survival. But Wayne Swan's tinkering with superannuation highlights the mischief cash-strapped governments can do. And with deficits stretching out as far as the eye can see, chiselling at negative gearing will be sorely tempting. As they gain currency, misguided claims make that temptation all the greater.

To see why they are misguided, start at the beginning. For those who think negative gearing is a trick cyclists use in the Tour de France, the term refers to the tax treatment of losses incurred on rental properties. Investors who borrow to buy a rental property, but earn less in rent than the interest payments on the loan, can deduct the shortfall against income tax.

Assuming they have other taxable income, the effect is to reduce the amount of tax paid. And of course, the higher an investor's marginal tax rate, the greater the deduction's value.

For the flat earth school of economic policy, who struggle with the fact that (in a progressive tax system) the gain from any deduction will rise with income, that suffices to condemn the policy as a blot on the landscape. Critics such as Eslake are more circumspect, focusing less on income distribution than on the assertion that the policy is economically inefficient.

Unfortunately, it is not clear why they believe that to be the case. Rather, negative gearing ensures the overall tax rate on rental income does not depend on how a property is financed; regardless of the financing structure adopted, the tax rate on that income will equal the income tax rate generally and the overall tax paid will depend solely on the net income the property generates. Abolishing negative gearing would remove that neutrality, distorting the financing of rental properties and inefficiently reducing their supply.

Consider, for example, a property with an annual rental yield of $20,000. Assume it is owned outright by a taxpayer who faces a marginal tax rate of 48.5 per cent. Given that rate, the tax office would collect $9700 from the property, which is 48.5 per cent of the rental income the owner received. And should the owner later sell the property, the tax office will also impose a tax on half of any capital gains.

Now assume that the owner instead lends $500,000 to an investor to purchase that property, at an annual interest charge of $25,000. Since the rental yield is only $20,000, the investor is incurring an annual loss of $5000, presumably in anticipation of the same capital gains that would otherwise have accrued to the

lender.

Under negative gearing, he or she can set that $5000 loss against other income; assuming a 48.5 per cent marginal tax rate, that reduces the investor's tax payable by $2425.

As a result, the lender will now pay tax of $12,125 on his or her annual interest income of $25,000; but the borrower, who has the $5000 annual loss, secures a tax reduction of $2425. Netting one against the other, the tax office collects $9700, making the effective tax rate on the income from the property 48.5 per cent ($9700 divided by $20,000): which is both the tax rate on other personal income and exactly the same tax rate the property paid when it was owned outright.

Assume instead that negative gearing were abolished, so that the amount the borrower could deduct was capped by the rental income the borrower received. In that case, if everything else remained unchanged, the tax office would still collect $12,125 from the lender; but it would not provide the $2425 deduction to the borrower. The effective tax rate on the rental income would therefore rise to 61 per cent, equal to the tax imposed ($12,125) divided by the income the property has actually generated ($20,000).

Abolishing negative gearing would, in other words, increase the tax rate on debt-financed rental income by 26 per cent, compared both to the tax rate on rental income from properties that were owned outright and to the tax rate on non-property income.

Of course, as the after-tax rate of return on debt-financed rental properties would now be much lower than that available on other assets, everything else could not remain unchanged. Were it costless for investors to switch from debt to equity - that is, to buy the properties outright - the only effect would be to induce such a switch. But there is no reason whatsoever to think that switch could possibly be costless, much less economically desirable.

That is because debt markets, so long as they are properly regulated, efficiently manage the uncertainty inherent in real estate by pooling the risk associated with investments in a very wide range of properties: indeed, that is why mortgages exist. By penalising investors who took advantage of that efficiency, the removal of negative gearing would increase the cost of rental accommodation and reduce its availability.

A moment's thought shows that would overwhelmingly harm the poor, who depend on rental accommodation. But time is scarce and thinking painful. So bad ideas prosper. And eventually, the community pays their price.