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Coward’s route to raising tax

HENRY ERGAS THE AUSTRALIAN 12:00 AM

It’s hardly about negative gearing. Rather, what the Left really wants is to increase income tax on the middle class. As it lacks the courage to do that directly, fiddling the definition of income is the coward’s way of achieving the same goal.

And you don’t need to understand the economic definition of income to know it’s a fiddle.

After all, if you are going to prevent interest expense from being fully deductible against property investors’ taxable income, as Chris Bowen has suggested Labor might do, why not limit investors’ ability to deduct maintenance costs as well? True, rental homes need to be maintained; but it is every bit as true that they need to be financed.

And if the interest deduction is “unfair”, as the Left claims, why would the maintenance deduction be any fairer, since it too provides far greater tax savings to investors who face high marginal tax rates than to those who would pay little income tax in any event?

For sure, were maintenance not a deductible expense, the cost of maintaining properties would be taxed at least twice: once as part of the property owner’s taxable income, and again as income to whoever carried out the work.

But if double taxation of maintenance is unacceptable, why would it be acceptable for interest payments, which would also be taxed twice if the opponents of negative gearing had their way, once as part of borrowers’ taxable income and a second time as the taxable income of lenders?

Merely to spell those questions out is to highlight the point: logic plays no role in the attacks on negative gearing. Nor does any consideration of the consequences.

To say that is not to deny that our tax treatment of housing is so complex as to confuse even the best intentioned of demagogues. But it should be obvious that owner-occupied housing enjoys any number of tax advantages that rental housing does not, including the complete exemption from tax of imputed rent (that is, the rent an owner would pay for using the dwelling) and of capital gains. And owner-occupied houses are also fully exempted from the means tests for the age pension and for aged care benefits.

Whether those advantages skew investment towards housing is controversial, as the states exploit them to impose high, and exceptionally distorting, stamp duties, seizing for their own coffers a share of the commonwealth’s generosity to homeowners. But whatever our tax system’s effects on the housing stock as a whole, what is certain is that it is heavily biased against rental housing — and removing negative gearing would only make that distortion more acute.

The US experience is telling: the 1986 tax reform, which imposed “quarantining” provisions that limit the scope to offset losses from real estate investment against other personal income, helped decimate investment in smaller rental properties, leaving a gap ever-growing public subsidies have been unable to close.

In contrast, as the Henry report recognised, negative gearing has contributed to keeping our supply of rental housing roughly in line with rapidly growing demand. And while prices for capital city houses have doubled since 2000, rents have risen only marginally more rapidly than median household incomes.

But that doesn't mean all is well in our housing markets. Rather, the opposite is true, with the problems being particularly severe in Sydney. Yes, quarterly land sales there are now nearly twice their levels at the end of the Bob Carr era; but greater land availability has not eliminated the shortfall Carr's embargo on Sydney's expansion left behind. With the city's population increasing by more than a quarter since 1995, the result is that Sydney property prices have skyrocketed. And the state's stamp duty revenues have followed, trebling in real terms per head of population.

No surprise then that the state's incentives to increase land availability are mixed, at best, as are local councils'.

And with so many Sydneysiders gaining from soaring property prices either directly or through inheritance, those incentives are further blunted by the fact that the boom's greatest losers are incoming migrants, who face ever higher entry costs into the city's property market.

The restrictions on land supply can therefore be viewed as taxing some of the willingness to pay to live in Australia that senator David Leyonhjelm believes the commonwealth could more efficiently capture for itself by auctioning off residence visas. But there are plenty of local losers too, not least renters, who now account for 34 per cent of Sydney households. And with similar, albeit less acute, constraints on housing supply in other capital cities, Sydney's renters aren't alone in missing out.

It would be foolish, however, to think repealing negative gearing would address renters' plight. And even the options that have been mooted as intermediate solutions are more likely to compound the difficulties than to solve them.

The proposal to limit negative gearing to new homes is a case in point. Given the restrictions on land availability, its immediate effect would be to raise the price of new, compared to existing, rental properties; over time, however, it would accelerate, possibly materially, the rate at which existing properties were scrapped so as to make room for new, tax-advantaged, dwellings.

That accelerated scrapping would be inefficient in itself; but even worse, study after study shows it would mainly harm low-income earners, who typically rent the older dwellings whose prices and rents are lower.

Yet that scarcely troubles the Left. Little wonder, for its aim is not to help the poor but to hurt the rich: and damn the damage. If so, in shooting at negative gearing, it has found the perfect target.

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