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It's clear, negative gearing has a positive influence

HENRY ERGAS THE AUSTRALIAN JULY 06, 2015 12:00AM

Let's be clear: John Daley, who heads the Grattan Institute, is perfectly entitled to his obsessions, among which negative gearing seems to figure prominently. But Ogden Nash had a point when he warned that: "Of obligations, by far the solemnest / Burden the conscientious columnist."

For, Nash continued, as well as "to citizens and the nation", the conscientious columnist has an "obligation divine, to keep other columnists in line".

To ignore the article, published in this paper last week, in which Daley excoriates negative gearing in terms an earlier age reserved for infanticide, intemperance and bestiality, would therefore be a gross dereliction of duty.

Now, one inevitably approaches Daley's onslaughts with a ghastly sense of foreboding. In this case, however, the gloom is quickly lifted by learning things one didn't know.

Unfortunately, the reason one didn't know them is that they are not true. "Australia is one of few developed nations to allow full deductibility of losses against wage income," Daley and his co-author Danielle Wood declare.

In fact, negative gearing is par for the course in those countries of continental Europe that have large private rental markets and which tax personal income on a consolidated basis.

Nor are their provisions more restrictive than ours; on the contrary, Germany, which is often praised for the quality of its housing markets (and is no slouch in the fiscal probity stakes), not only allows full loss deductibility but exempts rental housing from capital gains tax.

What is truly startling, however, is not Daley's and Woods's purported fact, but their explanation of it. "Other countries," they say, "realise (that) negative gearing distorts investment decisions by allowing investors to write off losses at their marginal tax rate but pay tax on their capital gains at only half this rate."

It is not easy to make sense of this statement, which, in the great class of sequiturs, must fall among the nons. After all, there is nothing in the mere fact of allowing the tax deductibility of losses on income-producing assets, and then applying capital gains tax to those assets at a particular rate, that distorts investment decisions. On the contrary, those standard features of any comprehensive income tax system are especially important for housing.

To repeat, for the benefit of the children: if owner-occupied housing is tax advantaged, then rental housing should be too, or investment decisions will be distorted, as will the choice between renting and buying. And the taxation of capital gains is no exception to that rule.

To say that is not to deny that optimal capital gains taxation can be complex. But in this case, the economics are straightforward. If the capital gains tax on owner-occupied housing is set at zero, then "production efficiency" — the situation in which society's resources are put to their best uses — requires that capital gains on rental properties also be taxed at a low, if not zero, rate.

All this, however, is merely an hors d’oeuvre; for where Daley and Woods really get into their stride is in discussing the price effects of negative gearing. Dismissing as drivel a report commissioned by the Property Council and the Real Estate Institute of Australia, they announce another discovery: the supply of housing in Australia is fixed.

On this too, our authors express themselves in fine Jabberwockian form; but the essence of their claim is that all negative gearing does is reshuffle the ownership of the housing stock, increasing the price of existing housing in the process.

That can only be true, however, if the supply of housing does not eventually respond to price rises: otherwise, the greater demand caused by negative gearing will induce an at least partially offsetting expansion in the housing on offer. And the fewer the constraints on supply, the less the price of existing housing must rise to induce that expansion, and the sooner prices will settle at what building new homes costs.

It would, for sure, be deeply troubling were Daley and Woods correct in assuming housing supply was virtually fixed in the long run; luckily, the evidence shows they are not. However, that hardly means supply is everywhere as price responsive as it should be.

Rather, as Daley and Woods agree, the supply of new housing, particularly in Sydney, has been constrained severely by zoning laws and by restrictions on land release. But it is absurd to suggest, as Daley and Woods do, that one should respond to those constraints by repealing negative gearing: that would do nothing to make the Sydney housing market more efficient, while making housing markets less efficient, and increasing rents, everywhere else.

Indeed, that has been the experience in the US, which largely abolished negative gearing in 1986 and has faced a rental crisis since; and it is also the case in Britain, where rental subsidies, of dubious efficiency, have doubled over the past decade and now amount to a quarter of the entire budget deficit.

Instead, the sensible course of action is to reform Sydney’s planning laws, which is what the Baird government proposes to do. Far from bidding prices up, negative gearing would then merely reduce the bias against rental housing. And as well as making renters better off, that would increase labour market flexibility by reducing “lock in” in housing markets, while improving the matching of employees and jobs, raising productivity.

Those efficiency gains should induce Daley and Woods to “soften their oughteries”, as Ogden Nash recommends. But perhaps they are not really motivated by efficiency concerns; perhaps they simply dislike anything they think benefits the better off, such as tax breaks for superannuation and negative gearing.

Fair enough, but then let them say so. And please, spare us the mumbo-jumbo along the way.

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