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Negative gearing plan an exercise in Cirque du Soleil economics

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Illustration: Eric Lobbecke

Even for a political party with a pronounced death wish, it seems reckless to propose a clampdown on negative gearing just as an NAB survey shows the housing market slowing and the share of established properties sold to local investors dropping to record lows.

But Labor faces a dilemma. Given the promises it has made, it needs $50 billion to avoid a budget blowout. And although its policy — which would restrict negative gearing to new houses and increase the capital gains tax on assets purchased after July 1, 2017 — only improves the bottom line by $565 million over the forward estimates, the annual gains could rise to more than $2bn in later years.

Of course, Labor doesn't present the policy as a revenue grab. Rather, it claims to be paring back an unsustainable and unfair tax expenditure.

In reality, negative gearing is not a tax expenditure, nor has it ever been considered to be one. While tax expenditures are cases in which particular activities are treated especially favourably, deductibility of the costs taxpayers incur in securing earnings on which they will be assessed has long been recognised as the essence of an income tax, with negative gearing being a feature of our income tax system since 1915.

To claim Labor's proposals would remove a tax expenditure is therefore entirely misleading; on the contrary, they amount to imposing a discriminatory tax penalty on housing. The question is what the consequences would be. On that question, the contortions in Labor's policy document are worthy of the Cirque du Soleil school of economics. Yet the likely outcomes are surely predictable.

To begin with, prices of existing houses would fall as investor demand for properties declined. And since investors have accounted for a fifth to a quarter of purchases of existing houses, the falls could be material. Obviously, the greatest losses would be borne by those owning properties best used for rental, as their resale value would be savaged. Labor's assertion that existing investors would not suffer from the change consequently makes little sense.

But it is not only investors who would feel the pain. Rather, since the decline in demand would affect the market as a whole, other homeowners would also be worse off. And the losses would loom largest for older Australians, as real estate (including the family home) accounts for 80 per cent of their net worth, with rental properties amounting to about half the investments they hold in assets other than the family home.

Whether those impacts would ultimately be mitigated is controversial. So too are the

gains that could accrue to first-time buyers, as well as to the owners of land on which new houses might be built. What is certain, however, is that renters would be substantial losers, as they were in the US when negative gearing was abolished. After all, if the supply of rental housing is to grow over the longer term, the return it generates cannot be much lower than it has been to date. But if the policy will cause house prices to increase less rapidly, as Labor claims, while capital gains tax rises, then after-tax returns can only be sustained by higher rents.

Nor is the likely increase trivial: on a rough rule of thumb, raising capital gains tax by 1 per cent requires a 2 per cent increase in rents to keep returns constant. As a result, even a 15 per cent increase in the effective tax rate implies rents must rise, in real terms, by nearly a third.

Removing negative gearing from existing properties would aggravate that increase, given detached and semi-detached houses, which are typically older than multi-dwelling units, account for the bulk of rentals and for 80 per cent of the growth in private tenancies over the past 30 years. No doubt, some renters would switch to buying; but since the median income of renters is 25 per cent lower than that of households with mortgages, most would simply face a drop in living standards.

All that makes the “fairness” of the policy questionable, but there are other problems as well. As both the Henry report and Treasury’s “Re:think” tax discussion paper emphasised, deductibility of interest expenses ensures investors with access to equity are not tax-advantaged compared to those who need to borrow. By abolishing that level playing field, Labor’s policy would benefit investors with deep pockets, such as the anaesthetists and surgeons its document excoriates, while shutting teachers and nurses out of the investment market.

Those consequences might be worth bearing if the changes would increase the efficiency of our tax system, expanding incomes overall. Unfortunately, they will do the opposite. By discriminating between new and existing houses and between equity and debt finance, while making renting even less advantageous than it already is, Labor’s policy would worsen the distortions that plague our housing market.

The increase in capital gains tax would then compound the damage, as it would induce owners to retain properties for longer, slowing turnover and making it more difficult for buyers and sellers to find their ideal match.

Indeed, that is one reason Harvard’s Martin Feldstein, who Labor presents as endorsing its approach, has repeatedly denounced the capital gains tax slugs Labor now proposes.

None of that may trouble Bill Shorten. But it should. For if this is the best Labor can

do, how long can it be before the grim hand that inverts the hourglass of political life sends his little grain of sand whirling through it?