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Labor must stop denying negative gearing truth

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With Labor spending last week denying the obvious about its proposed tax hikes, it was hard not to be reminded of writer Hannah Arendt's warning, which ought to be emblazoned on every street corner, that "no one has ever counted truthfulness among the political virtues".

Yet it really should not be that difficult. For sure, the more unorthodox a tax plan is, the harder it is to compute its likely effects. But Labor's slug at negative gearing and its increase in capital gains tax involve issues economists have scrutinised for decades. In a profession not known for unanimity, there can be little disagreement about what the economic impacts will be.

After all, no one could deny the changes will increase taxes on investor-owned property: indeed, that is precisely what they are intended to do. Nor could anyone deny that as the tax rate on investor-owned property rises, demand for that property will fall; and since that demand is a significant share of the market for housing, prices in the housing market must fall too, settling below the levels they would otherwise have reached.

It must also be true that those price falls will have an impact on all housing. For example, far from being untouched by the change, as Labor claims, current owners of rental properties will be affected, since the price at which they can sell their property will decline.

Owner-occupiers must also be affected, as they too will face a weaker market. And although house prices will fall, rents must rise, as some of the increased costs of owning rental properties are passed on to tenants.

That those effects are likely to be material should equally be uncontentious. Yes, any modelling depends on the assumptions made; but using entirely plausible parameters, Peter Abelson from Sydney University and Macquarie University's Roselyn Joyeux estimate that a 10 per cent increase in the tax rate on investor-owned property reduces the price of all houses by 3 per cent, while shrinking the rental market by more than 8 per cent.

Since Labor's proposed tax increase is substantially greater than 10 per cent, while the rental market is much larger than in 2004 (which they use as a reference year), the impacts could well be twice those Abelson and Joyeux found.

But it is not only desktop studies that suggest the consequences could be significant.

Rather, as Labor itself emphasises, its proposals would align our tax system more closely with the US which in 1986 eliminated negative gearing and increased the tax rate on capital gains. There is therefore a “natural experiment” against which Labor’s plan can be assessed.

That natural experiment has been carefully analysed, notably by James Poterba from MIT. As well as being the world’s leading authority on the impact of taxes on housing markets, Poterba is also the president of the National Bureau of Economic Research, placing him at the pinnacle of the profession.

He finds that the 1986 changes did not only decrease home prices and housing investment, while raising rents; they did so to a much greater extent than analysts had anticipated.

Where the analysts had gone wrong was in focusing on what would happen once the initial shock was fully absorbed, just as Abelson and Joyeux do. But housing markets don’t adjust smoothly: on the contrary, prices overshoot the mark, with impacts which are magnified as reductions in property owners’ net wealth ripple through the financial system and the economy as a whole.

Studies which assumed that the losses to sellers would be offset by gains to buyers therefore missed the point, and instead of a relatively painless transition, as some analysts had predicted, the 1986 changes helped transform a cyclical slowing in the housing market into a collapse.

No doubt, Labor’s proposals would phase in more gradually than those in the US. And even if it accepted Poterba’s findings, Labor might still argue its changes were desirable. But it is hard to see how such arguments could be justified.

For example, Abelson and Joyeux do not just show that raising taxes on investor-owned property would reduce house prices; they also demonstrate that by worsening the distortions that plague our housing markets, including those arising from tax preferences for owner-occupied housing, the higher taxes would decrease efficiency and national income.

As for the claim that the proposals would enhance fairness, there is nothing especially fair about slugging tenants and shrinking the economy. And the long run impacts on income distribution are likely to be even worse than that.

Here too, analyses of the US changes are enlightening. As the eminent American tax scholar Edward McCaffery shows in a recent book, the elimination of negative gearing meant “tax shelters for wage earners were shut down or drastically curtailed”; but exactly as would happen under Labor’s plan, the taxpayers with substantial investment income could still offset losses on rental properties against that income.

Moreover, the greater was those taxpayers' investment income, and the more diversified their property and securities portfolio, the larger was the relative tax advantage they obtained.

As a result, McCaffery concludes that instead of increasing equity, the tax change contributed to a dramatic rise in income inequality, not least by excluding middle class Americans from the investment opportunities open to the rich.

Of course, none of that may trouble Labor, which seems determined to transform itself into the party of "poll-groat bailiffs", as collectors of extortionate taxes were known in Shakespeare's day. That is its choice; but it would do well to remember that the words trust and truth, trustworthiness and truthfulness, come from the same root. If Labor wants to earn the one, it's high time it learned to respect the other.