

Should Negative Gearing Be Abolished?

NICK RENTON

SOME academic commentators and the social welfare lobby regard negative gearing as primarily a tax avoidance device. They were thus disappointed when the Coalition's tax reform package did not even mention the subject.

First of all, some background: *negative gearing* is the situation when an investment is purchased with the assistance of borrowed funds and where the rental or dividend income (after the deduction of expenses) is less than the interest commitment in the course of a year.

For income tax purposes, such negative net income can usually be offset against any positive income from other sources.

Many critics feel that this is unfair. They therefore call for the 'abolition' of negative gearing. Presumably, they really mean that they want a change to the tax rules, rather than the literal abolition of negative gearing itself.

It may not always be realized, but borrowing in order to undertake productive investment actually helps economic growth because value is being added.

Inevitably, there will always be some investments which have lower returns than the interest bill on the loans undertaken in order to acquire the investments concerned—for example, because of start-up periods or because things did not work out as planned. This economic fact of life has nothing whatsoever to do with tax.

A typical property investment, for example, may start off with a large loan and low rent. As time goes by the loan is paid off and the rent increases. Overall the investor makes a profit and the tax office gets its share of this.

Actually, there is not as much loss of revenue to the authorities, even in the early years of a transaction as most critics believe, because for every dollar of interest claimed as a tax deduction by a borrower there is a corresponding dollar of interest assessable to a lender.

Admittedly, the same rate of tax will not always apply to both legs of the transaction, so there is no doubt some leakage of revenue in practice. In some cases, this can be relatively large, as where the lender is outside Australia and thus subject to withholding tax at only 10 cents in the dollar.

But, in other cases, the borrower may be an ordinary Aussie battler on less than the top marginal rate of tax but still keen to have a tax saving, while the lending institution will, through the imputation system, effectively include recipients paying the top marginal rate of tax.

The borrower may be an ordinary Aussie battler on less than the top marginal rate of tax but still keen to have a tax saving

Furthermore, by the time the borrowing becomes positively geared it is probable that—because of bracket creep—many of the above-mentioned Aussie battlers will themselves have become subject to the top marginal rate of tax.

Investment is normally engaged in as a profit-making exercise—and one which puts the investor concerned at some risk. If profits are to be taxed then, as a matter of morality, losses ought to be allowed as a legitimate deduction.

In any event, the phenomenon of different tax rates applying to the pay-

ers and recipients of interest can apply to all types of borrowing and not just to negative gearing situations.

A LITTLE HISTORY

Now for some history. Legislation abolishing tax deductibility for interest on negative gearing property transactions was actually enacted in 1985, when Paul Keating was the Federal Treasurer. The move was made two months ahead of that year's Budget, itself an indication of how seriously the then government regarded the matter.

The new law covered only transactions entered into after 17 July 1985, the date on which the measure was announced.

The approach used involved quarantining all interest in excess of the net rent (gross rent less expenses). There was, however, a right to carry forward any undeducted amounts for use in a subsequent year, to the extent that interest was then less than the net rent.

This legislation was repealed in the 1987 Budget, with effect from 1 July 1987.

The 1985 legislation had a number of anomalies—for example:

- It did not extend to non-property situations, such as negatively geared share portfolios.
- It did not cater adequately for certain situations where some elements were subject to the pre-1985 rules and others to the post-1985 rules.

Far from helping low-income house purchasers and tenants, as most commentators had expected, the abolition of tax deductibility for some interest led to a further round of increases in house prices and rents.

While investors certainly stopped buying residential properties in the affected categories in competition with real end users, a factor which reduced demand, they also stopped building new ones, a factor which reduced supply. The latter factor outweighed the former.

Because the rules applied only to new lending arrangements instituted

after the date of the announcement, tenants were particularly badly hit, as most properties which changed hands after that date passed from investor-owners to owner-occupiers rather than to other investors who, with negative gearing, would have been willing to be landlords.

Possibly the introduction of capital gains tax a few weeks later on 19 September 1985 did not help either—although, of course, this levy affected assets at large and not just negatively geared real estate.

Ironically, the restoration of tax deductibility two years later, far from restoring the status quo, led to a *further* increase in house prices and rents. The investors who had stayed out of the market for that period then re-entered the market in an endeavour to catch up, and this raised house prices (and thus also rent levels). The loss of two years' worth of new construction, of course, could not be reversed overnight.

SWINGS AND ROUNDABOUTS

In a sense, under the present regime, the authorities get their pound of flesh each year. As pointed out above, for every dollar of tax deduction for interest paid by a borrower there is also a dollar of taxable interest received by a lender.

Furthermore, the tax losses in the early years of the ownership of any negatively geared property will, if the investment turns out as intended, be more than offset by the profits in later years.

Over the lifetime of a property transaction, from purchase to eventual sale, the investor will have had a number of dollars in (rent and sale consideration) and a number of dollars out (purchase price, expenses and interest). The difference between the two, representing the total profit from the transaction, will have been taxed either as ordinary income or under the capital gains tax rules.

Of course, governments from either side of politics may one day act against negative gearing for two sets of quite separate reasons—economic and social:

- they like to get cash up front—they would rather have a dollar of tax for the current year's budget than two dollars for a budget down the track (especially as the other political party may be the one in power at that time); and
- almost by definition, negative gearing is engaged in only by those who already have some wealth and, therefore, any loss of revenue under the present regime is occurring at the expense of low-income groups.

With luck, any legislative changes would distinguish between those who set out to use negative gearing intentionally and those who encounter it completely unintentionally—for example because:

- interest rates rise after a loan has started;
- rent levels fall after a loan has started;
- rental income ceases in respect of a particular property when it becomes vacant;
- market conditions force an owner to give a tenant a rent-free period in order to induce that tenant to enter into a new lease;
- of a practical necessity to make certain repairs; or
- of bad debts.

To deny persons who are making commercial losses in such circumstances a tax deduction would be to inflict a double whammy on them and simply to increase their hardship unduly.

Whenever governments set out to plug alleged loopholes the danger arises that the legislation may have unintended side-effects.

One final point: Moving against negative gearing might make the social welfare lobby feel better, but it would not be the panacea that its supporters expect. The revenue to be raised by any measures to curb negative gearing cannot really be estimated from an examination of current trading patterns.

Once any new laws are on the statute book people will change their investment behaviour and the actual increase in tax collections will undoubtedly be much smaller than critics of the present system seem to assume.



Nick Renton is the author of *Negative Gearing and Family Trusts* (Wrightbooks) and wrote on family trusts in the May 1998 edition of the IPA Review.

Musing...

The Meaning of Liberalism

JOHN HYDE

While reading Robert H. Bork's book *Slouching Toward Gomorrah*, I have been struck by many important things. One of the less important has been the difficulties we sometimes have in communicating because we use words differently.

No doubt in a manner that is consistent with American usage, Bork writes of traditional or classical 'liberalism' as a philosophy based on freedom from constraint. His liberalism, before it was subverted, was viable because it was, he wrote, 'tempered by opposing authorities and traditions'.

In contrast, I tend to regard liberalism as a philosophy based on personal responsibility. To me, liberalism is in aggregate no less constraining than socialism or conservatism and may be more so. What distinguishes my liberalism is that the individual is expected to carry the can for his errors, to be personally charitable, and to receive kicks in the bum from that harshest of all task masters, a guilty conscience. The necessary discipline is built into the philosophy and self-indulgent libertinism is not liberal.

The difference is, of course, purely semantic. Bork is well aware of it, and writes clearly about it. Australian readers of less comprehensive works that do not have the space to define their terms should, however, be aware that 'liberalism' can be employed to describe a highly disciplined way of life. The distinction matters to those of us who are sometimes asked to explain where we stand on life and the universe in five, or even five thousand, words.

John Hyde is a Senior Fellow of the IPA.

IPA