A Good Time to End Negative Gearing: If only some bi-partisanship were possible!

There are many things wrong with both housing policy and tax policy, and the interaction of them predictably creates distortions in our housing market. Politicians, unwilling to upset beneficiaries of those distortions in fear of losing votes are unfortunately generally loath to take the steps needed to improve things. A little bit of bipartisanship wouldn't go astray, but that is probably a forlorn hope.

One such distortion is the private tax benefits associated with "negative gearing", ultimately to the cost of other taxpayers. This is the well known practice of using large amounts of borrowed funds to gain unwarranted tax benefits from investing in residential property. It should be stopped, and the low interest rate environment now is a politically opportune time to do so.

Under current tax laws, interest expense on the borrowing can be deducted not just against rental income on the property, but against (virtually) any source of income to reduce tax on that other income. Moreover, capital gains on the property are not taxed until it is sold at a later date, and then (provided it is held for over one year) at a concessional rate (half of the investor's marginal tax rate).

Negative gearing occurs when the interest expense of the borrowing exceeds the rental income of the property, meaning that tax deductions are left over to shield against tax on other income. For wealthy investors, facing high marginal tax rates, there are obvious tax benefits.

Even less well-off individuals have been lured into the negative gearing game, by the prospect of (supposedly) ever-increasing property prices – often developing largish portfolios of negatively geared properties. Maybe they recognise the high risk involved – since a decline in property prices can lead to massive capital losses on geared investments, but hubris generally prevails.

Negative gearing has been one of the factors contributing to rising house prices and housing unaffordability for potential owner-occupiers over past decades. There is nothing in economic logic nor concepts of fairness which justify it.

What can be done about this scourge. Probably the most simple policy change would be to quarantine the borrowing expenses against income received from the property.

Rental income could be deducted from the interest (and other) expenses on the property, but any excess could not be deducted against other income, but instead carried forward for possible offset against future property related income. There may never come a time when those surplus expenses can be used, but one (not ideal) possibility would be to allow them to be deducted from proceeds of the future sale price when capital gains tax is to be paid.

Preventing investors from shielding their other current income from tax in this way would be likely to reduce the appeal of negative gearing and reduce its adverse impact on housing prices. There would still be some incentive for levered financing of investment properties due to the concessional capital gains tax treatment.

Ideally the concessional treatment of capital gains should be abolished – but that is probably a step too far for our vote-seeking political leaders. Some readers may remember that concessional treatment was not envisaged (other than applying tax only to real, rather than nominal, gains) when the tax was introduced in 1985. The distorting concessional treatment was introduced later by the Howard government for political rather than economic reasons.

Why is this a good time to abolish negative gearing? Low interest rates are the reason. Interest rates on mortgage borrowing are as low as they're ever likely to be. So there's less tax benefit to be gained from interest deductions from negative gearing at “normal” levels of gearing (and less to be lost from its abolition).

Indeed, to obtain negative gearing tax benefits, it is necessary to borrow larger amounts relative to the property value to get interest expenses exceeding rental income. Greater gearing of investment properties is not something compatible with good housing market policy, and would tend to amplify any future downturn.

So, in searching for policy changes to improve the functioning of our housing market, abolishing negative gearing would be one part of a solution. There is much more needing to be done. But low interest rates mean that the screams of horror from negatively geared investors and associated lobby groups may be less strident and easier for politicians with some gumption to resist. A bipartisan approach would be welcome, but probably too much to hope for.

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15 October 2021