

MICROECONOMICS AT WORK EXERCISE

TAXATION POLICY AND HOUSE PRICES

REFERENCE: Peter Davidson, 'A danger to the economy', *Business Review Weekly*, 21-27 August 2003, p. 52.

CHAPTERS RELEVANT TO THIS EXERCISE: Chapters 3, 14.

OVERVIEW

The Australian taxation system provides that costs of holding an income-earning asset (e.g. a house to rent) can be deducted from total income earned for the purposes of calculating the amount of income tax payable by a taxpayer, even if those costs exceed the income earned specifically from that asset. Thus the costs of borrowing money (interest) may be deducted from an individual's income even if, when combined with other costs (e.g. agent's commission) it exceeds the rental income. This is frequently done by individuals who expect the capital gain that they will make by owning the house will exceed the costs of borrowing money to purchase it, particularly when those costs are reduced by the 'tax-saving' for them of being able to deduct this loss from other income in the calculation of the income tax that they pay. It is argued that this 'tax break', by influencing the basis on which people make spending decisions, has encouraged 'over-investment' in housing and raised house prices over and above what it would otherwise be if based on economic decisions undistorted by the tax system. The result, it is also argued, is that this can have larger adverse economic consequences ('putting jobs and the economy at risk'). The abolition of 'negative gearing' would not, on the other hand, have any adverse effects except on those who benefit from the policy.

QUESTIONS

1. Explain how the policy of negative gearing may influence investment decisions.
2. How is negative gearing argued to have affected house prices?
3. How is the issue of capital gains tax relevant?
4. What are in arguments in favour of and against negative gearing?
5. Are there any *macro-economic* consequences of this policy?
6. Why is a policy officer with the Australian Council of Social Services writing about this?