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Perhaps the most woefully misunderstood economic issue of the election campaign has been negative gearing.

I’ve been baffled by the number of times I’ve read commentary by otherwise thoughtful people describing negative gearing as a distortion to the property market – as a rort we need to crack down on.

But as someone who knows a bit about the economics of taxation, I can say that simply isn’t true.

Negative gearing is a natural, orthodox and proper feature of any market for investment. And allowing negative gearing to be tax deductible is an essential component of an efficient tax system.

Negative gearing isn’t an account in the Cayman Islands

Negative gearing is a funny term. If you search online, you won’t find the term used in most parts of the world. Not because it’s not allowed, but because the term makes it sound grander than it is. In reality, negative gearing is nothing special – it’s boring and conventional.

If it didn’t have a fancy name, perhaps so many column inches wouldn’t have been wasted writing about it. And maybe we wouldn’t have cast it as a villain that must be slain.

When you buy an asset (such as a home), you bear costs (such as interest) in exchange for two types of return: cash (such as rent) and a rise in value (called a capital gain).

To tax the entire return, we should add up the rent and capital gain over the life of the asset and deduct the interest, maintenance and depreciation expenses.

The capital gain might not be achieved for years – not until the asset is sold, so the total might come out negative for some years while the interest and other expenses exceed the rent received (that's all "negative gearing" is).

Ordinary people do it

This needn't mean you're a wild speculator. With a 20% deposit, 4% interest rate and 3% annual rental yields seen in Sydney recently, you'd be running a loss until you sold.

Investors should be able to deduct this loss from their other income, or carry it forward to future years if they don't have income that year.

This is completely orthodox economics. It ensures tax applies equally to the upside and downside of an investment (or it would, if the eventual capital gain wasn't only half taxed – more on that later).

Restricting this will depress investment. Fewer investors will buy investment properties and those without the ability to negatively gear will spend less on maintenance and the like.

Fewer buyers of homes will mean lower prices for homes. How much lower is a matter of debate.

Removing it could push prices down, and up

On the other hand, in order to support the building of new homes, Labor will allow investors in new homes to continue to benefit from negative gearing, outlawing it only for new investors in existing homes. That'll push up the price of new homes, and encourage the building of more new homes than are needed.

Some have blamed negative gearing for house prices that are far higher than they should be. While there's no good evidence on that, it's surely true that prices are higher with negative gearing than without it.

But rather than being the root cause of the housing affordability crisis – of prices that are higher than they should be – negative gearing is really more of a catalyst.

It's an enabler rather than a problem

The real culprit is the generous 50% discount on the taxation of capital gains. It means that while losses can be written off at the full tax rate, the eventual gain is taxed at only half the full rate.

Winding back the capital gains tax concession was recommended by the Henry Tax Review, was hinted at in the Treasury tax discussion paper commissioned by Coalition Treasurer Joe Hockey, and has been adopted by Labor.

The focus of taxation when it comes to housing should be on neutrality – that decisions of whether to invest in housing are just as they would be if there were no taxes. A lower capital gains tax discount would come closer to doing that. Then negative gearing could stay.

The goal of tax policy should be neither to support nor depress house prices, but rather to let the market evolve on its own. Negative gearing can be part of that.

Read more: ***Confirmation from NSW Treasury. Labor's negative gearing policy would barely move house prices***

Steven Hamilton does not work for, consult, own shares in or receive funding from any company or organisation that would benefit from this article, and has disclosed no relevant affiliations beyond their academic appointment.

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