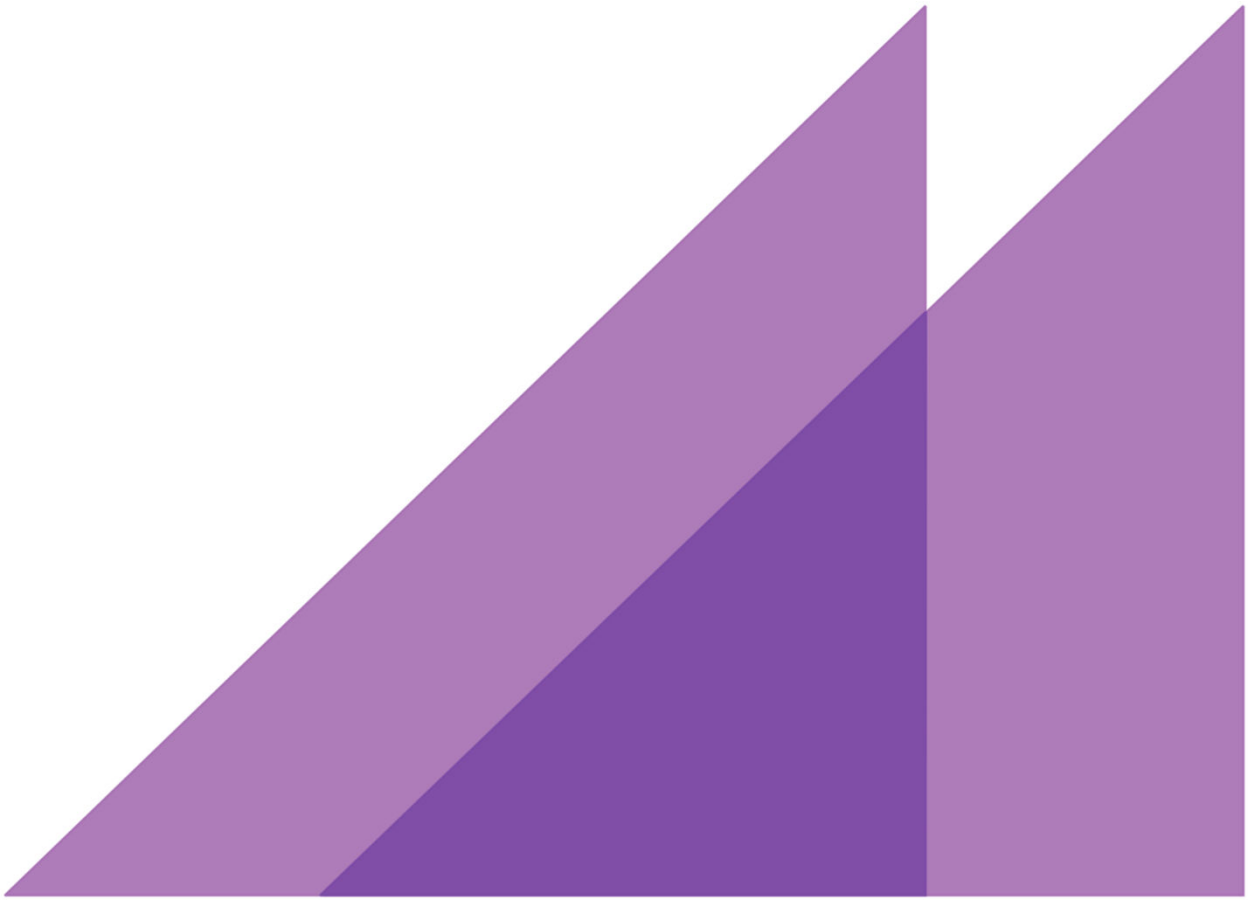
ACIL ALLEN CONSULTING

FINAL REPORT TO
**PROPERTY COUNCIL OF AUSTRALIA AND REAL ESTATE INSTITUTE OF AUSTRALIA**

12 JUNE 2015

# AUSTRALIAN HOUSING INVESTMENT

## ANALYSIS OF NEGATIVE GEARING AND CGT DISCOUNT FOR RESIDENTIAL PROPERTY



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## Some basic facts

Negative gearing is a tax deduction for investments in a variety of assets, including property investments, share investments and business ventures.

Investors both positively and negatively gear. Around two-thirds of residential property investors are currently negatively geared.

The ability of investors to gear and use debt is a crucial part of investing and fostering economic growth. It is a fundamental principle that taxpayers should be able to deduct the associated costs incurred in earning income from investments, including the cost of borrowing. The ability to deduct the cost of debt and losses against income is necessary to ensure that investments are not taxed punitively.

The rationale for the 50 per cent discount on capital gains is to ensure that only real capital gains are taxed (not nominal capital gains). This approach replaced the previous indexation of capital gains in 1999.

Taxing real, rather than nominal, capital gains is important to ensure an individual's consumption power is not eroded. If the capital gains of an asset were not adjusted by inflation (i.e. indexed) or the cost base discounted when calculating the Capital Gains Tax (CGT), an individual would be paying tax for inflation as well as real gains, eroding his/her consumption power.[1]

## Myths and misconceptions

The current booming residential property market and the need to make the tax system stronger has put the spotlight back onto negative gearing and the 50 per cent discount on capital gains for residential property investment.

This renewed interest has resulted in commentators blaming a number of the adverse consequences of the current property boom on the tax treatment of negative gearing and capital gains of residential property. This report examined a number of these claims and has found the following.

- *Negative gearing is not a special concession for property* — it is a legitimate deduction of expenses in the course of earning income from investments in all asset classes until the investment generates a positive income stream in the future.
- *Middle income Australians also benefit from negative gearing* — negative gearing benefits a range of Australian households by providing all individuals with an opportunity to invest in property, not just those in higher income brackets. Two thirds of property investors who benefit from negative gearing earn a taxable income of less than $80,001 a year. Furthermore, while individuals with incomes higher than $80,001 claim around

[1] For example, if an investor purchases an asset for $100, sells it a year later for $106 (earning a 6 per cent return) and inflation is also 6 per cent and the full return ($6) is subject to tax, then the individual would have had no increase in consumption power — a real return of zero. That is, the same bundle of goods that cost $100 last year would cost $106 this year. By being taxed on the inflationary return the individual is no longer able to consume the same bundle of goods. (Australian Treasury 2010, p.65)

42 per cent of the total value of losses on investment property, those earning less than $80,001 a year claim the majority (58 per cent of total value of losses in 2012-13).The data also shows that the majority of investors own only one property and this has not significantly changed over time.

- ATO Taxation Statistics show that in 2012-13 there were 1.97 million individuals who owned a rental property, of which around 1.26 million declared a net rental loss.[2] Around 67 per cent of those that declare a net rental loss have a taxable income of $80,001 or less.
- *The CGT discount benefits all Australians* — property is not the only investment class that benefits from the CGT discount. While around 41 per cent of the capital gains of individuals are sourced from real estate investments (which include residential and other types of property), 31 per cent of capital gains are from other assets and 28 per cent from shares. Furthermore, individuals across all income ranges benefit from the CGT discount.
- *Negative gearing contributes to the provision of new housing* — total dwelling commencements have been growing since the 1950s. A significant proportion of these new dwellings has been financed by investors. Indeed, around a third of all new dwellings construction is financed by investors every year and the absolute amount of investor loans committed to new housing has increased by more than seven-fold since 1986.
- *Many factors other than negative gearing and the CGT discount influence house prices* — it is not sound analysis to simply consider the effects of taxation arrangements on house prices. The cost of housing is shaped by a range of factors influencing demand and supply and hence it is hard to analyse the housing market in isolation from other markets and without considering the local, national and international interconnections. Furthermore, the evidence in this report shows that quantifying the effects of negative gearing on housing prices is a difficult task that would require modelling of complex investors' capital movements and secondary behavioural impacts as well as their effects on the macroeconomy. That said, the immediate removal of negative gearing without allowing to carry forward losses is likely to result in a portion of the average net rental loss (which was, on average, $9,500 in 2012-13 across all taxable income groups) being added to rental prices. The loss of the concession would also reduce the viability of investment in a rental property.
- *Negative gearing does not pose a huge cost on taxpayers* — the existence of negative gearing does cost taxpayers to some extent in terms of foregone tax revenues. However, simply examining the revenue cost of negative gearing is a partial analysis at best. The benefits must be examined as well.
- *Housing is not an unproductive asset* — it serves two important functions for households: it acts as a savings and wealth-building vehicle for owner occupiers and investors and it produces a flow of housing services that households consume.
- *Australia is not the only country with negative gearing or CGT concessions* — the ability to deduct expenses or have tax concessions on capital gains is a common feature of tax systems in other developed countries, and is not unique to Australia.

[2] Includes both taxable and non-taxable individuals.

## Public interest in negative gearing and the CGT discount

Negative gearing fosters the efficiency of the Australian taxation system by ensuring deductibility of expenses in the course of earning income. Access to negative gearing also ensures that all taxpayers (including individual PAYG taxpayers) can access the deduction, thereby promoting the horizontal equity of the taxation system.

The 50 per cent discount on capital gains helps to ensure that purely nominal gains are not taxed and in doing so, promotes the incentive for individuals to save and invest. This is consistent with promoting the efficiency of the taxation system. In addition, the ability of all taxpayers to access the discount (where an asset is held beyond 12 months) fosters equity of the system while the simple design of the discount (relative to indexation) fosters simplicity of the tax system.

The provision of negative gearing has also provided many Australians who are not high income earners with the opportunity to invest in property which they otherwise would not have had. This is because negative gearing reduces the amount of accumulated losses in the initial years of investment and by doing so, reduces the cost of investing. This benefit is particularly advantageous for 'ordinary' taxpayers (as opposed to the higher income taxpayers) who have fewer resources and capacity to carry real cash losses for several early years of investment.

This increased opportunity for ordinary Australians to invest in property also broadens the investment options for these individuals. By doing so, this increased investment opportunity enables individuals to augment their savings.

The provision of negative gearing in conjunction with the CGT discount promotes investment in rental properties and increases supply of new housing.

An increase in rental supply means higher rental vacancies and lower rents than would otherwise be the case. The benefit to renters from improved rental affordability was directly recognised by the Henry Tax Review (2010) which noted that 'the current tax advantages available to highly geared investment can operate as a subsidy to renters by placing downward pressure on rents.'

## Impacts of possible tax changes

Investors should be able to deduct expenses such as interest payments in calculating their taxable income. In a properly functioning taxation system income taxes are based on net income (as opposed to gross receipts). As such, the costs of earning income must be subtracted to arrive at a proper measure of income. If interest payment deductions are denied then it is revenue, not income, which is being taxed.

A policy of denying deductions associated with property would, additionally, distort investment decisions away from property and towards other asset classes for reasons of tax benefit.

Quarantining of expense deductions against corresponding income would primarily only affect the timing of tax payments, so would not result in a large tax collection increase for the Government.

Limiting negative gearing to a maximum number of properties per taxpayer would be highly distortionary, aside from the practicality of determining an acceptable upper limit.

If nominal capital gains are taxed without discount, then investors will be taxed on a gain they have not made (in real terms, which is what matters).

Removing negative gearing or the CGT discount altogether for property will dampen investment, diminish rental supply and make it more likely that in the short to medium term, rents and property prices will increase, as investors seek to recover their after-tax rental returns by increasing their before-tax returns (noting that the average rental loss for tax purposes in 2012-13 was $9,500 across all taxable income groups).

Key to the assessment of any proposed tax changes to property investment is the principle that the same tax rules should apply to all investments. Special tax rules for property investment would drive investment to other assets and would distort investment choices for no sound reason.

Adoption of the Henry Tax Review policy changes, especially the changes in the taxation of net rental losses and discounts on CGT, is likely to result in a marginal increase in taxes collected by Government and penalise the pursuit of capital gains. Furthermore, as noted by Henry, changes to residential negative gearing should only be implemented after other housing supply constraints are resolved.

## The wider economic impacts of tax changes

Eliminating or limiting negative gearing and capital gains tax concessions is likely to have direct impacts on asset prices and rents, returns on investment and the level of investment in the assets affected by the changes.

An economy-wide analysis can trace the direct and indirect impacts of changes to negative gearing and capital gains tax concessions as they flow through the economy and provide an 'on balance' view of their lasting impacts.

An economy-wide analysis by Independent Economics for the Housing Industry Association found that the Henry Tax Review recommendation to discount net residential income by 40 per cent would raise taxes on investors, which will flow through to reduced investment in property and higher rents. This would also flow through as an increase in costs to owner occupied housing through higher opportunity costs in not renting out their own occupied dwelling or higher 'imputed rents'.

# 1 This study

*The current booming property market and the need to make the tax system stronger to sustain government spending and address the longer-term budget problem has put the spotlight back onto negative gearing and the 50 per cent discount on capital gains for residential property investment.*

*This renewed interest has resulted in commentators blaming a number of the adverse consequences of the current property boom on the tax treatment of negative gearing and capital gains of residential property.*

*This report examines these claims in light of the available evidence.*

## 1.1 Research brief

The upcoming Australian Government's White Paper process on reforming both Australia's tax system and the federation (to be completed by the end of 2015) is expected to look closely at negative gearing and Capital Gains Tax (CGT) discounts/concessions for residential property. Given the multitude of opinions surrounding the impact of negative gearing and CGT concessions, the Property Council of Australia (Property Council) and the Real Estate Institute of Australia (REIA) have commissioned ACIL Allen Consulting to produce this report, which:

- investigates the myths surrounding the impacts that the negative gearing and CGT 50 per cent discount have on the property market and on the economy at large using available data and information;
- identifies the economic and social benefits of negative gearing and the CGT 50 per cent discount; and
- assesses the potential impacts of reforms to the existing negative gearing and CGT arrangements.

## 1.2 Report contents

The remainder of this report is structured as follows.

- Chapter 2 outlines some of the basic facts about negative gearing and the capital gains tax discount.
- Chapter 3 investigates the myths about the impact of negative gearing and capital gains tax concessions on the property market and on the economy at large.
- Chapter 4 identifies the economic and social benefits of negative gearing and capital gains tax concessions.
- Chapter 5 discusses the potential direct impacts of implementing a range of different policy suggestions relating to negative gearing and capital gains tax arrangements.
- Chapter 6 outlines the conclusions of this study.

# 2 Some basic facts

*This chapter outlines the mechanics and fundamentals of negative gearing and the capital gains tax 50 per cent discount. In doing so, it also discusses the rationale for their existence.*

## 2.1 Gearing and investment

In the finance literature, the term 'gearing' (also referred to as 'financial leverage') refers to the use of debt to finance an investment with the objective of increasing the expected return on equity (Brealey et al. 2006, pp. 997).

The ability of investors to borrow to finance their investments is essential to ensure that Australia's capital markets operate efficiently and allocate funds to those investments that generate the highest rates of return for a given risk. Borrowing allows investors to add to their own savings by borrowing from the savings of other individuals. This means that investors can access funds to purchase investments they would otherwise not be able to afford using their savings alone.

This is the reason why Australia and most of the OECD countries engaged in an extensive program of financial market deregulation in the 1980s aimed at improving capital market efficiency by removing credit constraints on household borrowing and increasing competition among financial institutions. To ensure the efficient operation of capital markets, it is essential that investors are able to borrow against both (EY 2006):

- the future income generated by the investment (i.e. engage in positive gearing); and
- their future wage and salary income and other investment income in order to finance assets producing capital gains, such as property, shares, precious metals, artworks and business ventures (i.e. engage in negative gearing).

The following sections provide additional details about positive and negative gearing.

### 2.1.1 Positive gearing

Positive gearing refers to a situation where an investor borrows funds to buy an asset and the income generated by that asset is greater than the total amount of the expenses related to it,[3] therefore resulting in a net gain for the investor (before accounting for capital gains or losses). Such gains are added to the investors' personal incomes and taxed according to their marginal tax rates.

Positively geared properties often possess strong rental yields, but have a lower level of capital growth.[4] It is generally believed that these properties are typically located in regional or fringe areas of cities where the properties achieve high rents in comparison to the value of the property (for instance, because of mining or infrastructure activity).

An example of a positively geared property is provided in Appendix A.

[3] For property investments these expenses may include: interest on the money borrowed to finance the investment, depreciation, council rates, body corporate, management fees, etc.

[4] Of course, skilled investors may find properties in the market that may be positively geared and achieve capital growth.

### 2.1.2 Negative gearing

Negative gearing arises when an investor borrows funds to buy an asset but the income generated from that asset is insufficient to cover the total amount of the expenses related to it, therefore resulting in a net loss for the investor (before capital gains or losses). The Australian personal income tax system allows such losses to be deductible against other taxable personal income, such as wage income. This ability to offset losses from one activity against income or profits from another (i.e. the ability to negatively gear) is part of the normal operation of the Australian tax system. It is consistent with the way the tax system treats other tax deductions on the costs associated with generating income and applied to a wide range of investments and business activities.[5] Negative gearing deductions from personal income tax are available for a variety of assets, including property investments, share investments and business ventures.

A property with negative cash flow is one where the rental income from that property does not cover all the outgoing cash costs associated with it. That is, it makes a loss. It is this loss that reduces a person's overall tax liability. An example of a negatively geared property is provided in Appendix A.

Properties that return less rental income than the costs of owning them are generally expected to appreciate in value over time (they are often called 'capital growth properties') as the investors rely on the property increasing in value over time to outweigh any short-term financial losses. This means that, in contrast with positively geared properties, negatively geared properties generally achieve higher capital growth but lower rental yields.

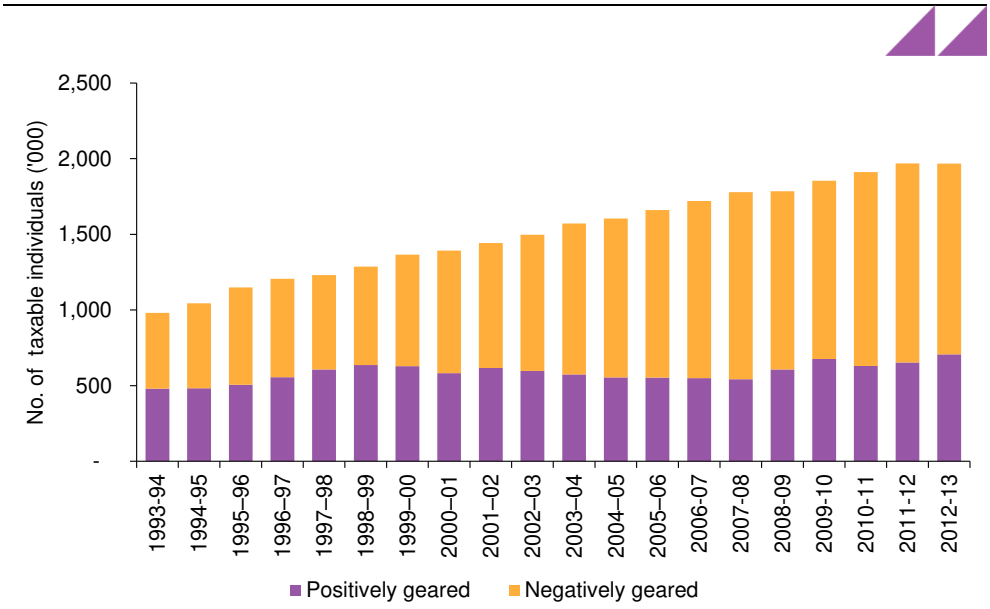
Properties that achieve high capital growth are thought to exist in major metropolitan areas where the value of the property is high in comparison to the rent it receives.

### 2.1.3 Geared property investments in Australia

As mentioned above, there are positively and negatively geared investments. According to statistics from the Australian Taxation Office (ATO), around two thirds of property investors are negatively geared (see Figure 1). This percentage has stayed relatively constant over the last ten years, with the proportion of negatively geared investors averaging 65.6 per cent over the period 2002-03 to 2012-13. The highest number of negatively geared property investments was recorded in 2007-08 when according to the ATO, around 69 per cent of property investors were negatively geared. More recently, lower interest rates have seen the proportion of negatively geared investors declining to 64.1 per cent in 2012-13. The number of individuals declaring a net rental losses is likely to increase when interest rates increase from their currently historic low levels.

[5] Additional details about the history of the tax treatment of geared investments in Australia is provided in Appendix B.

Figure 1 **Number of property investors by type, 1993-94 to 2012-13**




*Note:* The statistics for the 2012–13 income year were sourced from 2013 individual income tax returns processed by 31 October 2014. The statistics are not necessarily complete. Statistics for previous income years reported in this figure may not match the statistics reported in previous editions of Taxation statistics because they have been updated for the latest edition.

Source: ATO 2015.

## 2.2 Tax treatment of geared investments

As with all loans used to acquire an investment asset, deductions are available for the interest expenses on loans for both positively or negatively geared investments (including property and shares).

In order to be deductible for tax purposes, interest expenses must be incurred by the investor in the course of deriving assessable income. That is, to be allowed to claim a tax deduction on a property, the investor has to have the intent to generate revenue from the property, not just a capital gain. In some circumstances this nexus may be satisfied by the hope that the capital gain on eventual disposal of the asset will exceed the losses incurred due to negative gearing (EY, 2006). Additional details about the current tax treatment of negative gearing are outlined in Box 1 and a brief summary of the history of the tax treatment of geared investments is provided in Appendix B.

Box 1 **Current tax treatment of negative gearing in rental properties**

The current tax treatment of negative gearing is as follows.

- Interest on an investment loan for an income producing purpose is fully deductible if the income falls short of the interest. Any shortfall can be offset against income from other sources, such as salary, company income and other forms of investment income.
- Expenses that are fully deductible in the year that they occur include: advertising for tenants; body corporate fees and charges cleaning; council rates; gardening and lawn mowing; insurance (building, contents, public liability); interest expenses; land tax; pest control; property agent's fees and commission; repairs and maintenance; travel undertaken to inspect the property or to collect the rent; and water charges.
- Expenses that are deductible over a number of income years include: borrowing expenses (these are expenses incurred in taking out a loan for the property, such as loan establishment fees, title search fees, and costs for preparing and filing mortgage documents); amounts for decline in value of depreciating assets (e.g. carpet, furniture and appliances); and certain kinds of capital works (i.e. construction expenditure).
- Expenses that cannot be claimed as a deduction include:
  - acquisition and disposal costs of the property — instead, these are usually included in the property's cost base for capital gains tax purposes;
  - expenses borne by tenants (e.g. water and electricity charges);
  - expenses that are not related to the rental of a property; and
  - GST credits for anything purchased to lease the premises (GST does not apply to residential properties).

Source: ATO, 2013b.

## 2.3 Capital gains tax

The Capital Gains Tax (CGT) was introduced in September 1985 as one of a number of tax reforms by the Hawke/Keating government in response to the 1985 Draft White Paper (Australian Government, 1985). It applies to gains from a variety of assets, not only property (e.g. shares and business ventures).The CGT was introduced as an integrity measure to improve vertical and horizontal equity and broaden the tax base (Evans, 2002 and Minas, 2011).[6] Prior to 1985, Australia had no general tax on capital gains, with most capital gains excluded from the income tax base. Of the capital gains taxes that were in operation, the most important was the one applying to gains from property held for less than one year, which was introduced in the early 1970s (Reinhardt and Steel, 2006).

The CGT arrangements introduced in 1985 applied to realised gains and losses from all assets acquired after 19 September 1985 (i.e. it was not, nor is, specific or limited to capital gains from housing investment). However, the taxpayer's main residence is exempt from CGT.

From 1985 to 1999, an indexation system applied, so that only real, not nominal, gains were taxed. An averaging system was also in place to reduce the impact of the progressive income tax on realised gains accrued over a period of years (Reinhardt and Steel, 2006).

Taxing real, rather than nominal, capital gains is important to ensure an individual's consumption power is not eroded. If the capital gains of an asset were not adjusted by inflation (i.e. indexed) or the cost base discounted when calculating the CGT, the individual would be paying tax for inflation as well as real gains, eroding his/her consumption power.[7]

[6] Vertical equity refers to the notion that people with higher incomes should pay more tax (i.e. that tax is paid in a proportional or progressive way). Horizontal equity refers to the notion that people in an identical situation should be treated equally.

[7] For example, if an investor purchases an asset for $100, sells it a year later for $106 (earning a 6 per cent return) and inflation is also 6 per cent and the full return ($6) is subject to tax, then the individual would have had no increase in

### 2.3.1 The capital gains tax discount

As mentioned above, under the original arrangements introduced in 1985, the CGT was levied on the total real capital gains of an asset (the initial rules allowed the cost of assets held for one year to be adjusted/indexed by the consumer price index (CPI) before calculating a gain). However, in September 1999 a capital gains discount was introduced. [8] This change meant that the indexing of the cost base was discontinued and the CGT is now levied on nominal capital gains, with individuals and trusts receiving a discount of 50 per cent for assets (including investment housing) held for longer than 12 months. Superannuation funds receive a 33 per cent discount, but no discount is available to companies.[9,10]

The 50 per cent discount on capital gains was introduced by the Australian Government after consideration of the Ralph Business Taxation Review in 1999. The rationale for the discount was to improve Australia's international competitiveness while promoting investment in innovative and high growth companies likely to produce significant capital gains (Productivity Commission, 2004) and to ensure that only real capital gains were taxed after the abolition of indexation.[11] The Australian Treasury has noted that:

> The indexation method and the 50 per cent discount method result in broadly similar amounts for net capital gains, assuming CPI increases yearly by 2½ per cent (the middle of the RBA target band) and asset prices increase yearly by 5¼ per cent. For superannuation funds, eligible for a one third discount on their gains, the discount method is not as generous as the indexation method.
>
> [Furthermore,] the discount method does not apply to companies, whereas before 2000-01 all entities could adjust their capital gains income for inflation. This means that, following the 2000-01 changes to CGT, there is a reduced incentive for domestic companies to realise capital gains.
>
> *Clark, 2014, p.39*

More details about the current treatment of CGT are provided in Box 2.

consumption power — a real return of zero. That is, the same bundle of goods that cost $100 last year would cost $106 this year. By being taxed on the inflationary return the individual is no longer able to consume the same bundle of goods. (Australian Treasury 2010, p.65)

8 Other changes introduced at the same time included abolishing averaging provisions, rationalization and extension of a series of small business retirement and roll-over concessions and the removal of depreciable assets from the CGT regime. (Evans, 2002).

9 A range of special provisions apply to small businesses. These can be found on https://www.ato.gov.au/General/Capital-gains-tax/CGT-exemptions,-rollovers-and-concessions/Small-business-CGT-concessions/.

10 CGT is not paid by foreign portfolio investors, but it does apply to foreign direct investment (FDI) in Australia.

11 Although, as noted by Kirchner (2009, p.1), 'the abolition of inflation indexation raises the marginal tax rate when capital gains are less than twice the rate of inflation.'

Box 2 **Current taxation of capital gains**

A capital gain or capital loss is the difference between what it cost to acquire an asset and what is received when the asset is disposed of. The CGT is payable on any capital gains when assets are sold, rather than on an accrual basis. The taxable amount of capital gain is added to income in the year the asset is sold and taxed at the applicable income tax rates. If there is a capital loss, this cannot be claimed against taxable income, but can be used to reduce a capital gain in the same income year. If a taxpayer's capital losses exceed their capital gains or they make a capital loss in an income year where there is no capital gain, the loss can be generally carried forward and deduct it against capital gains in future years.

The capital gain or capital loss is calculated by subtracting the asset's 'cost base' (what it cost to get the asset) from the asset's 'capital proceeds' (what was received when the asset was disposed of). The amount a taxpayer declares on their tax return is the total capital gains for the year, less any capital losses and any CGT discounts or concessions the taxpayer is entitled to.

The cost base of a CGT asset is generally the cost of the asset, plus certain other costs associated with acquiring, holding and disposing of it. The cost base of a CGT asset is made up of five elements which need to be added together to work out the cost base for each CGT asset.

1. The money paid for the asset.
2. The incidental costs of acquiring the CGT asset or that relate to the CGT event (but that have not been claimed as a tax deduction in any year). This includes:
   - remuneration for the services of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal adviser;
   - costs of transfer;
   - stamp duty or other similar duty;
   - costs of advertising or marketing (but not entertainment) to find a seller or buyer;
   - costs relating to the making of any valuation or apportionment to determine the capital gain or capital loss;
   - search fees relating to an asset (e.g. fees to check land titles);
   - the cost of a conveyancing kit (or a similar cost);
   - borrowing expenses (such as loan application fees and mortgage discharge fees); and
   - expenditure that is incurred as a direct result of ending the ownership of a CGT asset (termination or exit fees).
3. The costs of owning the CGT asset. This includes rates, land taxes, repairs and insurance premiums, non-deductible interest on borrowings to finance a loan used to acquire the CGT asset and on loans used to finance capital expenditure incurred to increase an asset's value. Costs that have been claimed as a tax deductions in any year or can still be claimed are not included.
4. The capital costs to increase or preserve the value of the CGT asset or to install or move it (e.g. costs incurred in applying — successfully or unsuccessfully — for zoning changes).
5. The capital costs of preserving or defending the title or rights to the CGT asset (e.g. payment for a call on shares).

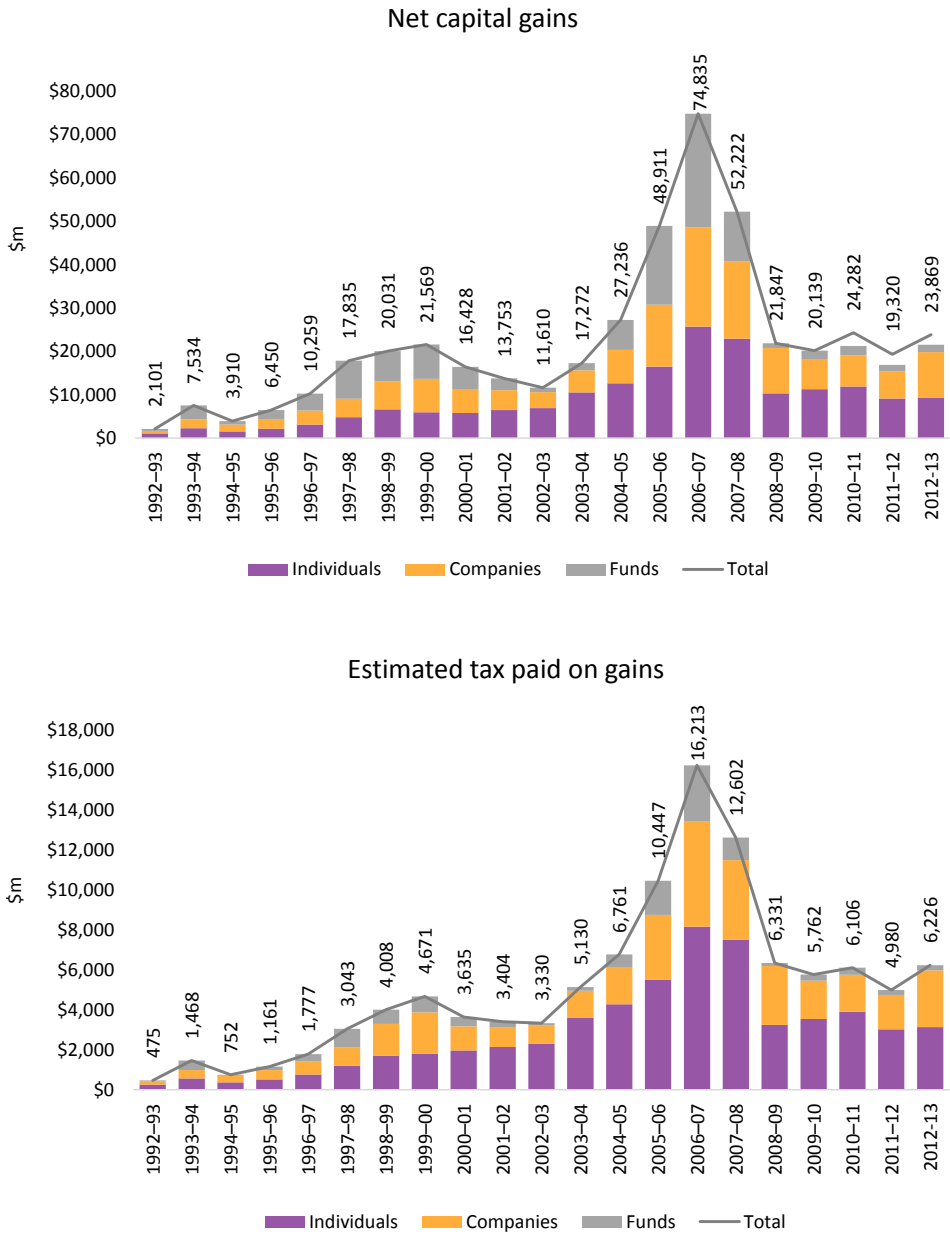
Source: ATO 2014a.

### 2.3.2 Capital gains tax in Australia

For the 2012-13 income year, an estimated $6.2 billion in CGT was payable by taxable entities on net capital gains totalling $23.9 billion. This decreased from a peak of $16.2 billion payable in 2006-07 for capital gains totalling $74.8 billion (see Figure 2). Over the last decade, the largest movements in net capital gains income have been related to the share market, particularly in the early 2000s associated with the dot-com crash, followed by the rapid increase in the ASX 200 to record index in October 2007 and the subsequent decline during the Global Financial Crisis (GFC) (Clark, 2014).

The majority of the payable CGT is contributed by individuals (who accounted for 50 per cent of the payable CGT in 2012-13 and for 53 per cent of the payable CGT over the period 1992-93 to 2012-13), followed by companies (46 per cent of the payable CGT in 2012-13 and 35 per cent of the payable CGT over the period 1992-93 to 2012-13) and funds (4 per cent of the payable CGT in 2012-13 and 12 per cent of the payable CGT over the period 1992-93 to 2012-13).

Figure 2 **Tax payable on capital gains, by entity type [a]**




[a] Taxpayers with net tax greater than $0.

*Note:* The statistics for the 2010-11 to 2012–13 income years were sourced from individual, company and fund income tax returns processed by 31 October 2014. The statistics are not necessarily complete. Statistics for previous income years reported in this figure may not match the statistics reported in previous editions of Taxation statistics because they have been updated for the latest edition. The tax on capital gains reported in this figure is an estimate of the tax required to be paid, based on using an average tax rate approach (more details about this approach can be found in ATO 2013).

Source: ATO 2015.

Notably, as shown in Figure 2, growth in CGT payable by individuals and funds since 1999 has outstripped that from companies, which did not benefit from a discount under the Ralph reforms. As discussed in Section 2.3.1, individuals received a larger discount than funds (50 per cent versus 33 per cent), yet CGT revenue collected from the former has exceeded growth in the latter. The CGT share of Commonwealth tax revenue (although modest) nearly doubled since the Ralph reforms, from 3.3 per cent in 1999 to 6.6 per cent in 2009 (Kirchner, 2009). This data suggest that, despite the introduction of the CGT 50 per cent discount, the Ralph reforms have resulted in more CGT revenue being collected, not less.

As noted by Kirchner (2009, p.2), 'this is consistent with international evidence on the responsiveness of capital gains realisations and tax revenue to changes in the CGT rate'.

## 2.4 Key points

- Negative gearing is a tax deduction for investments in a variety of assets, including property investments, share investments and business ventures.
- Investors both positively and negatively gear. Around two-thirds of residential property investors are currently negatively geared.
- The ability of investors to gear and use debt is a crucial part of investing and fostering economic growth. It is a fundamental principle that taxpayers should be able to deduct the associated costs incurred in earning income from investments, including the cost of borrowing. The ability to deduct the cost of debt and losses against income is necessary to ensure that investments are not taxed punitively.
- The rationale for the 50 per cent discount on capital gains is to ensure that only real capital gains are taxed (not nominal capital gains). This approach replaced the previous indexation of capital gains in 1999.

# 3 Myths and misconceptions

*This chapter examines the myths surrounding the impacts of negative gearing and the 50 per cent discount on capital gains with respect to residential property.*

## 3.1 Myth 1 — negative gearing is a special concession for property

Negative gearing is not a special concession for property. It is consistent with the way the tax system treats other tax deductions on the costs associated with generating income. As noted by the Reserve Bank of Australia (2003, p.55), 'the ability to offset losses from one activity against income or profits from another [(i.e. the ability to negatively gear)] is part of the normal operation of the Australian tax system, and applied to a wide range of investments and business activities'.

An efficient taxation system should ensure that taxes are based on net income (as opposed to gross receipts). As such, the costs of earning income must be subtracted to arrive at a proper measure of taxable income. While certain upfront costs would be considered capital expenses, a mining company, for example, is able to claim certain exploration and other expenses for a mine which does not produce a positive income for five years, in the year they pay those expenses. Or a small start-up business can claim expenses for years before earning a positive income. The same is for a property investor, who is able to use negative gearing to claim annual losses until the property earns a positive income.

Negative gearing applies to losses incurred on a variety of assets, not only property (e.g. shares, precious metals, artworks and business ventures).

**Conclusion:**

Negative gearing applies to losses incurred on a variety of assets, not only property and it is consistent with the way the tax system treats other tax deductions on the costs associated with generating income.

## 3.2 Myth 2 — middle income Australians do not benefit from negative gearing

The ability to offset losses from one activity against income or profits from another is available to all Australian taxpayers. By reducing the amount of accumulated losses in the initial years of investment, access to negative gearing lowers the cost of investment for all investors and provides them with the opportunity to invest in property and other assets.

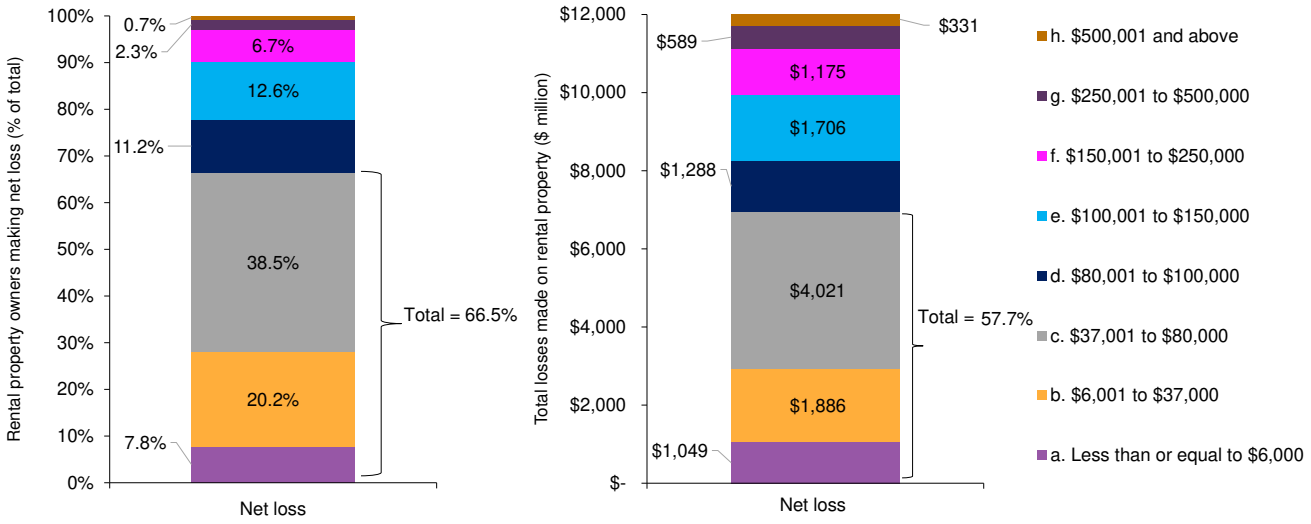
Data from the ATO shows that in 2012-13, 66.5 per cent of rental property owners who made a loss on their investment property earned a taxable income of $80,001 or less (Figure 3). This number increases to 78 per cent if individuals with taxable income of $100,001 or less are included. In dollar terms, the proportion of losses made on rental property (and therefore deductions under negative gearing) for owners earning $80,001 or less was around 58 per cent of total deductions claimed. Notably, these taxable income figures already account for deductions of net losses made on rental property (that is, they show taxable income already reduced/increased by net losses on rental property). Given

that the average net rental loss for an individual earning a taxable income of $80,001 or less in 2012-13 was around $8,300, this means that the taxable income pre-negative gearing deductions for an individual earning, say, $80,000 would be around $88,300.

This evidence shows that:

- negative gearing benefits a range of Australian households by providing all individuals with an opportunity to invest in property, not just those in higher income brackets. Indeed, two thirds of property investors who benefit from negative gearing earn a taxable income of $80,001 or less a year; and
- individuals with taxable incomes of $80,001or less a year claim the majority of rental losses (approximately 58 per cent of all losses).

Figure 3 **Number and value of net rental loss, by taxable income group, 2012-13**



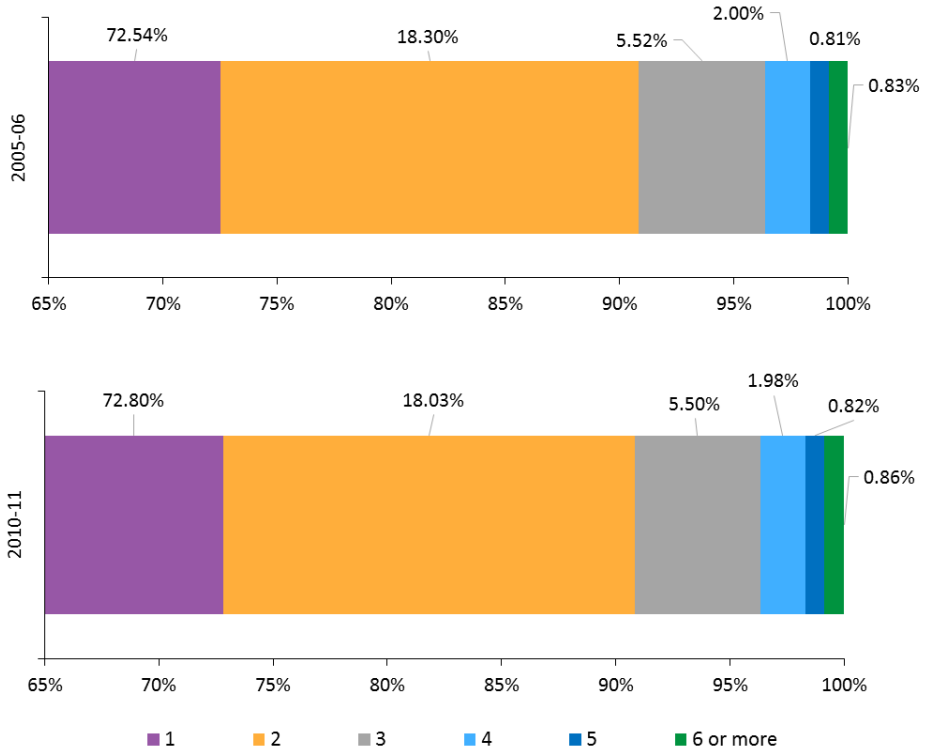

*Note:* Taxable income range has been specified by ACIL Allen based on ATO data, data includes both taxable and non-taxable individuals.
Source: ATO, 2015.

There have also been claims that negative gearing and the 50 per cent discount on capital gains for property results in the 'hoarding' of available housing stock by those who have the means to invest in them.

As shown in Figure 4, data from the ATO shows that the overwhelming majority of rental property investors (73 per cent) own only one property. Moreover, the distribution of rental property ownership by number of properties owned barely changed between 2005-06 and 2010-11. There was a marginal increase in the number of investors owning one property from 72.5 per cent to 72.8 per cent during this time (i.e. an increase of 0.26 per cent).

A marginal increase in the percentage of investors owning five properties and 'six or more' properties can also be observed for the same period, whilst the proportion of investors who owned two, three or four rental properties declined by a small amount.

Figure 4 **Individuals with an interest in rental property by number of properties owned, 2005-06 and 2010-11**




*Note:* Data includes both taxable and non-taxable individuals. The range commences from 65 per cent as it is difficult to highlight the different categories if scale commences at 0 per cent. Financial year 2005-06 is the oldest year for which data is available from the ATO.

Source: ATO, 2013 and ATO, 2006.

**Conclusions:**

- Negative gearing benefits a range of Australian households by providing all individuals with an opportunity to invest in property.
- While individuals with taxable incomes higher than $80,001 claim around 42 per cent of losses on investment property, those earning $80,001 a year or less claim the majority of rental losses (around 58 per cent of all losses).
- The majority of property investors owns only one property and this has not significantly changed over time. Furthermore, there has not been a significant surge in the numbers of investors owning multiple properties.

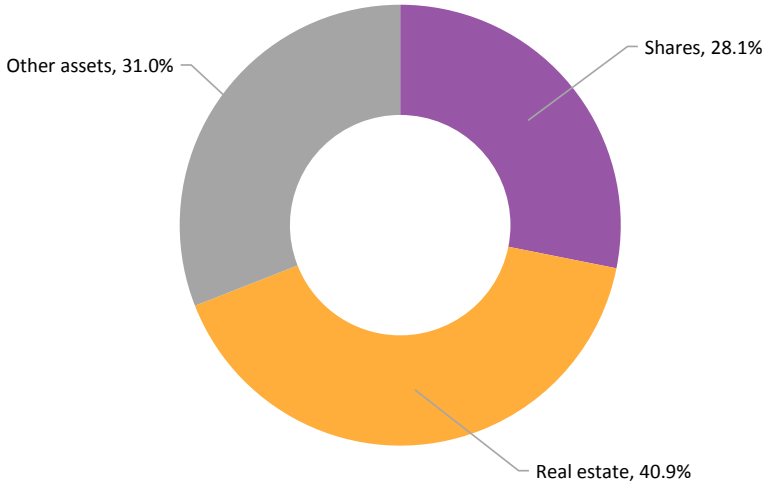
## 3.3 Myth 3 — the CGT 50 per cent discount does not benefit all Australians

The 50 per cent discount on capital gains was introduced to eliminate the taxation of nominal gains (see Section 2.3). Eliminating the taxation of nominal gains seeks to provide individual taxpayers with the incentive to invest in order to earn a capital gain and bolster savings and economic growth.

The ATO data for 2012-13 shows that individuals across all income ranges benefit from the CGT discount, with 57.1 per cent of the approximate 389,000 individuals who paid CGT earning a taxable income of less than $80,001. Notably, while there seems to be a

widespread misconception that the CGT discount benefits only property investors, data from the ATO indicates that capital gains from real estate investments for individuals represented approximately 41 per cent ($9.6 billion) in 2012-13 (see Figure 5), while 31 per cent of capital gains were from other assets ($7.3 billion) and 28 per cent from shares ($6.6 billion). Notably, the capital gains from real estate investments include all real estate investments, not only residential. [12]

Figure 5 **Capital gains of taxable individuals [a] by source, 2012-13**




[a] Individual taxpayers with net tax payable greater than $0 who completed a CGT schedule.
*Notes:* Sources include both active and non-active assets. Includes other CGT assets and any other CGT events.
Source: ATO 2015.

**Conclusions:**

- The CGT 50 per cent discount is used by investors across the income stpectrum.
- Property is not the only investment class that benefits from the CGT discount. While around 41 per cent of the capital gains of individuals are sourced from real estate investments (which include residential and other types of property), 31 per cent of capital gains are from other assets and 28 per cent from shares.

## 3.4 Myth 4 — negative gearing does not add to housing supply

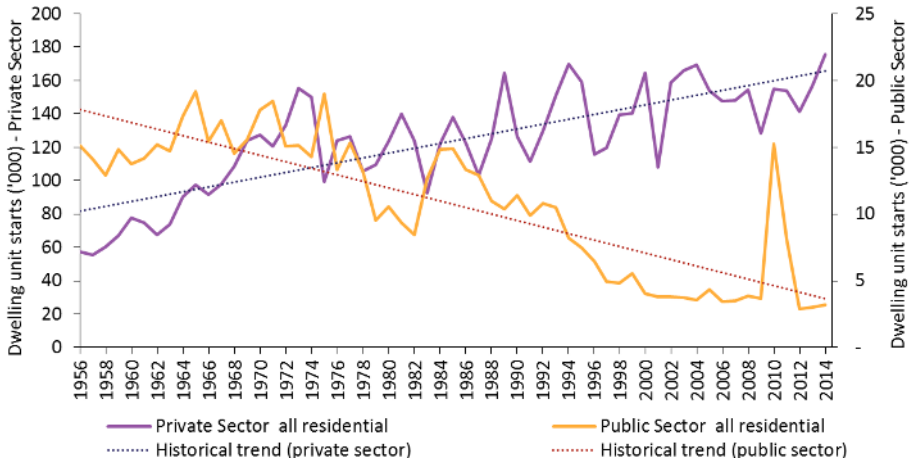
ABS data on dwelling commencements show that Australia's total housing stock has been on an upward trend since the 1950s (see Figure 6). Total private sector dwelling commencements have been on a clear upward trend, whilst total public sector dwelling

[12] Further details about the breakup of real estate investments would be required to assess the proportion of gains attributable to residential property (data available from the ATO on gains from real estate investments includes all investments in real estate, not only residential).

commencements[13] have been on a clear downward trend. Overall, however, the increase in private sector dwellings has compensated for the reduction in public sector dwelling commencements and total dwelling commencements have been on an uninterrupted growth trend. A significant proportion of these new dwellings have been financed by investors.

While ABS housing finance data suggest that property investors overwhelmingly invest in existing housing (see Figure 7), it is also the case that a significant proportion of new housing construction is financed by investors. As shown in Figure 8, around 27 per cent of all loans for the *construction* of new housing in 2014 were to investors.[14] This proportion has remained relatively constant over the last 30 years (see Figure 9).

Figure 6 **Dwelling commencements by sector**

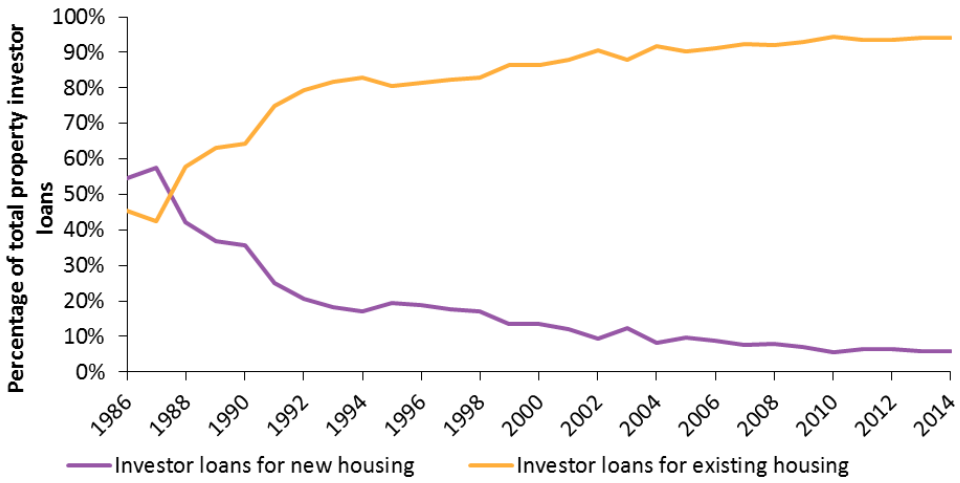



*Note:* All dwelling unit commencements are for new units.
Source: ABS, 2014, Catalogue 8752.33.

[13] ABS classifies the ownership of a building as either private sector or public sector, according to the sector of the intended owner of the completed building as evident at the time of approval. Residential buildings being constructed by private sector builders under government housing authority schemes whereby the authority has contracted, or intends to contract, to purchase the buildings on or before completion, are classified as public sector.

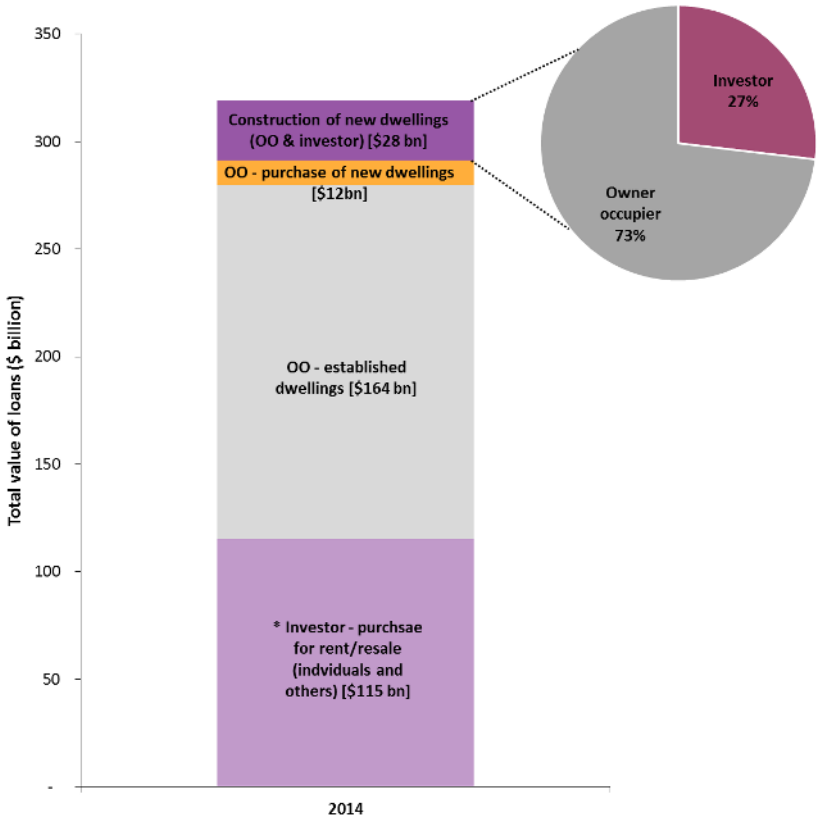
[14] Notably, while this estimate focuses on loans provided for the *construction* of new dwellings, investors also obtain finance for the *purchase* of new dwellings. The total proportion of investor loans for the *construction and purchase* of new dwellings could not be estimated using the existing ABS data (which does not separately report investors' loans for purchase of new and existing dwellings). Hence, this number underestimates the amount of new dwellings financed by investors.

Figure 7 **Investor housing finance commitments by new and established properties as proportion of total value of investor housing loans**



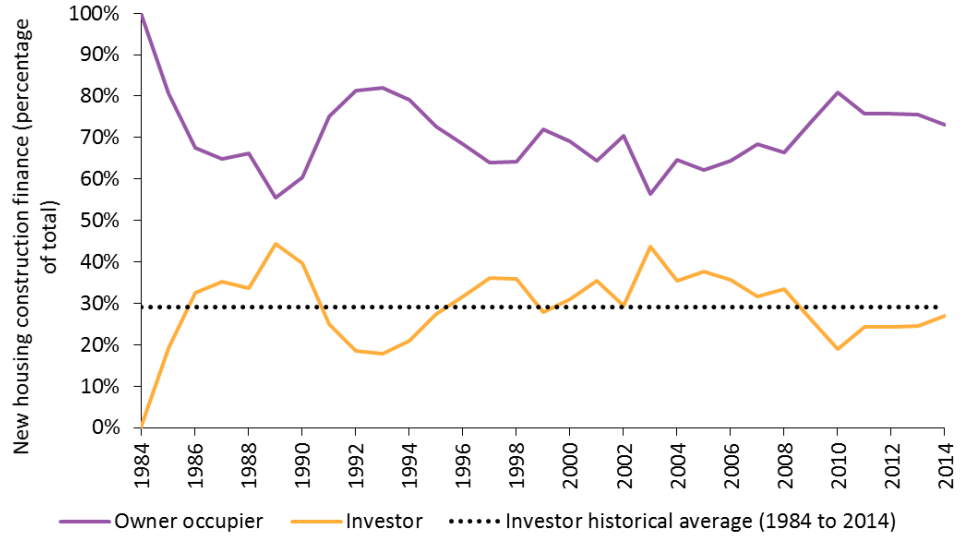

Source: ACIL Allen Consulting based on ABS cat.5609.11.

Figure 8 **Housing finance commitments in 2014 (value of loans)**




*Note:* OO stands for owner occupier. * ABS does not separately report investors' loans for purchase of new and existing dwellings.
Source: ACIL Allen Consulting based on ABS cat.5609.11.

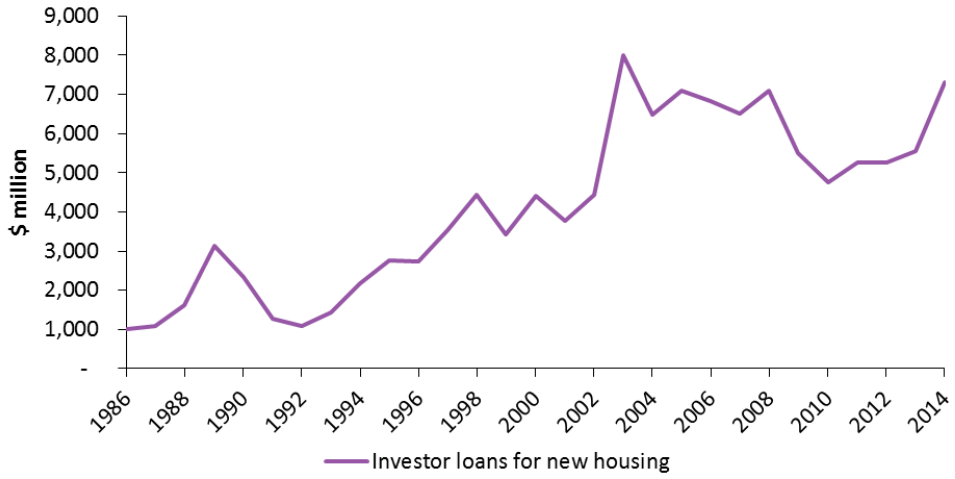
Figure 9 **Historical housing finance commitments for the construction of new dwellings**




Source: ACIL Allen Consulting based on ABS cat.5609.11.

While the proportion of loans for investors towards the construction of new housing has remained relatively constant at around 30 per cent over the last 30 years or so, the absolute amount of investor loans committed to new housing has increased over time. In 1986, total investor loans for the construction of new housing were approximately $1 billion; this amount increased by more than seven-fold to $7.3 billion by 2014 (see Figure 10).

Figure 10 **Total amount of investor loans committed to the construction of new dwellings**




Source: ABS cat.5609.11.

Many of these property investors would have made the decision to invest in rental property (regardless of new or established) reflecting many factors including the ability to deduct net rental losses made on their investment. Had negative gearing not been available, it is almost certain that total investment in property, regardless of whether new or established, would

have been lower. Investment loans for new housing grew at a significant rate after the reintroduction of negative gearing concessions in late 1987.

In this regard, the popular depiction of the declining amount of investor loans committed to new housing construction relative to the total value of housing finance for established properties is highly misleading. Given that the evidence shows a constant trend for investor loans committed to new dwelling constructions since 1986, the more important policy question that needs to be considered is, *why have investor loans committed to established housing grown at a much faster rate than for new dwellings?* Assuming that there is no discernible difference between the investment rate of return of new and established housing, there must be other factors apart from negative gearing (and the CGT 50 per cent discount) that have led to this change in investor loan profile.

The answer to this question requires detailed analysis of the state of housing markets as well as understanding the behaviour of property investors. Such an analysis is beyond the scope of this report. However, one plausible explanation is likely related to the fact that there are more purchase options available to investors in the established housing market than the new dwelling market. This is particularly true in urban areas in close proximity to city centres, where planning regulation constrains the amount of new dwellings constructed. In an environment where options to invest in new property are scarce, and given that a large share of property investors do in fact live in cities and urban areas, these investors are left with little choice but to purchase established dwellings.

As noted by the Reserve Bank of Australia (RBA):

> Whenever rising demand results in higher prices, the question arises of why supply cannot expand enough to prevent this. Australia faces a number of longstanding challenges in this area, including regulatory and zoning constraints, inherent geographical barriers and the cost structure of the building industry. There are also obstacles to affordable housing created by Australia's unusually low-density urban structure.
>
> *RBA 2014a, p.1.*

**Conclusions:**

- Total dwelling commencements have been on an uninterrupted growth trend since the 1950s. A significant proportion of these new dwellings have been financed by investors.
- Whilst the value of investors' loans for new housing has decreased as a proportion of total property financing, around a third of loans for the construction of new housing are to investors.
- The absolute amount of investor loans committed to the construction of new housing has increased by more than seven-fold since 1986.
- The reasons behind the changing investor profile need to be further investigated. It is likely that this change is related to other factors (such as supply-side issues) rather than the solely provision of negative gearing.

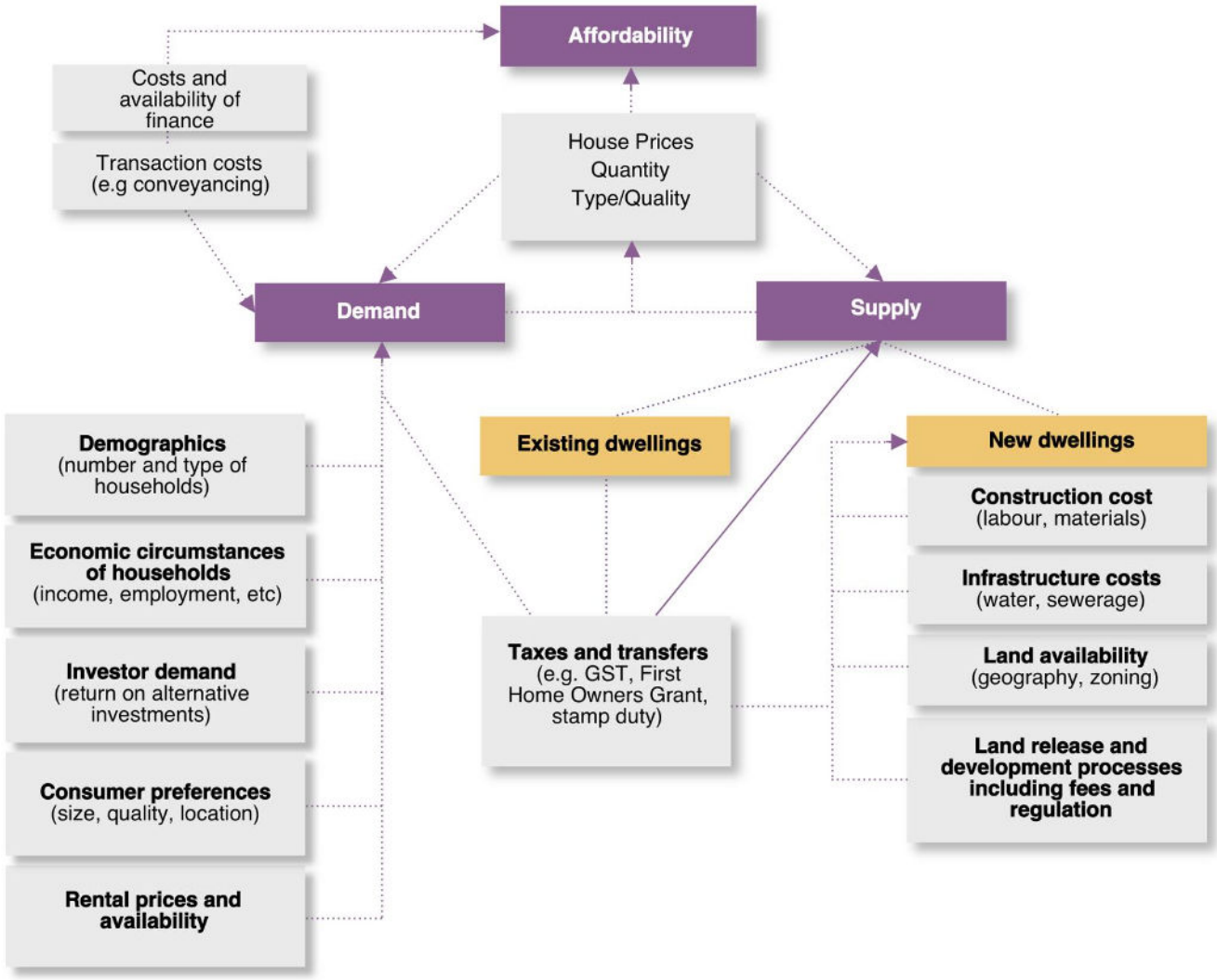
## 3.5 Myth 5 — Negative gearing and CGT 50 per cent discount increase house prices

### *Many factors contribute to house price increases*

As illustrated by Figure 11, the cost of housing is shaped by a range of factors influencing demand and supply. Housing supply is driven by factors such as land availability,

construction costs, profitability for developers and infrastructure costs such as water, power, sewerage and public transport. Housing demand is driven by factors such as the number and type of households looking for housing, household income and preferences (such as size, location and tenure type), investor demand and interest rates.

Figure 11 **Housing demand, supply and affordability**




Source: Adapted from NHSC, 2010.

Several econometric analyses have examined the fundamental demand factors and the relative magnitude of their effects in house prices in Australia. Earlier Australian studies highlight the role of income and demographic factors[15]; later studies focus on interest rate and wealth effects.[16] In broad terms, the same determinants have been shown to affect demand for owner-occupied housing and demand for investment housing.[17]

While these aggregate econometric analysis provide valuable insights into the factors affecting house prices, they are limited for a number of reasons (RBA 2011 p.264):

[15] See, for example, Bourassa and Hendershott (1995) and Abelson et al (2005).

[16] See, for example, Otto (2007) and Fry, Martin and Voukelatos (2010).

[17] See, for example, Kohler and Rossiter (2005)) (RBA 2011).

— the factors that affect house prices are complex and can vary over time;

— there are difficulties in measuring key variables (such as expectations);

— there can be problems in capturing the impact of structural shifts in key fundamental determinants, particularly when there are lags before their impact is felt; and

— it is difficult to capture the impact of changes at a sub-aggregate level that might occur slowly over time (such as structural changes that affect the spatial distribution of the population, changes in the distribution of income or changes in housing preferences).

Despite these issues, there is agreement that the main determinants of the increase in house prices from the mid-1990s are (RBA 2011, 2014a):

— the decline in nominal interest rates brought about by the decline in inflation;

— the increase in borrowing capacity enabled by financial deregulation; and

— the growth in average disposable income.

Given that the supply of housing takes time to adjust, these factors have been the predominant influence on house prices in the short to medium term. However, in the longer term, it is the housing supply response that determines the extent to which additional demand for housing results in higher prices over time (RBA 2014b).

**Conclusion:**

The cost of housing is shaped by a range of factors influencing demand and supply and hence it is hard to analyse the housing market in isolation from other markets (e.g. the finance and labour market) and without considering the local, national and international interconnections.

### *Impact of housing supply on prices*

Fundamental economic principles stipulate that an increase in demand for a good or service will be met by a combination of an increase in prices and an expansion in the quantity supplied. However, as noted by RBA (2014a, p.7), in the Australian housing markets 'the price responses seem to dominate the quantity supply responses'. This is due to the fact that the Australian housing market has a number of longstanding structural features that make it difficult for housing supply to respond to price increases driven by demand. These include (Australian Treasury 2014a, RBA 2014a):

— regulatory and planning constraints;

— inherent geographical barriers (a large percentage of the Australian population lives in coastal cities where expansion cannot occur in every direction);

— the cost structure of the building industry; and

— the urban population structure (which is unusually concentrated in two large cities).

Evaluating whether housing supply has been adequate in Australia requires benchmarking the appropriate demand level first. Controlling for factors such as 'housing finance' (i.e. ability to purchase housing as a result of increases/decreases in real mortgage rates), one benchmark 'demand level' of housing that could be considered is the amount of housing available with respect to population.

Figure 12 shows annual dwelling unit commencements and yearly population growth for the years 1980 to 2014. Dwelling unit commencements have generally hovered around its mean of 153,000 units over the past 10 years, whilst population growth has oscillated with much

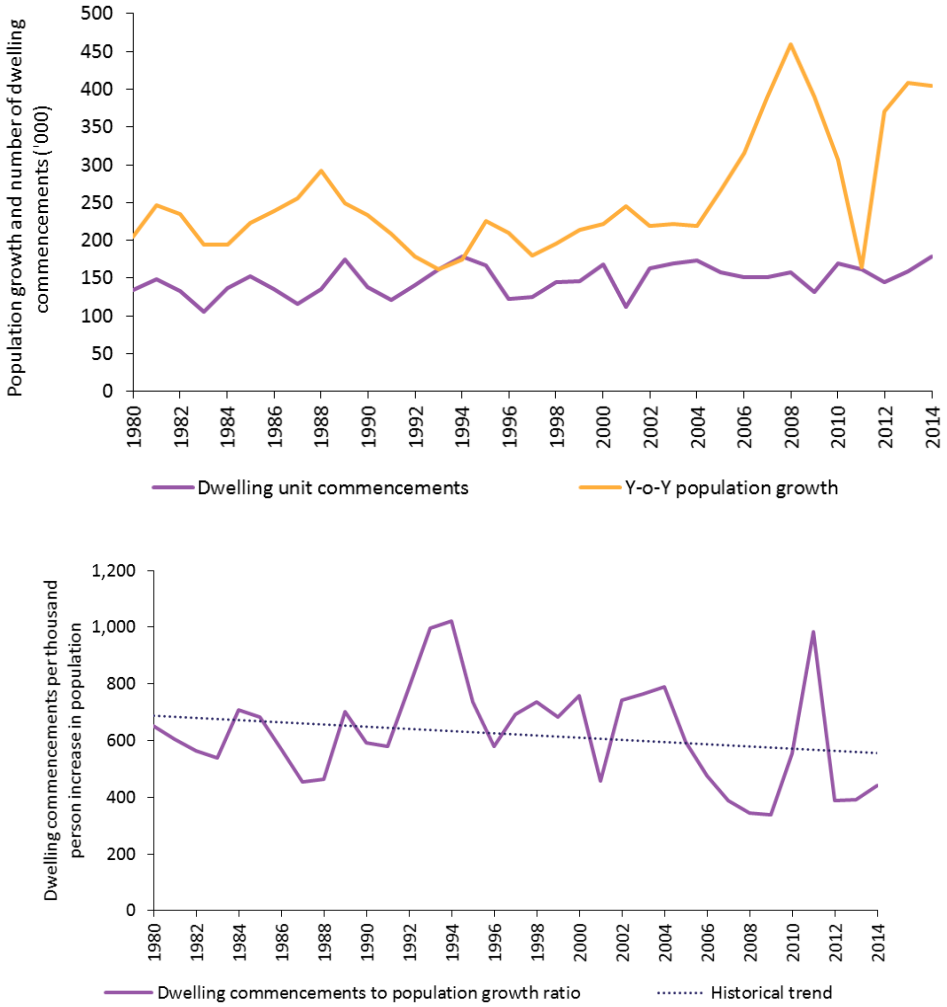
greater variation around its mean of 255,000, peaking as high as 500,000 additions to the national population in 2008 alone.

The number of households to be added to the population in the five years to 30 June 2016 is projected to increase by 821,525 which equates to an average annual increase of 164,305 per year. This number is projected to increase over each of the five years to 2021 to 171,804 households being formed per year. (ABS 2015). This shows that there is a shortfall of homes built for household formation.

Over a period of time, a faster rate of population growth compared to the rate at which new dwellings are added to the housing stock, represent a shortage of supply. The rate of residential housing construction compared to population growth is shown in the bottom chart of Figure 12, and also the ratio of new dwelling commencements to every thousand additional persons to the Australian population. The number of dwelling unit commencements is not a measure of housing stock itself, since a proportion of existing stock is decommissioned/demolished each year as the structure gets outdated, and replaced by new housing. However, in the absence of robust historical data for residential housing stock, annual dwelling commencements has been plotted as an indicator of housing stock growth that *does not* take account of the demolition/decommissioning of outdated properties each year.

The ratio of new dwelling commencements to population growth has been on a clear declining trend albeit at a gradual rate. The five year average number of dwelling commencements per thousand persons increase in population from 1980 to 1984 was 614 units whilst the average for 2010 to 2014 was approximately 10 per cent less, at 552 units. The important takeaway from this chart is the historical trend which is downwards sloping. Compared to 20 years ago, there are less new dwelling commencements per thousand additional persons. This means that there are less new dwellings available for purchase per person in Australia. This imbalance in housing demand and supply represents a supply shortage, when holding other factors such as housing finance conditions are held constant. The shortage of housing supply under conditions of sustained or increased demand results in increasing housing prices.

Figure 12 **Dwelling unit commencements and population growth, 1980- 2014**




*Note:* Dwelling unit commencements is not equivalent to housing stock since it does not take account of demolition of outdated housing stock.

Source: ACIL Allen Consulting, 2014 based on ABS 8752.0 and ABS 3105.0.65.001.

**Conclusion:**

There is a housing supply shortage in Australia. A shortage of housing supply under conditions of sustained or increased demand results in increasing housing prices.

### *Impact of negative gearing and the CGT discount on house prices*

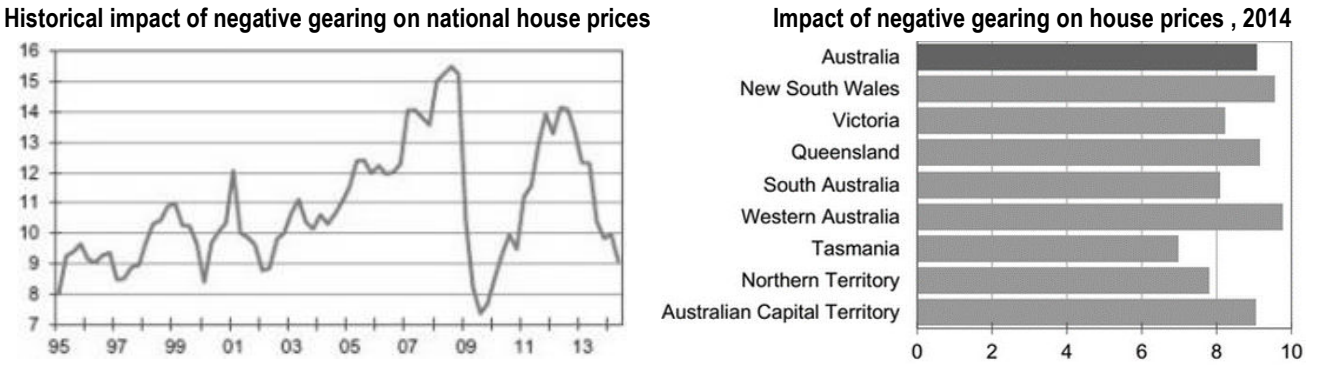
There is limited empirical evidence on the impact of negative gearing and the CGT discount on the Australian housing market, however the few references found in the literature are discussed below.

O'Donnell (2005) explores the arguments for and against negative gearing and found that house prices have a strong positive relationship with interest rates and to a lesser extent with the amount invested in private fixed capital formation. It also found that house prices have a significant inverse relationship with outstanding investment property loans. However, no observable relationship was found between house prices and negative gearing.

Seelig et al. (2009) explored the motivations, expectations and experience of rental property investors through in-depth interviews. They found that, for most participants in the study, negative gearing was not a deliberate investment strategy and was not a crucial factor in their investment decisions (but it was seen as an important component of the economics of property investment). However, they seemed evenly divided on whether they would have invested in the absence of negative gearing. Importantly however, negative gearing was also seen as an important consideration for some investors moving into the property market as it contributed to the 'affordability' factor.

In 2014 Moody's Analytics released a report estimating that 'negative gearing adds 9 per cent, or around $44,000 on average, to current home prices' (Janda, 2014). The study also found that this effect rises when interest rates are higher (when interest rates were at a peak in 2008 it was estimated that negative gearing added 15 per cent to national house prices) and that the effect on prices varies by state, with areas with higher incomes receiving a larger benefit from the policy, therefore creating a slightly bigger increase in home prices (see Figure 13) (Janda 2014a and Shapiro 2014).

Figure 13 **Difference between fair value of houses with/without negative gearing (per cent)**




Source: Moody's Analytics (cited in Janda 2014 and Shapiro 2014).

While the Moody's report is not publicly available for review by ACIL Allen, Treasury's head of revenue Rob Heferen told the Senate Inquiry into Affordable Housing (Commonwealth of Australia 2014) that he did not agree with this analysis. He suggested that analysis such as Moody's are done in an 'all other things being equal' kind of scenario where feedback loops are not analysed because this exercise is 'extraordinarily complex' and would require the use of general equilibrium modelling (e.g. analysing where would investors put their money when deductions are limited to rental income). Mr Heferen also acknowledged that Treasury

has not quantified the impact of negative gearing on house prices and that doing so would be 'extraordinarily difficult' (Commonwealth of Australia 2014, p. 20). While providing evidence to the Senate Committee, Mr Heferen also said that negative gearing was not a loophole and that it is consistent with the way the tax system treated other tax deductions on the costs associated with generating income (Commonwealth of Australia 2014, p. 22).

ACIL Allen agrees with the view that quantifying the effects of negative gearing on housing prices is a complex task that would require modelling of complex investors' capital movements and secondary behavioural impacts and their effects on the macroeconomy and that the current negative gearing arrangements are consistent with the way the tax system treats other tax deductions.

While negative gearing arrangements are unlikely to singlehandedly change the fundamentals of housing demand and supply, they do influence investment decisions (including the decision to invest in housing and the rental prices charged for an investment property). Given the complex interaction of factors affecting supply and demand for housing, the outcomes of significant changes to negative gearing on the housing market are uncertain.

**Conclusions:**

- Quantifying the effects of negative gearing on housing prices is a difficult task that would require modelling of complex investors' capital movements and secondary behavioural impacts and their effects on the macroeconomy.
- Given the above, the idea that financing arrangements such as negative gearing can singlehandedly change the fundamentals of overall housing demand and supply is not supported.
- Negative gearing arrangements influence investment decisions (including the decision to invest in housing and the rental prices charged for an investment property). Given the complex interaction of factors affecting supply and demand for housing, the outcomes of significant changes to negative gearing on the housing market are uncertain.

## 3.6 Myth 6 — Negative gearing poses a huge cost on taxpayers

There is a broad range of estimates regarding the actual cost of negative gearing to the Commonwealth budget. These estimates range from as low as $2 billion per annum (Daley, 2013) up to $4.3 billion per annum (Eslake, 2011), depending upon the year in which the estimates are made and whether the estimates are either in the short to long-run. Notably, reflecting the effect of lower interest rates, net rental losses decreased in the latest ATO data (2012-13) and so the current cost of negative gearing would be less than these estimated figures. However, net rental losses are likely to increase when interest rates increase from the currently historic low levels.

The extent of the deduction that investors may claim against their other income (i.e. the cost of negative gearing) depends on the investors' net rental income loss in a year, the amount of other income they receive and the marginal tax rate of each taxpayer.

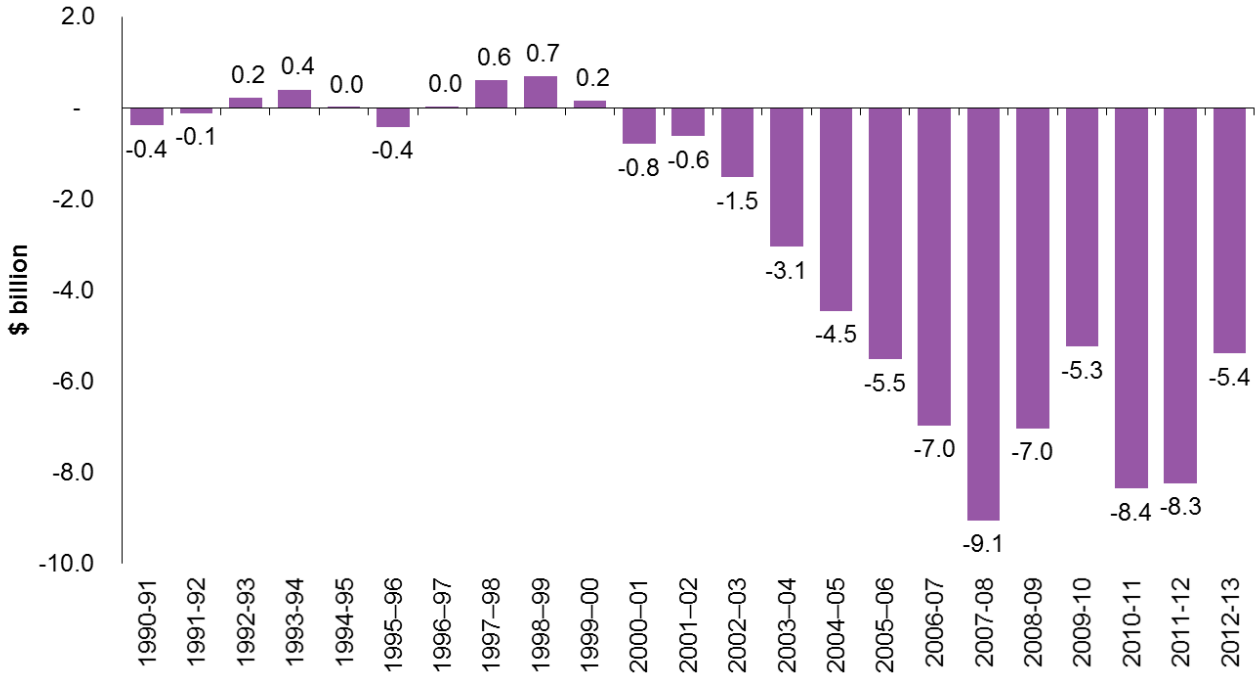
The ATO's latest tax statistics indicate that the net rental income losses across all taxpayers in Australia in 2012-13 amounted to around $5.4 billion, down from $8.3 billion in 2011-12

(see Figure 14). These net rental income losses provide an indication of the deduction that individual taxpayers and investors may claim against their other income, however, as mentioned before, the extent of the actual deduction depends on the amount of other income and the marginal tax rate of each taxpayer. Some investors may not have sufficient income from other sources to fully deduct all of their net rental losses. The presence of net rental income losses in a year does not mean that income (and wealth increases) from an investment property will be negative for all time. If each specific rental property in the future makes a capital gain when the property is sold, it will be subject to taxation.

According to the 2015 Commonwealth Budget, total tax revenue for 2012-13 was $326.4 billion. If negative gearing costs between $2 billion and $4.3 billion per annum, this means that it represents between 0.6 per cent and 1.3 per cent of total revenue. Although it is true that the existence of negative gearing does cost taxpayers in terms of foregone taxes, this shows that the relative cost of negative gearing to the Government's budget is not large.

While comparing the cost of negative gearing to other tax concessions or receipts can provide some perspective, the net cost of a policy can only truly be measured when it is judged against the measured benefits it provides. To our knowledge, such an analysis has not been undertaken.

Figure 14 **Net rental income, 1990-91 to 2012-13, $billion**




Note: Data shown is for individual income tax returns processed by 31 October 2014. The statistics are not necessarily complete. Statistics for the 2009–10 and 2010–11 income years reported in this table may not match the statistics reported in previous editions of Taxation statistics because they have been updated for the most recent edition.

Source: ATO, 2015.

**Conclusions:**

- The existence of negative gearing does cost taxpayers to some extent in terms of foregone tax revenues. However, the relative cost of negative gearing to the Government's budget is not large (it represents between 0.6 per cent and 1.3 per cent of total revenue).
- The net cost of a policy can only truly be measured when it is judged against the measured benefits it provides. To our knowledge, such an analysis of negative gearing has not been undertaken.

## 3.7 Myth 7 — negative gearing and CGT 50 per cent discount encourages unproductive investment in housing

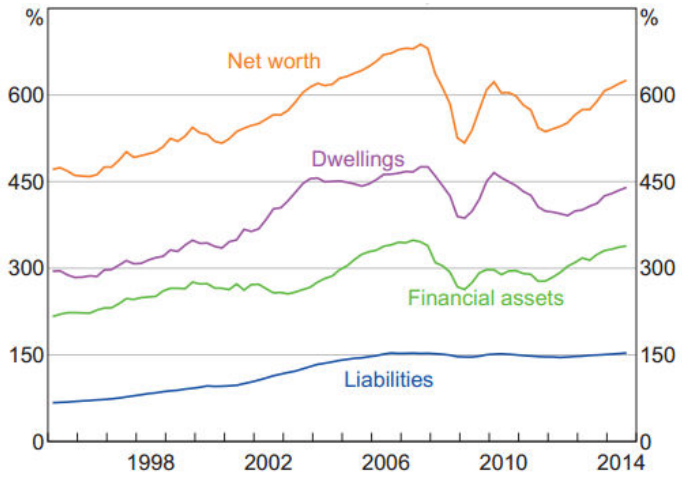
As stated in the Reform of the Federation White Paper, housing is about much more than just bricks and mortar. It satisfies the essential human need for shelter, security and privacy. There is also a positive relationship between stable housing and workforce participation and housing is important for children's wellbeing and development and to gain a sense of social connection through the community (Australian Government 2014, p.1).

Housing is also a significant part of the national economy and an important source of employment. Indeed, in 2012-13, dwelling investment accounted for around 5 per cent of Australia's Gross Domestic Product (Australian Government 2014, p.1).

As shown in Figure 15, housing is the major source of wealth for Australian households. Housing serves two important functions for households: it acts as a savings and wealth-building vehicle for owner occupiers and investors, and it produces a flow of housing services that households consume.

The value of housing services can be directly quantified by rental yields for investor properties and imputed rent for owner-occupied dwellings. If the value of property assets did not appreciate over time to produce a cash return, then it would be correct to label them 'unproductive'. However, the reality is that many residential assets do earn a real rate of return in the long-run, which makes residential property competitive against other types of investment asset classes such as equities, cash and superannuation.

Figure 15 **Household wealth and liabilities (per cent of annual household disposable income)**




*Note:* Household liabilities exclude the liabilities of unincorporated enterprises; disposable income is after tax and before the deduction of interest payments.

Source: RBA 2015.

The nature of property assets generating positive cash-flows (and therefore a real rate of return for many of them) in the long-run can be observed by the distribution of the number of people with profit-making and loss-making rental properties categorised by the taxable individuals' age group.

The pattern for profit-making and loss-making rental property ownership is clear in Figure 16: younger property owners typically make a net loss on their investment (i.e. they are negatively geared) whilst older people tend to own positively geared investments. As can be seen, more than 80 per cent of individuals below the age of 35 with an interest in rental property made net losses from their rental income in 2012-13.[18] The high concentration of loss-making rental property ownership diminishes as the age group increases, and by the retirement age of 60, approximately half of rental property owners become positively geared.

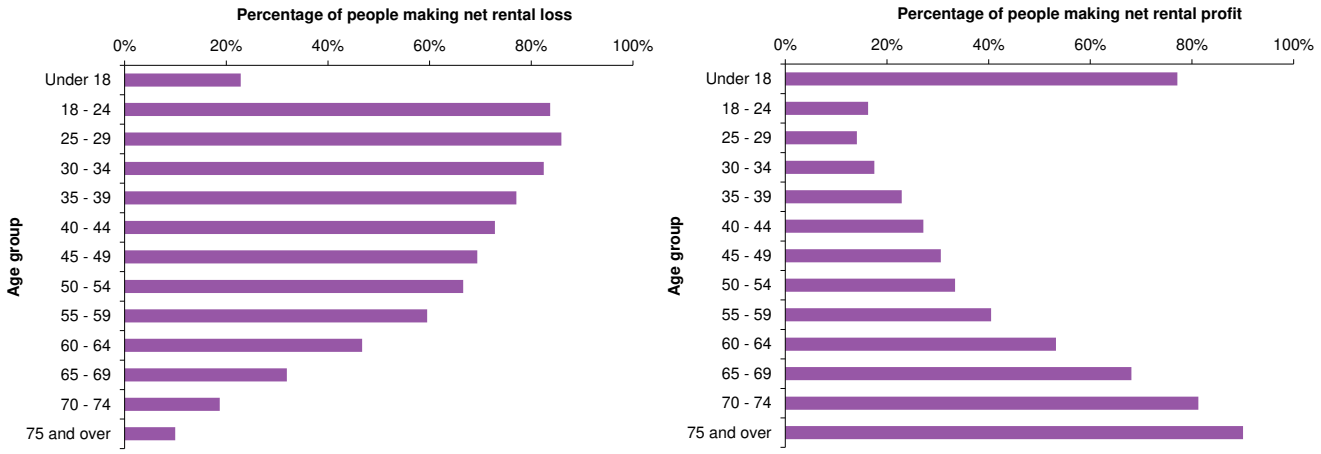
Positively geared rental properties serve as an important source of income for those no longer in the workforce. Indeed, analysis by the ASX shows that returns of investing in residential property via a superannuation vehicle have assisted with bolstering the savings of individuals by earning a rate of return of around 5.4 per cent over the past 10 years (ASX and Russell Investment 2014).

**Conclusion:**

Housing is a productive asset. It serves the valuable purpose of providing shelter to people, acts as a savings and wealth building vehicle for owner occupiers and investors, and produces a flow of housing services that households consume.

[18] Excluding individuals who were aged under 18 years.

Figure 16 **Percentage of individuals making net rental profit/loss by age group, 2012-13**




*Note:* Data shows combined number both taxable and non-taxable individuals.
Source: ATO, 2015.

## 3.8 Myth 8 — Australia is the only country that has negative gearing and CGT concessions

The key features of Australia's negative gearing and CGT regimes that apply to housing are not unique. Many other countries have similar concessions that are far more generous than the Australian arrangements.

Comparisons between countries are summarised in Table 1. This table also shows that other countries provide other concessions not available to Australian taxpayers in owner occupied housing.

Table 1 **Housing concessions in selected countries**

| | Owner occupier housing | | | Investment housing | | | | |
|---|---|---|---|---|---|---|---|---|
| | Imputed rent taxation | Interest deductibility | CGT | Negative gearing | Ability to carry back losses | Ability to carry losses forward | Ring fencing of losses | Capital gains concessions |
| Australia | No | No | No | Yes | No | Yes | No | Yes |
| Canada | No | No | No | Yes | Yes | Yes | Partial | Yes |
| France | No | No | No | Partial | Yes | Yes | Partial | Yes |
| Germany | No | No | No | Partial | Yes | Yes | Partial | Yes |
| Japan | No | No | Yes | Partial* | Yes | Yes | Partial | No |
| Netherlands | Yes | Yes | No | No | Yes | Yes | Partial | Yes |
| New Zealand | No | No | No | Yes | No | Yes | No | Yes |
| Sweden | Yes | Yes | Yes | Partial | No | Yes | Partial | Yes |
| United Kingdom | No | No | No | No | Partial | Yes | Partial | Partial |
| United States | No | Yes | Partial | Partial | Yes | Yes | Partial | Partial |

Source*: Ernst and Young (2006) and *Property Council of Australia (2015).*

Other comparable developed countries with broadly similar tax arrangements make provisions for the deduction of expenses for investment in housing or to provide an

allowance to ensure that taxation of capital gains captures the real gains rather than inflation. In addition to Australia, tax provisions in Canada and New Zealand allow unrestricted use of negative gearing losses to offset taxes due to income from other sources. Several other OECD countries allow partial offsetting with restrictions imposed, including USA, Canada, Japan, Germany, Sweden and France.

**Conclusion:**

Australia is not the only country that permits negative gearing or tax deductions from losses on investment in residential property.

## 3.9 Key points

The current booming residential property market and the need to make the tax system stronger to sustain government spending and address the longer-term budget problem has put the spotlight back onto negative gearing and the 50 per cent discount on capital gains for residential property investment.

This renewed interest has resulted in commentators blaming a number of the adverse consequences of the current property boom on the tax treatment of negative gearing and capital gains of residential property. This chapter examined a number of these claims and has found the following.

- *Negative gearing is not a special concession for property* — it is a legitimate deduction of expenses in the course of earning income from investments in all asset classes until the investment generates a positive income stream in the future.
- *Middle income Australians also benefit from negative gearing* — negative gearing benefits a range of Australian households by providing all individuals with an opportunity to invest in property, not just those in higher income brackets. Two thirds of property investors who benefit from negative gearing earn a taxable income of less than $80,001 a year. Furthermore, while individuals with incomes higher than $80,001 claim around 42 per cent of losses on investment property, those earning less than $80,001 a year claim the majority of rental losses (around 58 per cent of all losses).The evidence in this chapter also shows that the majority of investors owns only one property and this has not significantly changed over time.
- *CGT discounts benefits all Australians* — individuals across all income ranges benefit from the CGT discount. However, a higher proportion of taxable net capital gains income tends to be received by individuals at the higher end of the income distribution and hence these individuals receive a larger share of the benefits from the CGT discount. Moreover, property is not the only investment class that benefits from the CGT discount. While around 40 per cent of the capital gains of individuals are sourced from real estate investments (which include residential and other types of property), 31 per cent of capital gains are from other assets and 28 per cent from shares.
- *Negative gearing contributes to the provision of new housing* — total dwelling commencements have been on a growth trend since the 1950s. A significant proportion of these new dwellings have been financed by investors. Around a third of all new dwellings construction is financed by investors every year and the absolute amount of investor loans committed to new housing has increased by more than seven-fold since 1986.

- *Many factors other than negative gearing and CGT discounts influence house prices* — the cost of housing is shaped by a range of factors influencing demand and supply and hence it is hard to analyse the housing market in isolation from other markets and without considering the local, national and international interconnections. Furthermore, the evidence in this chapter shows that quantifying the effects of negative gearing on housing prices is a difficult task that would require modelling of complex investors' capital movements and secondary behavioural impacts and their effects on the macroeconomy. Given this, the idea that financing arrangements such as negative gearing can singlehandedly change the fundamentals of housing demand and supply is not supported.
- *Negative gearing does not pose a huge cost on taxpayers* — the existence of negative gearing does cost taxpayers to some extent in terms of foregone tax revenues. However, simply examining the revenue cost of negative gearing is a partial analysis at best. The benefits must be examined as well.
- *Housing is not an unproductive asset* — it serves a valuable purpose of providing shelter to people, but also serves two important functions for households: it acts as a savings and wealth-building vehicle for owner occupiers and investors and it produces a flow of housing services that households consume.
- *Australia is not the only country with negative gearing* — the ability to deduct expenses is a common feature of tax systems in other developed countries in the world, and is not unique to Australia.

# 4 Public interests in negative gearing and the CGT discount

*This chapter outlines the public policy case for retaining the existing tax treatment of negative gearing and the discount on capital gains for residential property.*

## 4.1 Good taxation policy principles

There are legitimate reasons for continuing the provision of negative gearing and the 50 per cent discount for capital gains.

- Negative gearing fosters the efficiency of the Australian taxation system by ensuring deductibility of expenses in the course of earning income. Access to negative gearing also ensures that all taxpayers (including individual pay-as-you-go (PAYG) taxpayers) can access the deduction, thereby promoting the horizontal equity of the taxation system.
- The 50 per cent discount on capital gains ensures that nominal gains are not taxed. This is consistent with promoting the efficiency of the taxation system. In addition, the ability of all taxpayers to access the discount (where an asset is held beyond 12 months) fosters equity of the system while the simple design of the discount (relative to indexation) fosters simplicity of the tax system.

Beyond the promotion of the 'good' taxation policy principles, negative gearing and the CGT discount advance a number of public interests. These are discussed in more detail below.

## 4.2 Increases supply of rental properties

It is well established that there is a housing supply shortage in Australia. Chapter 3 showed that the ratio of new dwelling commencements to population growth has been on a clear declining trend and that, compared to 20 years ago, there are fewer new dwellings available for purchase per person in Australia. Furthermore, the National Housing Supply Council (NHSC) estimates that Australia has a housing gap (i.e. a shortage of housing relative to the underlying demand for it) of about 284,000 dwellings as at 2011 (NHSC 2014).

Chapter 3 also showed that investors finance a significant proportion of the construction of new housing (around a third) every year.

If negative gearing is abolished, property investors will re-consider their investment options in light of the impact of the tax change on their overall investment returns. For some investors, this change will mean that they will re-invest their funds in other assets (such as equities and cash) while other investors will attempt to increase their rental income in order to increase the overall return from investing in residential property. This potential impact was recognised by the Henry Tax Review (2010) which noted that:

> 'the current tax advantages available to highly geared investment can operate as a subsidy to renters by placing downward pressure on rents'
>
> *Australian Treasury, 2010, p419.*

The Henry Tax Review also noted that any changes to negative gearing or the capital gains tax discount could reduce residential property investment which in a market facing supply

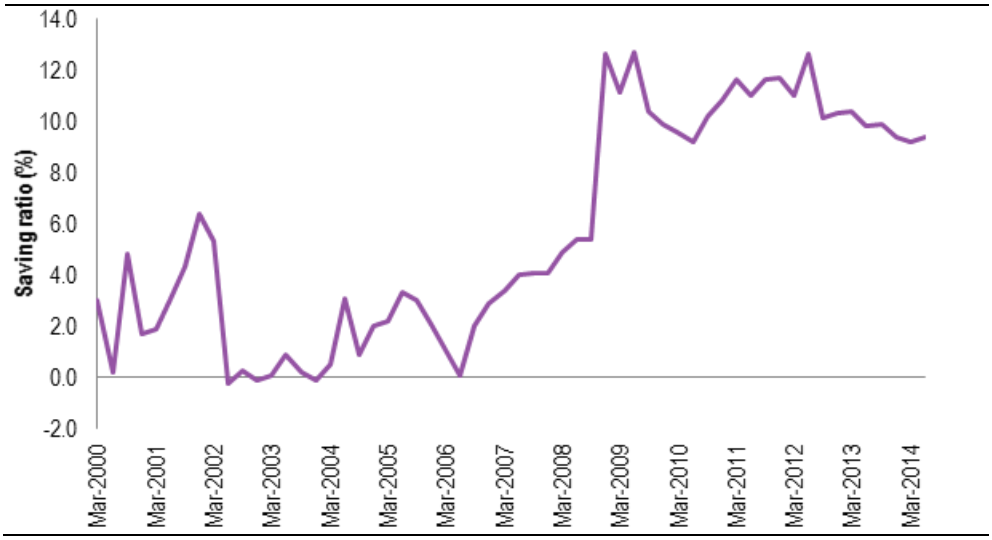
constraints would place further pressure on the availability of affordable rental accommodation within the private rental market.

All of these factors indicate that negative gearing and the CGT discount support investment in new housing and the increase in housing supply.

## 4.3 Increases savings

Australians have increased their savings in recent years. Figure 17 shows the significant increase in savings since the Global Financial Crisis (GFC).

Figure 17 **Australian household savings ratio**




Source: ABS (a), Catalogue 5206.0, 2014.

However, despite this increase, it is still recognised that even greater retirement savings will be necessary to ensure that retired Australians can live a comfortable retirement, due to increases in the cost of living:

> Single retirees will need to spend $767 more this year in order to live a comfortable lifestyle in retirement.
>
> *ASFA Retirement Standard*

To boost investments and savings, there are three main asset choices available to Australians: equities (domestic and global), residential property and cash, with superannuation often being a composite of all three.

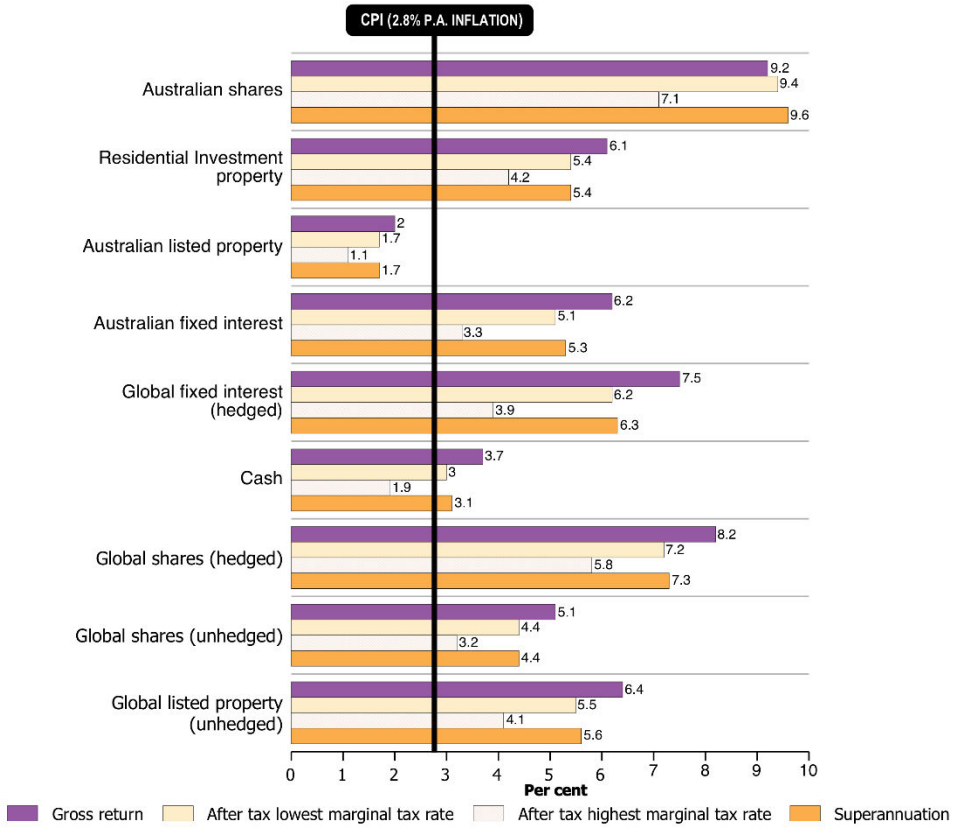
The existence of negative gearing and the capital gains tax discount recognises that investment in equities and property in particular is a real and effective method for bolstering savings of middle income Australians. In the case of residential property, this was also recognised by the Commonwealth Treasury in its recent Tax Expenditure Statement (2014) where it states:

> Given owner occupied housing is the largest form of savings held by Australian households, and is taxed consistently with an expenditure tax benchmark, arguably this benchmark could be used for savings rather than the current comprehensive income tax benchmark.
>
> *Treasury 2014, p.5.*

In its long-term investing report, the Australian Stock Exchange (ASX, 2014) provides an analysis of the long-term returns across a suite of Australian assets over the past 10 to 20 years (see Figure 18). This analysis shows that Australian shares remained the strongest performing asset over the 10 year period with a 9.2 per cent per annum gross return and

Australian residential investment returning 6.1 per cent per annum gross return. The analysis also shows that investment returns materially change when tax is incorporated into the analysis.

Figure 18 **Before and after tax returns for 10 years to December 2013**




Source: Australian Stock Exchange and Russell Investment, 2014.

The ASX analysis also incorporated borrowed funds into the analysis of investment returns on both equities and residential property (see Figure 19). The analysis clearly highlights that gearing enhances the returns earned for investors at both the highest and lowest marginal tax rates. The returns on residential property for lower marginal tax rate investors were lower after gearing because in recent years the cost of borrowing has not been fully offset by rental income and tax deductions.

The returns earned on equities and residential property indicate that the existence of negative gearing and the capital gains tax discount recognises that investment in equities and property is a real and effective method for bolstering savings, and in particular retirement savings.

Figure 19 **Investment returns for 10 years to December 2013**


Source: Australian Stock Exchange and Russell Investment, 2014.

## 4.4 Provides fairer access to investment in property

The provision of negative gearing promotes the equity of the Australian taxation system and has provided many people with the opportunity to invest in property which they otherwise would not have had.

There are two aspects to providing more equitable access. First, negative gearing provides individual PAYG taxpayers with the ability to deduct interest payments in the year incurred which is analogous to that accessed by non-PAYG taxpayers.

Secondly, negative gearing provides ordinary individual taxpayers, compared to high-income taxpayers, with more opportunity to invest in property than otherwise would be the case. By reducing the amount of accumulated losses in the initial years of the investment, access to negative gearing lowers the cost of investment for all investors. Negative gearing reduces the total amount of accumulated losses by as much as 30 per cent to 40 per cent (equivalent to the taxpayer marginal tax rate). This benefit is particularly advantageous to those investors who have less resources and capacity to carry real cash losses for several years, before positive income is generated from the investment.

This opportunity is reflected in the most recent statistics. In 2012-13, approximately 389,400 taxable individuals reported making a net capital gain from their investments (across all asset classes). These individuals benefited from CGT concessions available to them, the amount of which depending on the type of assets held as well as exemptions available on a case-by-case basis.

Importantly, of this total, 57.2 per cent of individuals (i.e. approximately 222,000 people) earned a taxable income of less than $80,001 per annum. Those earning between $30,001 and $80,000 had the highest representation at 40.7 per cent of total number of individuals recording net capital gains, whilst the lowest representation was those earning less than $6,000 at 0.3 per cent (this is unsurprising given that these individuals are unlikely to be able to allocate much of their earnings to investments), followed by those earning more than $500,001 at 2.0 per cent.

## 4.5 Key points

- Negative Gearing fosters the efficiency of the Australian taxation system by ensuring deductibility of expenses in the course of earning income. Access to negative gearing also ensures that all taxpayers (including individual PAYG taxpayers) can access the deduction, thereby promoting the horizontal equity of the taxation system.
- The 50 per cent discount on capital gains ensures that nominal gains are not taxed and in doing so, promotes the incentive for individuals to save and invest. This is consistent with promoting the efficiency of the taxation system. In addition, the ability of all taxpayers to access the discount (where an asset is held beyond 12 months) fosters equity of the system while the simple design of the discount (relative to indexation) fosters simplicity of the tax system.
- The provision of negative gearing promotes the equity of the Australian taxation system and has provided many ordinary Australians with the opportunity to invest in property which they otherwise would not have had. This is because negative gearing reduces the amount of accumulated losses in the initial years of investment and by doing so, reduces the cost of investing. This benefit is particularly advantageous for 'ordinary' taxpayers (as opposed to the higher income taxpayers) who have less resources and capacity to carry real cash losses for several early years of investment.
- This increased opportunity for ordinary Australians to invest in property also broadens the investment options for these individuals. By doing so, this increased investment opportunity enables individuals to augment their savings.
- The provision of negative gearing in conjunction with the CGT discount promotes investment in rental properties and increases supply of new housing.
- An increase in rental supply means higher rental vacancies and lower rents than would otherwise be the case. The benefit to renters from improved rental affordability was directly recognised by the Henry Tax Review (2010) which noted that 'the current tax advantages available to highly geared investment can operate as a subsidy to renters by placing downward pressure on rents.'

# 5 Impacts of possible tax changes

*This chapter identifies changes to negative gearing and CGT that are frequently proposed and examines the likely direct impacts of these changes.*

Reflecting the apparent popularity of the myths about negative gearing and the CGT discount, many commentators have also proposed changes to these features of income taxation. These changes are generally advanced on the basis that they would 'repair' or 'correct' what is wrong with the tax system, yet the proposals are rarely accompanied with an assessment of the impact of the changes. As these proposals relate to fundamental elements of the tax system, the changes would also be expected to bring fundamental changes to tax collection, the community and the underlying economy.

Alternatives to the current negative gearing and CGT 50 per cent discount that are frequently proposed include the following broad measures:

- repeal of negative gearing;
- quarantining of losses;
- limit negative gearing to a certain number of properties;
- repeal the CGT 50 per cent discount for residential property only;
- limiting negative gearing and CGT 50 per cent concessions to new dwellings; and
- the Henry Tax Review recommendation to impose a 40 per cent savings income discount for net rental property income and capital gains.

Each of these proposals is examined in turn.

## 5.1 Repeal of negative gearing

Public discussions of negative gearing, especially calls for the removal of negative gearing, often conflate two different issues:

- the deductibility, as such, of expenses incurred in the earning of income; and
- the quarantining of expenses incurred in earning a particular stream of income against that stream of income.

Even more confusingly, sometimes the discussion appears to be that whatever restrictions might apply to tax deductibility of expenses, they should apply only to property income.

Taking the last point first (the quarantining of losses is discussed in the next section), property income and expenses should be treated the same as other income and expenses. The policy discussion should not lose sight of the fact that deductions on expenses incurred from investments are applicable to *all* asset classes so as not to create distortions in the market.

Assets are assets, income is income and expenses are expenses. It makes little sense to allow investors who borrow money to buy shares be able to deduct interest expenses, while not allowing deductions for investors who borrow to buy property. That would distort investment decisions away from property for tax reasons, and it is always bad when investment decisions are driven primarily by tax considerations — unless there is a very good policy reason to promote a particular class of investment, and even in that case, there is usually a better way to do it than through the tax system.

Moreover, disallowing expense deduction only for property investments would not be practical. Suppose investors buy shares in a company that invests only in property. Have they invested in shares, or in property?

The next issue is whether income-generating expenses should be deductible at all for the purposes of determining taxable income. This discussion is often framed around interest costs from geared investments (i.e. those that have been financed by debt, as opposed by equity), but the principle applies to all costs (e.g. in the case of residential property, local government rates). Plainly, to disallow any expense deductions would be a clear violation of the principle that income, not revenue, should be the basis of income tax. Disallowing any expenses to determine taxable income for investments would be analogous to disallowing any wage costs in determining taxable income for a business (and the business paying taxes on their revenue instead of profits).

**Conclusion:**

Deductibility of expenses is an integral component of the income tax system. That being the case, negative gearing should not be repealed.

## 5.2 Quarantining of losses

This point is more subtle, and concerns proposals that would allow deductibility of expenses, but would only allow those expenses to be deducted against the corresponding income. The maximum that could be deducted in a year, therefore, would be an amount equal to the gross income. In effect, this would take the negative out of negative gearing.

It is important to realise that such a policy would not result in a revenue bonanza for the Government. This is because undeducted losses would be (presumably) carried forward to future years until they can be deducted. For example, with residential property investments, typically rental income increases over time (if for no other reason than keeping up with inflation) while loans for investment properties are sometimes paid down, in part or whole. A smaller debt means lower interest payments. The combination of higher income and lower interest payments means that the property becomes cash flow positive, which enables the deduction of expenses that have been carried forward.

The quarantining of expenses thus mostly will only change the timing of deductions to determine taxable income, not the total amount that can be deducted. What the Government will gain earlier in tax revenues by a policy of quarantining losses, it will lose later. The Government is unlikely to raise additional revenue overall, though it will gain revenue in present value terms.

**Conclusion:**

Quarantining of expenses will not be an effective policy.

## 5.3 Limit negative gearing to a certain number of properties

Public discussions of negative gearing have included all kinds of ideas, including a suggestion to place limits on the number of properties that could be negatively geared. Here are the reasons why limiting the number of properties that an individual could negatively gear would be bad policy.

Supposing that the limit on the number of properties an individual could negatively gear is set at three, for no reason other than tax benefits:

1. It would incentivise people to invest in more expensive properties for no other reason than tax benefits. For example, someone who has a $1 million property could negatively gear a larger amount of expenses compared to someone who has four $250,000 properties as they could only negatively gear expenses up to $750,000 of assets. The latter individual may decide to replace the asset portfolio with fewer but more expensive properties, thereby creating a distortion in the market.
2. It would encourage artificial property splitting within families for no other reason than tax benefits.
3. It would encourage inefficient capital allocation by investors. For instance, an investor with four properties would shift capital amongst loans for properties to ensure that only three of them are negatively geared, with the fourth one positively geared, with total gearing unchanged.
4. It would encourage the inefficient use of corporate structures and trusts as holding vehicles for properties for no other reason than tax benefits.
5. There would be definitional problems, adding administrative complexity and cost on the tax system. For example, would an individual who owns a block of four apartments be treated as owning one property or four?
6. A corollary of forcing such a policy on property assets raises the question, why not also limit negative gearing to shares for up to three companies? This proposal would not measure up against principles of good policy making. Therefore, the idea of a similar limitation for property does not either.

**Conclusion:**

There is no sound basis for choosing an upper limit on the number of properties that can be negatively geared. Doing so would be bad policy.

## 5.4 Repeal of the 50 per cent discount on CGT for residential property

The 50 per cent discount on capital gains for assets held more than one year was introduced in 1999 to replace the previous policy of no discount, but with real (inflation adjusted) capital gains being taxed. There are good arguments for taxing real capital gains without a discount, or for taxing discounted nominal gains, but there are no good arguments for taxing nominal capital gains without a discount.

Repealing the 50 per cent discount for CGT without restoring indexation would be bad tax policy. To see why, suppose somebody buys an investment property for $300,000 and it rises in nominal value with inflation to $350,000 (as do identical properties). If upon sale the

nominal capital gain of $50,000 is taxed, the investor has suffered, in effect, a real capital loss, for they would not be able to buy an identical property with the sale proceeds. Tax policy should not intend to impose real capital losses on investors.

If the 50 per cent discount on capital gains was repealed just for property, that would have far greater implications by distorting investment decisions between classes of assets as well as possibly imposing real capital losses.

A policy of removing the 50 per cent discount on CGT for property may discourage the sale of properties to avoid crystallising the additional tax burden and slow transactions. If so, this would distort investment towards other asset classes which are still able to access the CGT discount.

**Conclusion:**

Repeal of the 50 per cent discount on capital gains on property assets would be bad policy.

## 5.5 Limiting negative gearing and the 50 per cent discount on CGT to new dwellings

A general principle of good taxation policy is that it should not favour particular investment classes. The broad intent of limiting the use of negative gearing in residential property investment to new dwellings would be to channel tax benefits to investment that increases the stock of housing and reduce purchases of existing houses that is thought to raise dwelling prices. However, as noted in Section 3.4, already around one third of loans for the construction of new housing are by investors. Limiting negative gearing to new dwellings will only add a distortion.

### 5.5.1 Mechanics of the proposal

For the purposes of this analysis the key changes that could be done include the following:

- limiting the tax deductibility of net rental losses for residential properties and the CGT 50 per cent discount to properties that are classified as 'new' properties;
- defining 'new' properties to include the vacant residential lots, buildings built by the owner builder, buildings owned by developers and builders that have not been occupied previously; and
- it would be impracticable to apply this change retrospectively, so current investors of existing residential properties would still be able to make deductions for these properties if they continue to hold them into the future (i.e. the measure would be 'grandfathered').

### 5.5.2 Direct and immediate implications for taxation

The measure would reduce deductions and raise taxes for investment in existing residential properties. This would pose a significant increase in taxation on those properties. Taxes would not increase for investment in new properties.

According to the ATO, the total deductions claimed on interests and other costs on rental income (which includes capital work expenses on rental property) in 2012-13 was

approximately $35.3 billion.[19] If the annual growth in residential housing stock is assumed to be 3 per cent, then the growth component to the total residential property deductions would be approximately $1.06 billion. Given that only 7 per cent of property investor housing finance is committed to the construction of new dwellings, of the $1.06 billion additional deductions claimed each year, the remaining 93 per cent of it would no longer be claimed as deductions (i.e. $1 billion).

This estimate of increased tax collection reflects estimates of the direct changes in tax receipts before investors, taxpayers and markets adjust to the change in taxation. The estimates of taxes to be collected would be reduced significantly if investors elected to shift their investment to other assets where they are able to make deductions for costs. The tax collection would also fall if some investors increase investment in new rental properties.

### 5.5.3 Economic impacts

If a large proportion of negatively geared investors do not shift to purchasing new dwellings or there is insufficient new stock available in future years to accommodate the shift of investors from existing to new dwellings, the main effect would be to impose an increase in the taxation of savings invested in residential property. The implications of this tax proposal could stop new investment into residential property.

Furthermore, limiting negative gearing and the 50 per cent CGT to new dwellings would be a negative shock to the market which would likely result in upward pressure in prices. It is also possible that property investment would be skewed to outer suburbs where employment opportunities are scarce and where transport infrastructure is poor.

### 5.5.4 Impacts on the market for dwellings

It is likely that there would not be sufficient new dwellings to soak up a shift in investor demand towards new dwellings, which indicates that the measure would encourage many investors to exit the rental property market. This reflects the fact that new dwellings add less than 2 per cent to the total stock of residential dwellings in a year. In recent years, the growth in the number of property investors has been growing, on average, at around 3 per cent per year. The difference in growth rates of new dwellings and the number of property investors suggest that there would not be enough new dwellings to meet investor demand, even if 100 per cent of new dwellings is purchased by investors. Consequently, some of these investors are likely to shift their attention to alternative investment assets where yields are larger but riskier.

In addition, the policy measure would pit a large number of investors against aspirant owner occupiers in the relatively small new dwelling market. Many of the aspirant owner occupiers of new dwellings are first home buyers. These buyers obtain stamp duty exemptions for the purchase of new dwellings in some states while the investors are seeking to bypass punitive taxes on savings and costs if they invest in existing dwellings. The competition is likely to be intense.

Given these factors, the proposed tax change is likely to impose upwards pressure on the prices for new dwellings.

The impact on the market for existing dwellings is more difficult to discern. There would be considerably less demand for existing dwellings from potential residential property investors. Meanwhile there would be additional demand for existing dwellings from owner occupiers

[19] For taxable individuals only.

escaping the tight competition for new housing stock. These forces are likely to be in balance over the national marketplace over the medium to longer term as market forces play out. There is likely to be significant imbalances between these forces in particular markets that do not start from a market equilibrium and where constraints on the supply side of the market play a significant role.

It is notable that there would likely be significant community unhappiness if there was a widespread and enduring displacement of the opportunity for first home buyers to actually own a new dwelling as a result of the proposed policy reform.

### 5.5.5 Summary

In summary, removing negative gearing and the 50 per cent discount on CGT for investment in existing residential property would probably increase investor demand for new dwellings, displace owner occupier buyers and stall further investment in established dwellings. If new housing supply is weak, higher rents and higher new dwelling prices would be expected. Shifts in demand for existing dwellings are likely to add volatility to the prices that apply to existing houses, but the overall effect is likely to be neutral in the medium to longer term.

This tax change is likely to add considerable turmoil and volatility to rental property and housing markets. It would probably not raise much additional tax revenue once taxpayers have adjusted to the changes.

It is likely that the main and lasting effect of the measure would be to add significant distortions to investment in different categories of residential property, therefore reducing the flexibility of the economy and the community to meet their housing needs in response to changing circumstances, and a reduction in investment in established dwellings.

**Conclusion:**

Limiting negative gearing and the 50 per cent discount on CGT to new dwellings would be bad policy. It risks stalling investment in existing property and higher rents.

## 5.6 Apply Henry Tax Review SID recommendations

The Henry Tax Review recommended the introduction of a Savings Income Discount (SID). This would apply a discount of 40 per cent evenly to most forms of savings including the net rental income from investment in residential property and capital gains.

The SID is designed to:

- provide a more even tax treatment of rental income and capital gains; and
- curb some of the tax benefits from negative gearing.

Before discussing this proposal, what needs to be made clear is that the SID recommendations should not be considered until the problems that inhibit the supply of housing are fixed. Even under the most optimistic projections, closing the gap between demand and supply for housing will take five years (and this after a record 197,000 new dwellings were commenced in 2014). As noted by the Henry Tax Review:

> Given the current problems in the rental housing market, the discount for net residential rental income should only be adopted following reforms to housing supply and housing assistance.
>
> *Australian Treasury 2010, p.62*

The key point is that piecemeal changes, like the SID recommendations, are vastly inferior to comprehensive reforms.

### 5.6.1 Mechanics of the proposal

Instead of including 100 per cent of net income from property investments in assessable income, the investor is required to count 60 per cent as assessable income. The SID would apply to net income from property (and all other assets) as well as net losses.

At present, 50 per cent of capital gains are reported as assessable income and after the introduction of the SID this would increase to 60 per cent.

The SID measures are viewed as a means of blunting the incentives to chase less certain capital gains.

### 5.6.2 Direct and immediate implications for taxation

It is likely that the Henry Tax Review recommendations would pose a small increase in taxes on net rental losses and all capital gains relative to the outcome without the policy change.

As mentioned before, according to the ATO, the net rental income losses across all taxpayers in Australia in 2012-13 amounted to around $5.4 billion. If 60 per cent of these losses were now counted as assessable income due to the proposed policy change and an average marginal personal income tax rate of 30 per cent is applied, the additional revenue to government from the proposed discount to negative gearing would be roughly $972 million.

In addition, according to the ATO, around $3.1 billion were claimed in 2012-13 by individuals through the 50 per cent discount of CGT. After the introduction of the SID this discount would be reduced to 40 per cent, which would mean that an additional $620 million in revenue would be collected. In total, the combined discounts to negative gearing and capital gains would result in approximately $1.6 billion in additional tax revenue.

### 5.6.3 Economic impacts

The main direct effect would be to raise taxes on savings in general (due to the change in the CGT discount). This would likely reduce the incentive to save (and invest) at the margin. Given that the change in the discount is 10 per cent of capital gains that will normally be realised in the future, the reduced saving incentive is likely to be relatively small. Day to day changes in interest rate settings are likely to exert a larger influence on savings.

The more particular increase in taxation on negatively geared rental losses (which would face a 40 per cent discount) would have a significant change on this asset class which would probably change investor costs materially, and alter investment and prices.

The overall effect of the Henry package of reforms apply a more even 40 per cent SID which would have the effect of levelling the tax burden on most savings, and reduce the distortions posed by differing tax arrangements for different asset classes. It is likely that the long run net effect of the Henry SID package would be to drive more benefits and growth from the reduction in distortions in current random taxation arrangements on savings than the costs to growth due to the increases in taxation on savings involved in withdrawal of the arbitrary tax advantages applied to some savings.

### 5.6.4 Impacts on the market for dwellings

By themselves, the SID measures are likely to raise taxes on net rental losses and raise investor costs. The response by some investors would be to recover higher costs through higher rents. Some potential investors would alter their decision and invest elsewhere. There would be pressure towards higher vacancy rates and higher rents.

The SID would also provide a 40 per cent discount for those earning positive net rental incomes. Their after tax returns will be boosted and if supply from this group of investors responds positively, it can help to offset an expected fall of supply from negatively geared investors.

The overall outcome in the rental market depends on the share of negatively geared investors and the response of supply to the change in after-tax economic costs and returns. It is notable that at present the share of investors with net rental losses is larger than those with neutral or positive returns. It is likely that declines in investment from negatively geared investors will be larger than the offsetting increase in positively geared investors.

There would be small offsetting shifts in demand for dwellings, but with slightly higher rents a small increase in dwelling prices is possible. The increase is likely to be less than day-to-day volatility in house prices.

There may be an increase in demand for public housing and rent assistance from renters facing higher rents. This increase in demand could be paid for from the increase in taxes collected (especially CGT).

It is important to note that the Henry Tax Review made many recommendations beyond the introduction of the SID that were intended to remove or alleviate significant structural problems and tax impediments that hampered the efficient operation of housing markets — particularly problems in the supply of housing, and suggested changes in government assistance to improve fairness. Looking at the likely impact of the SID measures alone would reveal a largely incomplete picture that raises apparent imbalance in market outcomes.

### 5.6.5 Summary

Adoption of the Henry Tax Review policy changes, especially the changes in the taxation of net rental losses and higher CGT payments, is likely to result in a marginal increase in taxes collected by government and penalise the pursuit of capital gains. The qualitative impact on the rental property market would be higher rents. This points to the need for measures to boost the supply of housing.

**Conclusion:**

The Henry SID recommendations, by themselves, would be counter-productive for housing affordability. If they are ever implemented, they would have to be preceded by measures that increase the supply of housing.

## 5.7 Key points

— Investors should be able to deduct expenses such as interest payments in calculating their taxable income. If these deductions are denied then it is revenue, not income that is being taxed.

- A policy of denying deductions associated with property would, additionally, distort investment decisions away from property and towards other asset classes for reasons of tax benefit.
- Quarantining of expense deductions against corresponding income would primarily only affect the timing of tax payments, so would not result in large tax collection increase for the Government.
- Limiting negative gearing to a maximum number of properties per taxpayer would be highly distortionary, notwithstanding the practicality of determining an acceptable upper limit.
- If nominal capital gains are taxed without discount then investors will be taxed on a gain they have not made (in real terms, which is what matters).
- A policy of removing negative gearing and the 50 per cent discount on CGT for investment in existing residential property would probably increase investor demand for new dwellings, displace owner occupier buyers and induce capital flight from investment in established dwellings.
- Adoption of the Henry Tax Review policy changes, especially the changes in the taxation of net rental losses and higher CGT payments, is likely to result in a marginal increase in taxes collected by government and penalise the pursuit of capital gains. Furthermore, as noted by Henry, changes to residential negative gearing should only be implemented after other housing supply constraints are resolved.

# 6 Conclusions

The analysis in the report has sought to look beyond the popular and widely cited myths about negative gearing and the 50 per cent CGT discount that are available to residential property investors. Some of the key findings from this analysis are summarised below.

- *Negative gearing is not a special tax concession provided solely for investors in the rental property* — it enables tax deductions for losses that are widely available to individual investors in any business interest (including property, shares, cash and business ventures).
- *Middle income Australians do benefit from negative gearing* — most owners of rental property that make a loss in rental property earn a taxable income less than $80,001 per annum and most investors do not have large property portfolios. Residential property landlords are often called 'mum and dad' investors and they have a similar profile to older Australians.
- *The CGT 50 percent discount does benefit all Australians* — the discount is used by investors across the income spectrum as it encourages people from every income range to invest.
- *Negatively geared investors buy new property and add to housing supply* — most new housing is purchased by owner occupiers many of whom benefit from first home buyer stamp duty concessions, but investors do purchase some of this stock and do add to supply.
- *Many factors other than negative gearing and the CGT discount influence house prices* — the cost of housing is shaped by a range of factors influencing demand and supply. The idea that financing arrangements such as negative gearing can singlehandedly change the fundamentals of housing demand and supply is not supported.
- *Negative gearing does not pose a huge cost on taxpayers* — the existence of negative gearing does cost taxpayers to some extent in terms of foregone tax revenues. However, simply examining the revenue cost of negative gearing is a partial analysis at best. The benefits must be examined as well.
- *Housing is a productive asset* — it serves a valuable purpose of providing shelter to people, but also serves two important functions for households: it acts as a savings and wealth-building vehicle for owner occupiers and investors and it produces a flow of housing services that households consume.
- *Australia is not the only country that permits negative gearing or tax deductions from losses on investment in residential property* — this is not a tax rule exclusive to Australian. Tax deductions for losses in rental property are available in many other countries in one form or another.

The report has also sought to identify and measure what public interests are served and advanced through the negative gearing and CGT discount features of our tax system. The key points to be drawn from this analysis are outlined below.

- The allowance of deductions for interest expenses and other costs are important elements of the fabric of the tax system constructed to avoid penalising investment and savings.
- The CGT discount works to reduce the possibility of taxing inflation which would otherwise apply a disproportionate burden on investment and reduce investment.

— Negative gearing provides ordinary individual taxpayers, compared to high-income taxpayers, with more opportunity to invest in property than otherwise would be the case. By reducing the amount of accumulated losses in the initial years of the investment, access to negative gearing lowers the cost of investment for investors. This benefit is particularly advantageous to those investors who have less resources and capacity to carry real cash losses for several years, before positive income is generated from the investment.

The myths about negative gearing have spurred much debate about remedies. A large number of policy recommendations have been proposed to reverse the tax losses posed by negative gearing, or redirect the incentives posed by negative gearing or to blunt the impact of negative gearing.

Key policy recommendations dealing with the negative gearing question and the CGT discount and rental property investment have been identified from the popular debate and include:

1. repeal of negative gearing;
2. quarantining of losses;
3. limit negative gearing to a certain number of properties;
4. repeal the CGT 50 per cent discount for residential property only;
5. limiting negative gearing and CGT 50 per cent discounts to new dwellings; and
6. the Henry Tax Review recommendation to impose a 40 per cent savings income discount for net rental property income and capital gains.

The following general conclusions can be made about these recommendations.

— The measures that offer the opportunity to recover the most taxes for government from the removal or restriction of negative gearing also seem to pose significant adverse impacts on savings and investment in the economy. This would also put the economy into the same situation it was in the 1980s, where inadequate savings reduced the competitiveness of the Australian economy, forced reliance on foreign savings, reduced investment opportunities, reduced economic growth and entrenched relatively high levels of unemployment.

— Other measures that focus on withdrawing negative gearing from residential property churn and distort savings and investment options. They are likely to raise little additional revenue for government and pose risk of a significant capital flight from the rental property market and higher rents.

— Other measures that curb and limit the use of negative gearing in the residential property market impact adversely on savings and investment in the residential market.

The Henry Tax Review SID involves introduction of more even incentives for savings and investment in general and in particular to negatively geared and positively geared investors. This approach would not increase government revenue greatly or block the use and rumoured abuse of negative gearing, but would curb reckless pursuit of capital gains at a small cost of probable reductions in investor involvement in residential rental property. If the SID reforms are to be implemented, this should not be before supply-side reforms have balanced the supply and demand for housing.

The analysis of direct effects only looks at half of the picture. The flow on and indirect effects from tax reforms that penetrate deeply into savings and investment decisions in something as large and fundamental as the residential property market and alter the shape of budgets are likely to be profound.

A more complete assessment of fundamental tax reforms requires analysis using an economy-wide framework, preferably using a Computable General Equilibrium (CGE) model that can assess the interaction of change and counter change in key interconnected sectors of the economy.

CGE analysis of the large number of policy options analysed in the direct impacts analysis would take time and significant resources. The time available for the conduct of this study has included a review of a pivotal CGE analysis of key aspects of the Henry Tax review changes to negative geared investment property undertaken by Independent Economics for the Housing Industry Association (see Appendix C).

The economy-wide analysis by Independent Economics found that the Henry Tax Review recommendation to discount net residential income by 40 per cent would raise taxes on investors which will flow through to reduced investment in property and higher rents. This would also flow through as an increase in costs to owner occupied housing through higher opportunity costs in not renting out their own occupied dwelling or higher 'imputed rents'.

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# Appendix A Examples of geared investments

An example of a positively geared property is provided in Box A1.

Box A1 **Example of a positively geared investment**

This example illustrates the cash flows and return of a positively geared investment and assumes the following.

- An investor borrows $300,000 to buy a $400,000 rental property. The remainder of the purchase price is funded from the investor's savings (i.e. equity financed).
- The interest rate on the investor's loan is 6 per cent per annum. The loan is interest only.
- The property is expected to generate a total return to the investor of 6 per cent over a period of 10 years. This return is achieved through rental income of 6 per cent per annum.
- The property is held for a period of 10 years and then sold.
- For simplicity, it is assumed that there is no depreciation in the value of the property or inflation.

| Year | Asset cost | Rental income | Interest expense | Income from sale of property | Accrued capital gain | Pre-tax cash flow |
|---|---|---|---|---|---|---|
| 0 | -$400,000 | $0 | $0 | $0 | $0 | -$400,000 |
| 1 | $0 | $24,000 | -$18,000 | $0 | $0 | $24,000 |
| 2 | $0 | $24,000 | -$18,000 | $0 | $0 | $24,000 |
| 3 | $0 | $24,000 | -$18,000 | $0 | $0 | $24,000 |
| 4 | $0 | $24,000 | -$18,000 | $0 | $0 | $24,000 |
| 5 | $0 | $24,000 | -$18,000 | $0 | $0 | $24,000 |
| 6 | $0 | $24,000 | -$18,000 | $0 | $0 | $24,000 |
| 7 | $0 | $24,000 | -$18,000 | $0 | $0 | $24,000 |
| 8 | $0 | $24,000 | -$18,000 | $0 | $0 | $24,000 |
| 9 | $0 | $24,000 | -$18,000 | $0 | $0 | $24,000 |
| 10 | $0 | $24,000 | -$18,000 | $400,000 | $0 | $424,000 |
| **Net Present Value** | | | | | | **$0** |
| **Rate of return** | | | | | | **6%** |

As shown on the table, in this example the amount of rental income generated by the investment exceeds the amount of interest expense incurred in order to fund that investment. In particular, the investor earns $24,000 per year in rental income for the property (i.e. a rental rent of return of 6 per cent on the $400,000 investment) and pays $18,000 per annum on interest (i.e. 6 per cent of the $300,000 loan used to fund the investment), resulting in a net income of $6,000 per year on which the investor has to pay tax.

Source: EY, 2006.

An example of a negatively geared property is provided in Box A2.

## Box A2 **Example of a negatively geared investment**

This example illustrates the cash flows and return of a negatively geared investment and assumes the following.

- An investor borrows $300,000 to buy a $400,000 rental property. The remainder of the purchase price is funded from the investor's savings (i.e. equity financed).
- The interest rate on the investor's loan is 6 per cent per annum. This loan is interest only.
- Similarly to the positively geared property described in Box A1, this property is expected to generate a total return to the investor of 6 per cent over a period of 10 years. However, the rental yield is only 3 per cent per annum. The other 3 per cent is expected to be generated in the form of a capital gain which is expected to be realised on the sale of the property.
- The property is held for a period of 10 years and then sold for $558,170.

| Year | Asset cost | Rental income | Interest expense | Income from sale of property | Accrued capital gain | Pre-tax cash flow |
|---|---|---|---|---|---|---|
| 0 | -$400,000 | $0 | $0 | $0 | $0 | -$400,000 |
| 1 | $0 | $12,000 | -$18,000 | $0 | $12,000 | $12,000 |
| 2 | $0 | $12,000 | -$18,000 | $0 | $12,000 | $12,000 |
| 3 | $0 | $12,000 | -$18,000 | $0 | $12,000 | $12,000 |
| 4 | $0 | $12,000 | -$18,000 | $0 | $12,000 | $12,000 |
| 5 | $0 | $12,000 | -$18,000 | $0 | $12,000 | $12,000 |
| 6 | $0 | $12,000 | -$18,000 | $0 | $12,000 | $12,000 |
| 7 | $0 | $12,000 | -$18,000 | $0 | $12,000 | $12,000 |
| 8 | $0 | $12,000 | -$18,000 | $0 | $12,000 | $12,000 |
| 9 | $0 | $12,000 | -$18,000 | $0 | $12,000 | $12,000 |
| 10 | $0 | $12,000 | -$18,000 | $558,170 | $12,000 | $570,170 |
| **Net Present Value** | | | | | | **$0** |
| **Rate of return** | | | | | | **6%** |

As shown on the table above, in this example the amount of rental income generated by the investment is not sufficient to cover the amount of interest expense incurred in order to fund that investment. In particular, the investor earns $12,000 per year in rental income for the property (i.e. a rental rent of return of 3 per cent on the $400,000 investment) and pays $18,000 per annum on interest (i.e. 6 per cent of the $300,000 loan used to fund the investment), resulting in a net cash loss of $6,000 per year which the investor has to cover from their other income. However, each year the investor expects to accrue a capital gain of $12,000, which is more than enough to offset the cash loss. Notably, the investor will pay capital gains tax when the property is sold.

This example shows that a rational investor may decide to invest in an asset that is expected to generate net cash losses for a number of years if that asset is expected to generate more income in the future that will more than offset the value of the losses.

Source: EY, 2006.

# Appendix B Tax treatment of geared investments — brief history

The ability to claim deductions arising from negatively geared investments appears to have been present since uniform personal income taxation was implemented by the federal government during the 1930s with the establishment of the *Income Tax Assessment Act 1936* (Soos, 2012). In December 1967, the Commissioner of Taxation issued an income tax ruling giving tacit approval to negative gearing and on 30 June 1983 the Treasurer announced that the Commissioner would not be changing the long standing practice of allowing deductions in full for interest on moneys borrowed to invest in rent-producing properties where the interest and other outgoings exceeded the rental income in any year (O'Donnell, 2005). This came after a brief period when the Victorian Deputy Commissioner of Taxation briefly denied Victorian real estate investors the deduction for interest in excess of the rental income.

However, on May 1985, the Australian Treasury released a Draft White Paper on options for tax reform that recommended tightening the tax provisions in negative gearing of investment properties and the introduction of capital gains taxes (NAA, 2014). To implement the Draft White Paper recommendation, the government introduced legislative changes to the *Income Tax Assessment Act 1936*, which imposed restrictions on negative gearing of rental property. The restrictions affected only real estate purchased after 17 July 1985. The reform quarantined any losses made from owning rental properties, so that any excess of deductions over rental income could not be used to reduce tax on other sources of assessable income. However, losses could be carried forward to offset against future rental profits and reduce taxable gains made from other rental properties purchased after that date (O'Donnell, 2005). Later in the same year capital gains tax was introduced. Two years later in July 1987, this decision was reversed and the restriction on negative gearing removed, allowing losses to be offset against income derived from other sources (such as salary and other forms of investment income).

Since July 1987, negative gearing has been allowed on all forms of investments in Australia (including property investments, share investments and business ventures).

# Appendix C The wider economic impacts of tax changes

*As discussed in Chapter 5, eliminating or limiting negative gearing and capital gain tax concessions can have direct impacts on asset prices and rents, returns on investment and the level of investment in the assets affected by the changes. The overall magnitude and impact of these changes can only be robustly measured though an economy-wide model that is able to trace the direct and indirect impacts of the changes as they flow through the economy.*

*This chapter reports the findings of an economy-wide analysis undertaken by Independent Economics of key aspects of the Henry Tax Review changes to negative geared investment property.*

## C.1 Economic modelling approach

Independent Economics recently completed a report for the Housing Industry Association (HIA) analysing the economy-wide effects of different policy settings for the housing market (HIA -Independent Economics, 2014). Amongst other policy scenarios, this report assessed the impacts of implementing the Henry Tax Review recommendation to discount net residential income. The analysis used a Computable General Equilibrium (CGE) model of the Australian economy (the Independent CGE model) to examine these changes. Box C1 provides more details of this model.

Box C1 **The Independent CGE model**

The Independent CGE model of the Australian economy was developed in 2012. It includes a number of notable features that set it apart from other models of the Australian economy.

- The model uses recent data from the ABS. The starting point was calibrating the model to the 2007/08 Input-Output (IO) tables from the ABS, which were released in late 2011. The model is then updated in the baseline scenario to a normalised version of the Australian economy in 2012/13. This includes allowing for growth in wages, prices, productivity and employment from 2007/08 to 2012/13, as well as normalised commodity prices.
- The model is based on the most up-to-date ABS industry classification, ANZSIC 2006, which replaced ANZSIC 1993. The 111 industries originally in the ABS data have been extended so that the model distinguishes 120 industries.
- The model incorporates a sophisticated modelling of production in each industry. Production in a standard CGE model involves at least three factors of production — labour, capital and intermediate inputs. The Independent CGE model extends this to distinguish 43 types of labour, nine types of capital, land and natural resources. The model also allows for different degrees of substitutability between these different inputs.
- The model provides a valid measure of changes in consumer welfare or living standards based on the equivalent variation, so that policy changes can be correctly evaluated in terms of the public interest.
- The model takes into account the respective contributions of the supply of residential land, the dwelling stock, and the ability to change housing as needs change, on housing affordability and the level of amenity from housing services. It also captures the impacts of the tax system on the housing sector and other industries better than comparable models.

Source: HIA- Independent Economics, 2014.

The Henry Taxation Review's (Australian Treasury, 2010) full recommendation for the taxation of savings was to provide a 40 per cent savings income discount to individuals for non-business related:

a) net interest income;
b) net residential rental income (including interest related expenses);
c) capital gains (and losses), and
d) interest expenses related to listed shares held by individuals as non-businesses investments.

The economy-wide analysis summarised in this chapter only refers to the impacts of the recommendation for a 40 per cent discount on net residential rental income (i.e. part b of Henry's full recommendation) as this is what was modelled by Independent Economics. In addition, the modelling only considers scaling back the tax deductions for negative gearing for housing but no other assets (e.g. shares and businesses). As explained in Chapter 5, favouring other assets compared to housing effectively introduces a new economic distortion.

The scenario modelled assumed that a 40 per cent discount is applied to net residential rental income. Taking into account marginal tax rates and projecting forward net rental losses, it was estimated that this policy would increase tax revenue by $1.4 billion in 2012-13 terms. Hence, the 40 per cent discount on rent incomes/losses was modelled as an increase in net tax on the housing services industry of $1.4 billion in 2012-13 terms. The analysis also took into account the fact that this increased tax collection would have other tax benefits which are reflected in a reduction in income tax collected on the household sector of the economy. That is, the changes in tax revenue were projected to be revenue neutral.

The following sections discuss the effects of the 40 per cent discount to residential negative gearing on the housing market and the overall Australian economy.

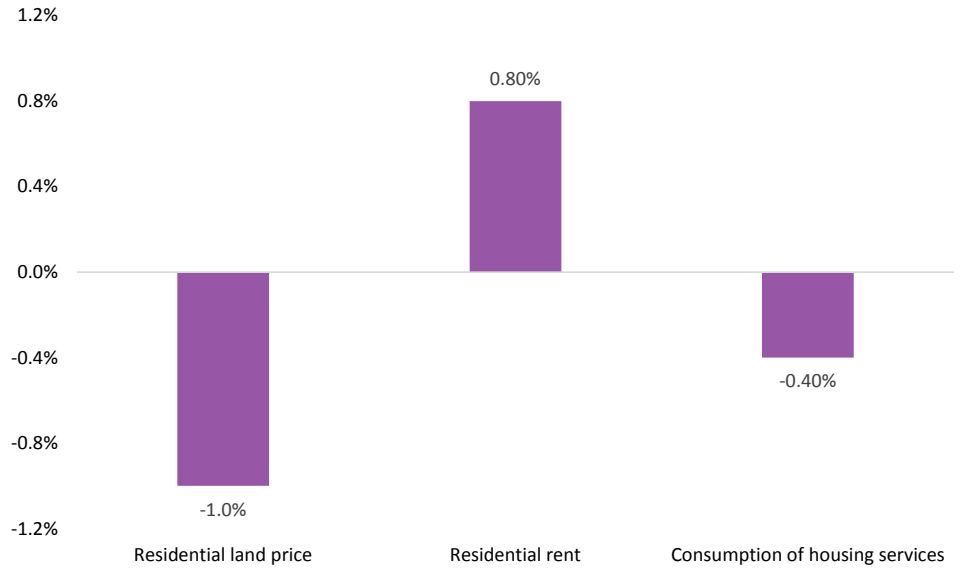
## C.2 Housing market impacts

Key impacts in the housing market from discounting net rental income by 40 per cent are summarised in Figure C1. As shown in this figure, applying a 40 per cent discount to net residential rental income would:

- increase the cost of investing in property and reduce incentives to invest in housing, thereby reducing housing supply and raising the cost of housing for both renters and owner occupiers (i.e. reduce affordability). In particular, it is projected that:
  - rental prices would be 0.8 per cent higher than they would otherwise be in the long run;
  - imputed rents[20] faced by owner occupiers would increase in line with actual rents as the opportunity cost from living in their own house (rather than renting it), increases; and
  - consumption of housing services would be 0.4 per cent lower as a result of more expensive housing.
- lead to 1 per cent lower residential land prices in the long run. Despite land prices being lower than they would otherwise be, residential rents would be higher because residential investors would pass on the additional costs to renters from the increase in investment costs as a result of the tax change.

[20] This is the rent that an owner occupier would have received if they had rented out their dwelling instead of occupying it themselves. That is, it is the opportunity cost of occupying their house rather than receiving income from renting it.

Figure C1 **Impacts of a 40 per cent discount to residential negative gearing on the housing market (deviations from baseline)**




*Note:* Rents include both actual rents paid by renters and imputed rents paid by owners.
Source: HIA- Independent Economics, 2014.

## C.3 Broader impacts

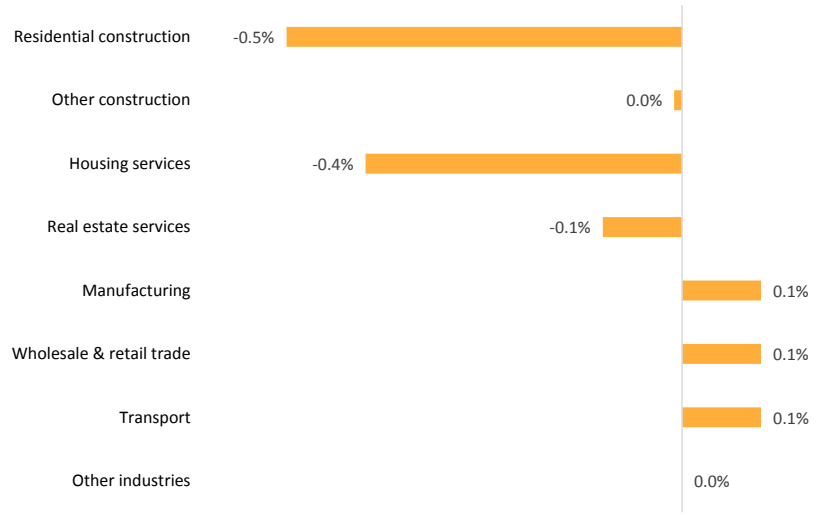
Looking beyond the housing market at other industries, discounting negative gearing would (see Figure C2):

- reduce activity in the residential construction industry by around 0.5 per cent;
- reduce activity in the housing services sector where output is expected to be 0.4 per cent lower;[21]
- lower demand for goods and services from other construction related industries due to reduced demand for their goods and services. This would reduce output for both the 'other construction' and the real estate services industries by 0.1 per cent; and
- increase consumer spending and the output of other non-housing related sectors.

While industries related to the housing sector would be negatively affected by the discount to residential negative gearing, other non-housing related sectors would benefit from the reduction in personal income tax and experience an increase in consumer spending and hence, output. Overall, the negative effects caused by the discount to negative gearing are almost completely offset by the gains from cuts in personal income tax, resulting in a small overall loss in GDP (see Figure C3).

[21] Housing services are the annual value of housing (accommodation services) consumed by renters and owner occupiers.

Figure C2 **Effects of a 40 per cent discount to residential negative gearing on industry output (deviations from baseline)**

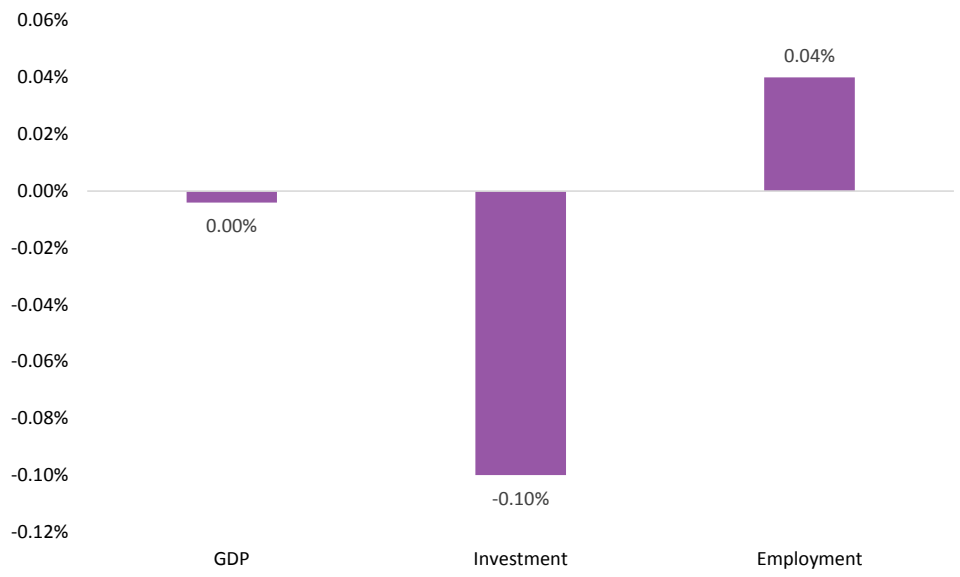



Source: HIA- Independent Economics, 2014.

Figure C3 and the points below summarise other macroeconomic impacts of discounting negative gearing for residential properties.

- By increasing the existing distortions from an already high tax burden in the housing market the change would lead to lower living standards. A reduction in living standards indicates a decrease in welfare of Australian households. It is estimated that a 40 per cent discount to residential negative gearing would lead to Australian households being worse off by around $21 million per year (in 2012-13 terms).
- It would lead to overall investment across Australia being lower by 0.1 per cent than would otherwise be the case. This is a result of lower levels of investment on dwelling construction stemming from the higher cost of investing in residential properties.
- It would result in employment in the long run remaining almost unchanged. However, the impacts vary by sector. There would be lower employment in housing-related industries (the employment effects would follow a similar pattern to the industry effects described above). In the long run, these effects would be offset by slightly higher employment in other non-housing related industries.
- Overall, discounting negative gearing would reduce economic output marginally. The negative impacts caused by the discount would be almost completely offset by the gains from cuts in personal income tax (resulting in a small overall loss in gross domestic product (GDP).

Figure C3 **Economic impacts of a 40 per cent discount to residential negative gearing on key macroeconomic variables (deviations from baseline)**




Source: Independent Economics 2014.

## C.4 Key points

- Eliminating or limiting negative gearing and capital gain tax concessions is likely to have direct impacts on asset prices and rents, returns on investment and the level of investment in the assets affected by the changes.
- An economy-wide analysis can trace the direct and indirect impacts of changes to negative gearing and capital gain tax concessions as they flow through the economy and provide an 'on balance' view of their lasting impacts.
- An economy-wide analysis by HIA- Independent Economics found that the Henry Tax Review recommendation to discount net residential income by 40 per cent would:
  - add to the already high tax burden in the housing market and reduce incentives to invest in property, therefore reducing housing supply and raising the cost of housing for both renters and owner occupiers;
  - result in an increase in residential rents as investors pass on to consumers the additional costs to them stemming from the deterioration of the tax treatment of their housing investment;
  - lead to lower residential land prices due to lower investor demand for housing;
  - reduce the welfare of Australian households;
  - reduce activity in the residential construction industry and in other related industries which operate across the construction sector;
  - lead to overall investment across Australia being lower;
  - lead to lower employment in housing related industries; and
  - result in an overall small loss in GDP.
- The analysis also shows that, after taking into account the different direct and indirect effects, the overall net effects of a 40 per cent discount to residential negative gearing are, while negative, relatively small. This is because:

- some of the negative impacts of the change would be offset by the modelled reduction in personal income tax; and
- the change being analysed is relatively small relative to the overall housing market and the other existing taxes and charges applying to the property sector.

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