UNTANGLING THE DEBATE OVER NEGATIVE GEARING

There are more desirable ways to improve housing affordability than proposed changes to negative gearing, argues **Gene Tunny**

In the lead-up to the 2016 federal election campaign, Prime Minister Malcolm Turnbull compared the Labor Opposition's proposed changes to negative gearing and capital gains tax to a 'big sledgehammer' being taken to the property market. The Opposition has proposed that negative gearing—whereby losses on investment properties can be deducted from other income for taxation purposes—should be restricted to new properties and that the discount on capital gains income be cut from 50% to 25%.[1]

The PM claimed that the proposed policy changes would have a major adverse impact on property prices. While Labor's policy is motivated by a desire to improve housing affordability, it would be politically unfavourable for the party if its policy did result in a large fall in property prices. Hence, Shadow Treasurer Chris Bowen has since seized on advice from the Australian Treasury, released in early 2018 under Freedom of Information (FOI), which appeared to contradict the PM, noting that Treasury referred to 'a relatively modest downward impact on property prices.'[2]

The debate over negative gearing will no doubt continue up until the next election in 2019, so it is important to assess where the truth lies. In this article, I argue that negative gearing is a logical feature of the tax system. Proposals to radically change it are misguided and will likely have adverse impacts on the property market. Studies that purport to show large benefits from restricting or abolishing negative gearing have major flaws and should not be used in the policy debate.

What is negative gearing?

Negative gearing is when a taxpayer uses declared losses from a rental property (or multiple properties) to reduce their taxable income, including wage and salary income, thus receiving a reduction in taxes paid. Negative gearing is allowed in Australia, New Zealand and Sweden but is subject to a range of restrictions in the US and the UK, where rental losses cannot be used to offset labour income.[3] Such restrictions are generally seen as integrity measures aimed at reducing tax evasion.

In Australia, a taxpayer is able to deduct a variety of rental expenses from their total income—in addition to interest payments on a loan used to finance the property—including, among others, depreciation, repairs and maintenance, utility bills, rates, insurance, management fees and (until recently) travel expenses.

Assuming legitimate deductions are claimed and depreciation is accurately calculated, an investor is still losing money on a rental property in each year it is negatively geared, but the size of the loss is reduced by being able to reduce

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total taxable income and receive a tax saving.[4] What can make negative gearing pay off eventually is net rental income, if and when a property becomes positively geared, and the capital gain that is ultimately realised on the property.

Negative gearing has been a major topic of debate in Australia for years now. Concerns about negative gearing grew in the 2000s in line with the increase in the number of landlords in general—which grew at more than twice the rate of population growth—and negatively-geared landlords in particular (Chart 1). While 51% of landlords declared net rental losses in 1998-99, the share peaked at 69% in 2007-08. This upward trend in negatively-geared landlords may have been driven by:

a) changes to capital gains tax in 1999-2000 when a 50% discount on capital gains for taxation was adopted, replacing the previous inflation-adjustment of the cost-base method;
b) greater availability of finance for investors, including interest-only loans; and
c) an increase in mortgage interest rates of around 2 percentage points from 1998-99 to 2007-08.

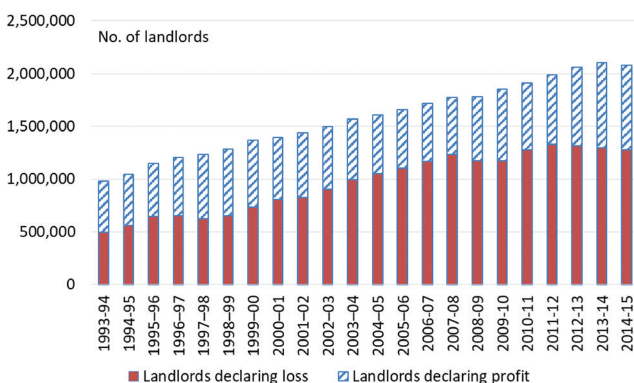
After strong increases over the 2000s in the number of negatively-geared landlords and net rental losses, there appears to have been a levelling off in negatively-geared landlords and substantial reductions in rental losses in recent years. The share of landlords who are negatively geared was 62% in 2014-15, down around 7 percentage points from the peak in 2007-08. To a substantial degree, this decline has been related to lower interest rates and hence lower deductions for interest payments.

According to ATO data, total net rent has improved substantially in recent years, from -$8.4 billion in 2011-12 to -$3.6 billion in 2014-15 (Chart 2). This is most likely due to lower interest rates and reductions in deductible interest payments. Total declared rental losses fell from a peak of $14.6 billion in 2011-12 to $11.1 billion in 2014-15. The average rental loss has fallen from around $11,000 to around $8,700 over this period. Given recent restrictions on some deductions, discussed in the next section, it is possible total rental losses will continue to fall. These recent trends mean the potential revenue increase from the Opposition's policy, an estimated $32 billion over ten years, is likely reduced.

Rationale for negative gearing

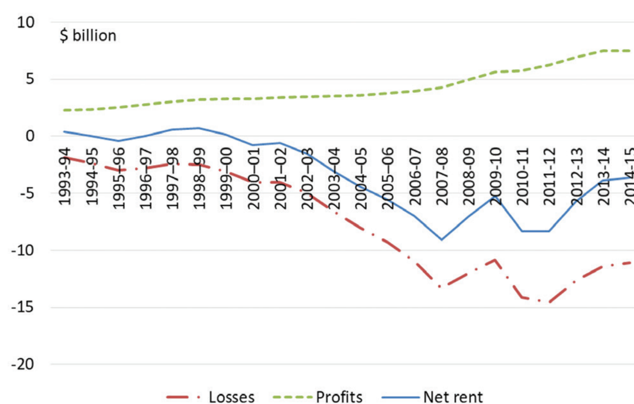
Negative gearing is a logical feature of the tax system, as it leads to consistent treatment of debt and equity regarding the financing of investments, a point made in 2015 by the Australian Treasury.[5] After all, if an investor were to use additional equity to purchase a property rather than debt, they would forgo a rate of return on that equity and hence would pay less in taxes. Negative gearing is not a tax concession as such, and for this reason is not included in the Treasury's annual *Tax Expenditure Statement*.

Chart 1. Landlords by net rental profit status



Source: ATO Taxation Statistics. *Note:* the number of landlords declaring a profit reported in the chart also includes a relatively small number of landlords who declare zero net rent.

Chart 2. Landlords by net rental profit status



Source: ATO Taxation Statistics. *Note:* the number of landlords declaring a profit reported in the chart also includes a relatively small number of landlords who declare zero net rent.

Given that a person's income for tax purposes—and the marginal tax rate they are liable to pay—is built up by adding up income from different sources, generally wage and salary income but also income from businesses and investments, it is natural that deductible expenses are built up in the same way.

Negative gearing does not unfairly advantage investors relative to people who only own an owner-occupied property, for which there is no deduction of mortgage interest payments available. Economic theory and empirical evidence suggest owning your own home in Australia is very tax effective and a person should typically prefer an owner-occupied property to 'rentvesting', whereby they rent their place of residence and buy an investment property.[6] The advantage of owner occupation comes through the implicit rental income of the property you live in being exempt from taxation and capital gains on the property also being exempt.

Critics of negative gearing often note that negative gearing is disproportionately undertaken by high-income earners. The Grattan Institute has observed that 'the top 10% of income earners before rental deductions receive almost 50% of the tax benefits of negative gearing.'[7] It is misleading, however to refer to tax benefits. As noted above, negative gearing means an investor loses less money than they otherwise would because they are able to deduct expenses associated with earning that income. This is not illogical or improper. Furthermore, the observation that the top 10% disproportionately negatively gear is hardly surprising, given they are more likely to own investment properties and indeed multiple properties in many cases. The top 10% also pay around half of all income tax in Australia.[8] So it is unsurprising and not inequitable that the top 10% should receive around half of negative gearing's so-called tax benefits.

Regarding the equity implications of negative gearing, consider that—as the Treasury noted in its *Re:think Tax Discussion Paper*—negative gearing also allows more people to enter the property market than would otherwise be the case.[9] This is certainly correct, and research by the Australian Housing and Urban Research Institute suggests that if negative gearing were not available, around half of investors may not have purchased an investment property.[10] ANU Associate Professor Ben Phillips has observed, 'While negatively geared investors do typically have larger incomes it is also true that their spread of incomes covers low, middle and high incomes.'[11] Using ATO data, Phillips estimated that around 25% of negatively geared investors are in the five lowest family income deciles.[12]

While negative gearing is logical from a tax policy perspective, and is not unfair, the Treasury does need to be mindful of potential abuse of negative gearing through inappropriately claiming deductions. This is why the 2017-18 Budget introduced changes to the deductibility of some items in rental properties, saving the government $800 million over the next three financial years. Specifically, the ATO will no longer allow deductions for travel expenses associated with inspecting and maintaining rental properties or collecting rent from tenants; nor for depreciation of plant and equipment (e.g. dishwashers, ceiling fans) that were already in place when the property was purchased.

Although such integrity measures may result in inefficiency by reducing the returns to large numbers of investors who were not claiming inappropriate deductions, implementing such measures to prevent abuses is a better approach than abolishing negative gearing entirely.

The impacts of negative gearing

It is uncontroversial that negative gearing increases house prices and lowers rents relative to what they otherwise would be, as it increases the post-tax return to investors in rental properties. So if negative gearing were removed, prices would fall and rents would increase (relative to what they otherwise would have been), and some households that previously rented may now find it economic to become owner occupiers. The policy debate is over the magnitude of these impacts and how different groups such as first-home buyers, home owners, investors and tenants are affected. The challenge in assessing the Opposition's policy is the differential treatment of existing and new investment properties purchased after the policy's implementation date of 1 July 2017, and the grandfathering of investment properties already owned before the implementation date.

Restrictions on negative gearing would reduce the rate of return on investment properties,

reducing their attractiveness relative to other assets. Hence, all else being equal (i.e. if rents remain the same) property investors looking to purchase properties would want to pay less for the property than previously, so the yield (risk-adjusted) remains similar to other assets. Existing investment property owners would try to raise rents to restore previous yields, but they may be constrained by market conditions in doing so, particularly if there is a relatively high vacancy rate for investment properties as there has been in some capital city markets recently owing to the apartment building boom.

The extent to which the adjustment in investment property yield occurs by an adjustment of property prices or rents will depend on prevailing conditions and property and rental markets across Australia if negative gearing changes were enacted, and it is almost impossible to forecast how the adjustments would occur in advance. Evidence from the US suggests that it is more likely that property prices rather than rents would adjust in the short- to medium-term.[13] US researchers have found only around one-sixth of a change in the after-tax user cost of rental housing is reflected in rents within ten years.[14]

The Grattan Institute has analysed the impact of the rate of return of different investment types from a proposal to eliminate negative gearing but to allow quarantining of rental losses to offset against future property income, and to cut the CGT discount to 25%. That is, it has essentially modelled Labor's negative gearing policy. According to Grattan, house prices would be 'unlikely to fall by more than about 2%.' They note that price falls could be greater in some markets where investors are heavily concentrated, such as for inner city apartments, but the maximum rational price fall would be 7%.[15]

In my own analysis, using a similar methodology and assumptions to Grattan, I found larger impacts on prices, up to 4% on house prices on average.[16] This would not imply a property market crash, but it would mean a reduction in value of $15,000 to $20,000 for a $500,000 property, which is not insignificant.

In contrast, BIS Shrapnel has estimated very large impacts from restricting negative gearing. BIS Shrapnel models a policy proposal similar to the Opposition's proposal, but with no changes to capital gains tax. BIS Shrapnel found restricting negative gearing would increase rents by up to 10%, decrease new home building by around 4% per annum; and reduce GDP by 1% and job creation by 175,000 over the next decade.[17]

The Grattan Institute's John Daley said the BIS Shrapnel findings were 'manifestly ridiculous', and they certainly appear so given estimated impacts on the rate of return undertaken by Grattan and myself.[18] Daley rejected the prediction there would be a 10% increase in rents, noting an increase of such a magnitude was not observed when negative gearing was temporarily abolished in the mid-1980s.

BIS Shrapnel was on firmer grounds when it argued that ' . . . the inability to fully negatively gear an established dwelling would mean the price of new stock will immediately fall as subsequent buyers cannot receive the same negative gearing concession. This will deter many investors from investing in new dwellings.'[19]

Negative gearing increases house prices and lowers rents relative to what they otherwise would be. The policy debate is over the magnitude of these impacts.

New properties as well as existing properties would be affected by the Opposition's proposed changes as the bulk of properties would be affected by the lower willingness of investors to pay for investment properties owing to lower rates of returns. This is because a large proportion of properties could be used for either owner-occupation or as a rental property, and property investors form an important part of the demand for a large number of properties.

While the reduction in the rate of return would be greater for established investment properties (purchased after the policy's implementation date) under Labor's policy changes, new investment properties would also have a lower rate of return than they otherwise would, owing to the reduction in the capital gains discount. This may have an adverse impact on the number of new dwellings constructed.

Conversely, UNSW Economics Professor Richard Holden, in a report for the McKell Institute that informed the Opposition's policy, predicted increasing new supply under the proposal: '. . . this scenario has the additional benefit of boosting the construction sector . . a plausible estimate is that a net 10% increase could occur.'[20] However, he did not model the possible switching of investor demand from existing to new investment properties, and he noted it was beyond the scope of his report to estimate the impact. He simply asserted there would be an increase in new housing construction. Yet such an increase may not be forthcoming, given the likely adverse impacts on rates of return even for new investment properties.

> The differential treatment of established and newly constructed properties under Labor's proposed policy is illogical and would introduce a significant distortion to the property market.

In early 2018, a University of Melbourne study presented at a Reserve Bank workshop in late 2017 attracted attention because it claimed that removal of negative gearing would result in around one-third of current renters becoming home owners.[21] However, this study—which the authors acknowledged was 'preliminary and incomplete'—modelled a radical policy in which losses incurred on rental properties can never be used to reduce an individual's tax bill. This is not the Opposition's policy, as the Opposition would allow investors to save up losses incurred and use them to offset income in the year a property is sold, thus allowing past losses to help offset what may be a large capital gains tax bill.

The University of Melbourne study was based on a housing market simulation model that was calibrated, based on observed data, to a utility (i.e. satisfaction) premium for owner-occupation of around 30% relative to renting. This is very high relative to what is typically used in other studies (e.g. 5% in the major US study on which the workshop paper was based).[22] It is this very high parameter that drives the large switch to owner occupation by renters. Partly, the switch is driven by the savings from the abolition of negative gearing being redistributed to households, allowing them to save up the deposit for a property. This is all extremely unrealistic, particularly when one considers that many households renting are lower income households that would struggle to save a deposit, and indeed may be better off continuing to rent given they may face other more pressing needs than purchasing a house.

Overall, there is a lot of uncertainty regarding the magnitude of impacts of changes to current policy settings. For many people, such changes will not be beneficial. House prices would be lower than they otherwise would be and rents may be higher. And there is reason to suspect that claims that the removal of negative gearing would prompt a surge in home ownership are dubious.

Beyond negative gearing

Owing to their impacts on the rate of return on investment properties, changes to negative gearing and capital gains tax (CGT) have the potential to substantially affect investor behaviour. The differential treatment of established and newly constructed properties under Labor's proposed policy is illogical and would introduce a significant distortion to the property market, with attendant risks as noted by ANU economists George Fane and Martin Richardson. It is challenging to forecast the ultimate outcomes of this distortion.[23] Any changes should be carefully considered, taking into account economic modelling by the Treasury. Incidentally, the Treasury's advice to the government, which was released under FOI, does not appear to have been based on economic modelling.

The proposed reforms to negative gearing are not well founded in theory or evidence, although there may be a case for modifying the tax treatment of capital gains. Former CIS Research Fellow Michael Potter has alluded to the impact of the CGT changes in 1999 on the prevalence of negative gearing and has suggested that

> . . . instead of playing with the fundamental principle of deductibility of losses, a better option would be to return to the CGT system before 1999 (which involved indexation and an averaging provision

> that avoided over-taxation of one-off large gains), with an additional discount. This discount should be set so that the tax burden on capital remains lower than the burden on other income, in alignment with the views of many tax experts.[24]

A discount for capital gains is generally uncontroversial, as there is widespread recognition that capital gains should be taxed at a concessional rate because part of any capital gain is due to inflation, and also because capital gains are booked in a single year for income tax purposes making them more likely to be subject to a high marginal tax rate. However, it may be desirable to reform the current arrangements along the lines of Potter's suggestions, as it appears the 1999 changes were partly responsible for the surge in negative gearing in the 2000s.

The Opposition's policy is motivated by its expressed concern regarding housing affordability, particularly in Sydney and Melbourne. But the proposed changes to negative gearing and CGT would be an undesirable way to address these concerns. The large rise in house prices since the early 2000s is related to a wide range of factors and their relative influence is difficult to tease out. As Griffith University Professor Andrew Worthington has noted regarding housing price growth:

> The main contributor at the national level has been the escalation of housing prices because of continuing strong demand arising from strong economic and population growth, the availability of cheaper and more accessible finance, and tax and other incentives for home and investor housing ownership. An additional contributor is unresponsive housing supply resulting from an extensive governmental role in land release and zoning, infrastructure charges, and building and environmental regulation.[25]

Leading Australian economist and public finance expert Peter Abelson has made similar comments regarding the adverse impacts of government restrictions on housing supply.[26]

It is therefore important to consider the full range of policy options when making recommendations regarding housing affordability. If the goal is to promote housing affordability, there are arguably better ways to do so including reductions in stamp duty, reforms to local and state government planning laws that may be limiting land supply, and macro-prudential supervision.

Recent macro-prudential supervision by the Australian Prudential Regulation Authority (APRA) has had some impact in restraining the growth in investor loans—for example, there has been a decline in interest-only loans among property investors, and the proportion of investor loans with very high loan-to-valuation ratios has fallen. APRA's actions have also likely impacted property prices. In the final quarter of 2017, the CoreLogic Home Value Index fell 2.1% for Sydney and property value growth has moderated in Melbourne, increasing only 0.9%.[27]

The large rise in house prices since the early 2000s is related to a wide range of factors and their relative influence is difficult to tease out.

Conclusion

There are more desirable ways to improve housing affordability than the Opposition's proposed policy to restrict negative gearing and halve the CGT discount. Indeed, based on its previous views cited earlier, it is likely that Treasury—which is responsible for tax policy advice and development—would recommend changes to the Opposition's current proposal were Labor to win government. It may be preferable to tackle the affordability problem from the supply side while maintaining negative gearing.

Importantly, policy proposals to modify negative gearing and the CGT discount should only be enacted after extensive modelling and analysis of potential impacts by Treasury and external experts—and after a period of public consultation—given the risk of adverse impacts on property and rental markets and the broader economy.

Endnotes

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4 This is the case even if the property is cash flow positive, recognising that an investor could be negatively geared but still cash flow positive given depreciation is a non-cash expense. It is unwise for property investors to ignore the depreciation of their properties in their investment decision making.

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13 Dixie Blackley and James Follain, 'In Search of Empirical Evidence That Links Rent and User Cost', *Regional Science and Urban Economics* 26:3-4 (June 1996), 409-431.

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