

Top Gears:

How negative gearing and the capital gains tax discount benefit the top 10 per cent and drive up house prices.

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Summary

The combination of negative gearing and the capital gains tax (CGT) discount is distorting the Australian residential property market, encouraging speculative behaviour and being used by predominately high income households as a tax shelter.

Modelling commissioned by The Australia Institute shows that these tax perks are costing tax payers \$7.7 billion per year.

The modelling also shows that the majority of the benefits of negative gearing and the CGT discount are not going to middle Australia but rather to high income earners. 56 per cent goes to the top 10 per cent of income households and 67 per cent goes to the top 20 per cent. By comparison relatively little flows to low income households with just four per cent going to the bottom 20 per cent of households. The bottom half of Australian households only get 13 per cent of the benefits.

Negative gearing and the CGT discount combine together to encourage Australian investors to invest in residential property which is having the effect of pushing up house prices and lowering rates of home ownership. The proportion of housing finance that is going to investment properties is growing. These tax perks encourage investors to make a loss and to focus not on rental returns but on capital gains.

The proportion of investment loans in total housing finance has grown from 16 per cent 23 years ago to 40 per cent in 2014. A larger proportion of residential investment properties are showing up as more and more low and middle income households being forced to rent. Low and middle income households are being squeezed out of the property market.

This type of speculative investment makes the property market more susceptible to bubbles; it also makes it more difficult for the Reserve Bank (RBA) to conduct monetary policy. While the domestic economy is weak the RBA is reluctant to lower interest rates further for fear of pushing up already inflated house prices in Sydney. A focus on capital gain means that rising house prices draw in more speculators which could further inflate prices.

A good tax is efficient and equitable. Negative gearing and the CGT discount fail on both those criteria. These two tax policies are highly inefficient as they distort the residential housing market by encouraging speculation and make it more susceptible to asset bubbles. They are inequitable as they make it more difficult for lower income Australians to buy their own home. The benefits also overwhelmingly flow to high income households.

These are taxes that are ripe for reform. This paper will propose reforms that

- End the CGT discount
- changing negative gearing on residential investment property to
 - Only apply to newly built housing
 - Only be deductible for 10 years after purchase of new housing
 - Grandfather existing negative gearing for five years

Introduction

Negative gearing is where losses made on investments can be deducted from taxable income derived from other sources. In Australia negative gearing most commonly relates to investments in real estate. An investor borrows money to buy an investment property and rents the property out. If the rent being paid is less than expenses relating to the property, then this loss can be deducted from other taxable income. The investor loses money on the property, but the reduction in tax they pay from their regular income, say from a high salary, is very valuable. The deductible expenses include interest paid on investment loans - an important part of these deductions.

The ability for investors to reduce the amount of tax they pay by negatively gearing their residential investment properties is an unusual arrangement. Apart from Australia only two other OECD nations allow full tax deductibility, New Zealand and Japan.¹

It is also an unusual investment because it is set up to lose money. Most investments are designed to make a profit but many residential investment properties are designed to make a loss to take advantage of the tax deduction.

Importantly, while the investor is making a loss on their property in cash terms and deducting this loss from their taxable income, the property itself is usually increasing in value. When the investor sells their investment property it is (hopefully for the investor) worth more than they paid for it. As the property is now more valuable, the investor has experienced a “capital gain”.

Capital gains are subject to capital gains tax (CGT). CGT is paid when an asset is sold for more than it was purchased for, minus some deductions. Since 1999, Australia has a 50 per cent discount on CGT if the asset was held for more than 12 months by individuals or trusts. The discount means that only half the capital gain on an investment property is subject to tax. So for example if a \$100,000 capital gain was recorded, only \$50,000 is taxed.

The ability to deduct those ongoing losses while owning a property from other taxable income under negative gearing means the taxpayer is paying a proportion of the loss and so improving the chance and any size of any ultimate gain. The discount on CGT means the taxpayer loses out again on collecting the full amount of revenue that would otherwise accrue to the government.

These two policies combined result in significant forgone tax revenue for the Australian Government. This report assesses how big this revenue loss is and how the benefits of the tax break is distributed through the Australian population.

Cost and distribution of negative gearing and the CGT discount

The Australia Institute commissioned modelling from the National Centre for Social and Economic Modelling (NATSEM) to assess the distribution of benefits from negative gearing and the CGT discount, as well as how changes to these tax breaks would affect households of different income levels and age groups.

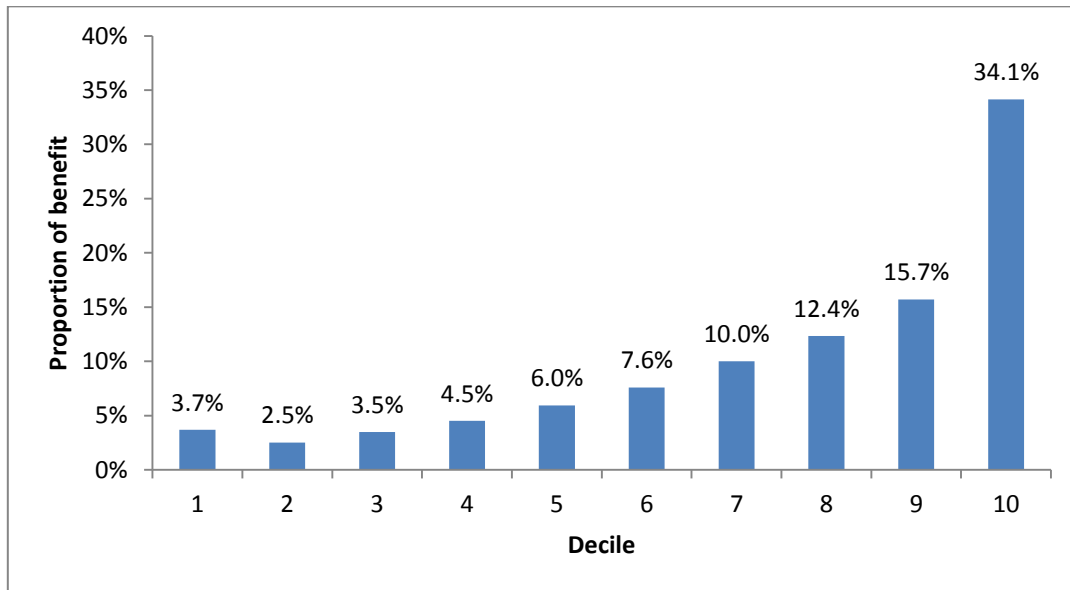
NATSEM calculated the changes to negative gearing and the CGT discount using NATSEM's extensive data on households combined with the most recent Australian Tax Office (ATO) statistics from 2011-12, updated to 2014-15.

NATSEM estimates that negative gearing of residential investment property is currently reducing tax revenue by \$3.7 billion per year. Half of the tax break flows to the top 20 per

¹ Productivity Commission (2004) *First Home Ownership*

cent of households. By comparison the bottom half of Australians only get 20 per cent of the benefit of negative gearing.

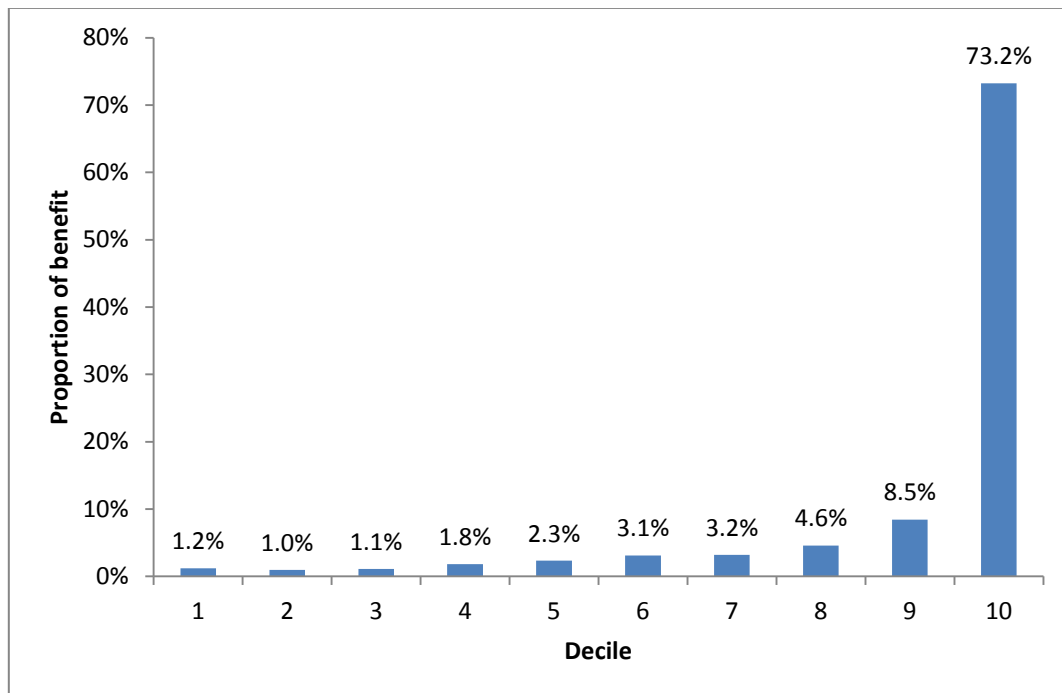
Figure 1: Distribution of negative gearing benefits by household income



Source: NATSEM, ATO (2014) *Taxation Statistics 2011-12*, updated to 2014-15

NATSEM estimates that the CGT discount is currently costing the budget \$4 billion per year. The distribution of the CGT discount is also skewed to high income households. Almost three quarters (73.2 per cent) flowed to the top 10 per cent of households. 82 per cent went to the top 20 per cent of households while just 7 per cent went to the bottom half of households.

Figure 2: Distribution of the CGT discount benefits by household income



Source: NATSEM, ATO (2014) *Taxation Statistics 2011-12*, updated to 2014-15

Note that NATSEM's estimate of the cost of the CGT discount is lower than Treasury's estimate of \$5.8 billion. The difference is that Treasury includes the CSG discount on both individuals and trusts while NATSEM only includes the impact on individuals.²

While exact estimates will vary, it is clear that these tax breaks represent a significant amount of revenue foregone by the federal government and that the benefits of the tax breaks overwhelmingly accrue to the highest income households. To understand how a reform of these policies might affect government revenue and different Australian households, NATSEM modelled a change to current policy of:

- Ending the CGT discount
- changing negative gearing on residential investment property to
 - only apply to newly built housing
 - only be deductible for 10 years after purchase of new housing.

NATSEM estimates these changes would increase government revenue by \$7.4 billion. The distribution of the impact of the policy change is shown in Table 1. It shows that more than half (56 per cent) of the revenue would come from the top 10 per cent of households, with 67 per cent from the top 20 per cent. Meanwhile only 13 per cent of the savings come from the bottom half of households.

Table 1 – Distribution of impacts of suggested policy change by household income

Household income decile	Annual revenue increase from changes to Negative Gearing and the CGT discount (\$m)	Proportion of total households
1	\$173	2.3%
2	\$123	1.7%
3	\$163	2.2%
4	\$225	3.0%
5	\$293	4.0%
6	\$379	5.1%
7	\$463	6.3%
8	\$598	8.1%
9	\$866	11.7%
10	\$4,099	55.5%
Total	\$7,382	100.0

Source: NATSEM, ATO (2014) *Taxation Statistics 2011-12*, updated to 2014-15

Table 2 below shows the impacts of this policy change by age. Most of the savings come from people in their 50s and 60s, generally the age groups that hold the most wealth.

² Commonwealth of Australia (2015) *Tax Expenditure Statement*

Table 2 – Distribution of impacts of suggested policy change by age group

Age group	Savings from changes to Negative Gearing and the CGT discount (\$m)	Proportion of total households
Less than 25	\$99	1.3%
26-30	\$221	3.0%
31-35	\$458	6.2%
36-40	\$698	9.5%
41-45	\$958	13.0%
46-50	\$882	11.9%
51-55	\$1,046	14.2%
56-60	\$1,074	14.5%
61-65	\$863	11.7%
66-70	\$504	6.8%
70 plus	\$580	7.9%

Source: NATSEM, ATO (2014) *Taxation Statistics 2011-12*, updated to 2014-15

NATSEM's modelling assumes that negative gearing applies to 10 per cent of residential properties that are newly built and have been held by their owners for less than 10 years. This is a conservative assumption since only six per cent of current residential investment loans are for new housing. It also factors in some possible behavioural change, as the amount of new housing being negatively geared is expected to increase if changes are made so that only new housing can be negatively geared.

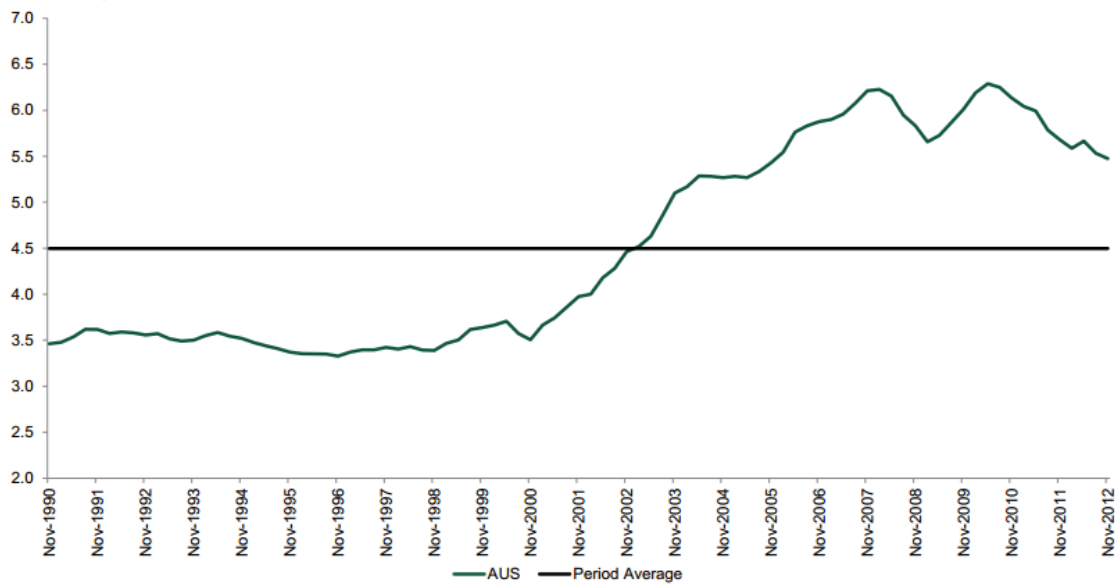
It is also important to note that the savings modelled here would only occur once the full changes were implemented, beyond the proposal for a five year grandfathering period. (See more detail on page 11). Initial savings would be very small since investors will be able to continue negatively gearing residential properties they already own under the old system for five years. The increases in revenue are therefore indicative of what can be earned once the change is fully implemented.

Negative gearing, CGT and housing affordability

Negative gearing and the CGT discount not only reduce tax revenue, but are contributing to the growing housing affordability problem in Australia. The favourable tax treatment for investment in property encourages more investors into the housing market who are able to outbid other Australians who want to buy a home to live in. This increases house prices.

Housing affordability is often measured with the ratio of house prices to income. Figure 3 shows house price to income ratios from 1990 to 2012. The house price to income ratio was relatively flat through the 1990s but then began rapidly increasing after the year 2000. It is important to note that the CGT discount was introduced in 1999, just before the acceleration in house prices.

Figure 3 - House price-to-income ratio (1990-2012)

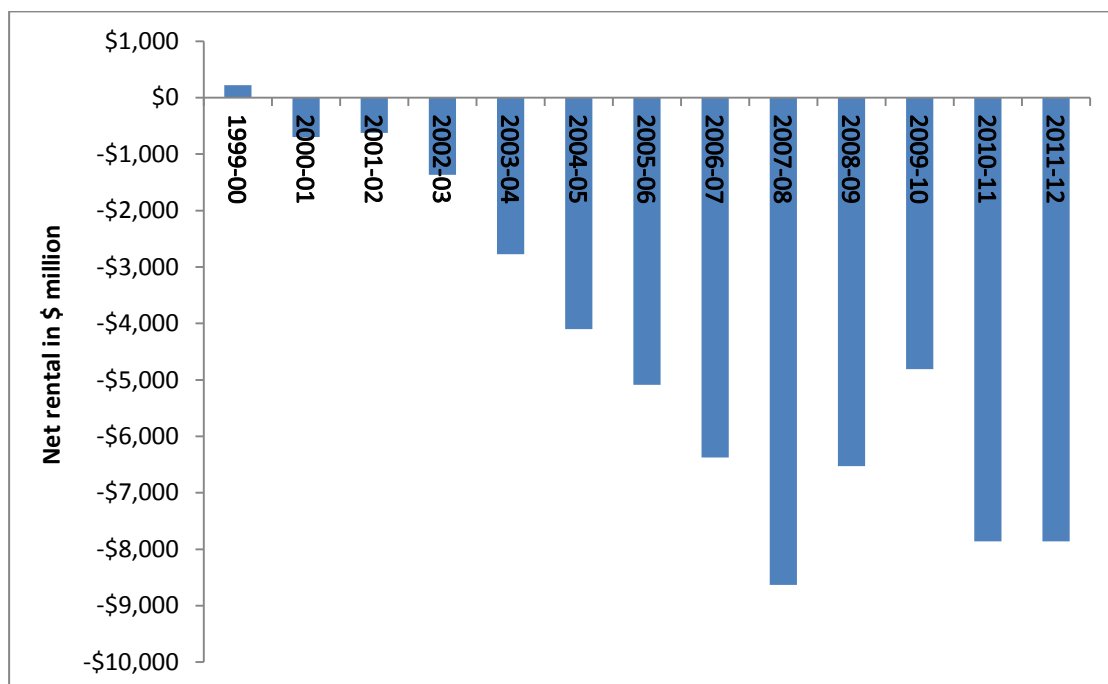


Source: HIA economics group (2013) Perspectives on Australian House Prices

While it is clear that housing is becoming less affordable over time in Australia, the international evidence indicates that Australia has high house prices when compared to similar countries. Australia has the second highest house price to income ratio among the OECD nations. So housing is not only historically less affordable in Australia it is also internationally unaffordable.

The size of the loss that people are claiming on their property investments has grown rapidly since 1999-2000. As Figure 4 shows net rental income was \$219 million in 2000 but quickly turned into a net rental loss that has continued to increase. In 2012 it was \$7.9 billion.

Figure 4 – Net rental loss over time



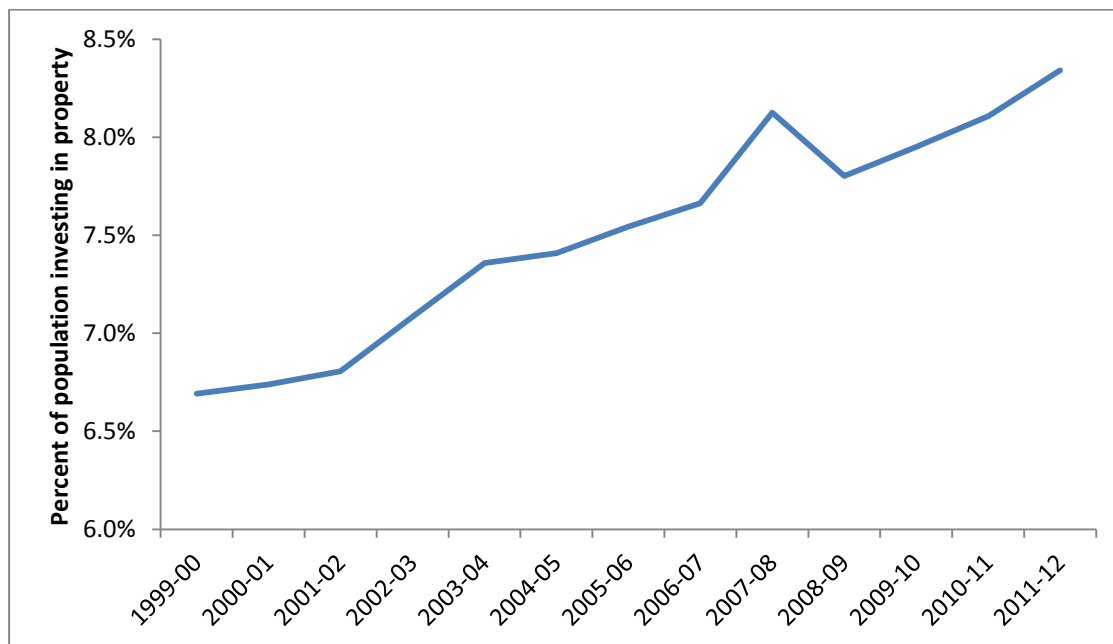
Source: ATO (2014) Taxation Statistics 2011-12, Individual tables, Table 13

The growing net rental loss shows that Australian property investors are unconcerned with rental yield but are focused on capital gains – exactly as we would expect given the incentives provided by negative gearing and the CGT discount.

Completing this picture is Australian Bureau of Statistics housing finance data for owner occupied and investment housing going back 23 years to 1992.³ In 1992 16 per cent of finance by value was for investment property. By 2014 it had grown to 40 per cent.

The number of people with residential investment properties has been growing rapidly. As Figure 5 shows the proportion of residential property investors to the population has grown from 6.7 per cent in 2000 to 8.3 per cent in 2012.

Figure 5 – Number of property investors as a proportion of the population



Source: ATO (2014) *Taxation Statistics*, various years, Individual tables and ABS (2014)

Earlier work by The Australia Institute also shows that the percentage of high-income households with investment property loans is increasing, while low and middle income households are renting more. People are renting and carrying mortgages until much later in life.⁴

Higher rates of renting for low and middle income households show that they are being squeezed out of the property market. Renting rates increased by 13 per cent for low income households between 2002 and 2012. Over the same period of time middle income households renting rates increased by 19 per cent.⁵

Negative gearing and rents

An argument against removing negative gearing is that to do so would increase rental prices. Since low income earners are over represented as renters any increase in rental prices would disproportionately impact on low income earners. The logic is that negative gearing encourages investors to build new houses to rent. This increases the supply of rental

³ ABS (2015) 5609.0 - *Housing Finance, Australia*

⁴ Johnson et.al (2015) *The great Australian lockout: Inequality in the housing market*

⁵ Johnson et.al (2015)

properties and hence puts downward pressure on rental prices. This argument was recently put by the Treasurer Joe Hockey.⁶

For this to be correct a significant proportion of housing that is purchased for the purposes of negative gearing would need to be new housing stock. ABS data shows that only 6 per cent of investment loans are for new housing stock.⁷ The vast majority is for existing housing stock.

The percentage of investment loans for new houses is also in decline. In 1992 loans for new houses made up 18 per cent of investment loans.⁸ This has fallen steadily to six per cent in 2014. This means that 94 per cent of investment loans are for existing housing stock. This shows the tiny importance that the investment market is having on bringing new housing stock to the market.

Monetary policy

Negative gearing and the CGT discount are causing concern at the Reserve Bank (RBA), particularly relating to Sydney's house prices. The minutes of the most recent meeting of the Reserve Bank Board say;

*In Australia, risks in the household sector continued to be centred on housing and mortgage markets. The composition of these markets remained skewed to investor activity, especially in Sydney.*⁹

While the broader economy remains weak and could potentially need further stimulation the RBA needs to consider Sydney house prices which the Governor of the RBA called "exuberant".¹⁰ He went on to say;

*Credit conditions are only one of several factors at work here. But credit conditions are very easy. So while the conduct of monetary policy can't allow these financial considerations to dominate the 'real economy' ones completely, nor can it simply ignore them. A balance has to be found.*¹¹

The speculative nature of Sydney's residential investment property, affected by negative gearing and the CGT discount, is making interest rate changes less effective. The consequences of this might be that the Australian economy is deprived of further monetary policy stimulation and remains weaker for longer because negative gearing and the CGT discount encourage speculative behaviour in the housing market.

Proposed changes to Negative gearing and the CGT discount

When making changes to negative gearing and the CGT discount it is important to consider how to retain the positive aspects of the current policy, as well as consider transitional arrangements.

Negative gearing can result in additional new houses being built but as discussed above only in relatively small amounts. The proposed reform is to allow negative gearing only for new

⁶ Martin (2015) *Joe Hockey outclassed on Q&A, by an economist*

⁷ ABS (2015)

⁸ ABS (2015)

⁹ RBA (2015) *Minutes of the Monetary Policy Meeting of the Reserve Bank Board*

¹⁰ Hutchens (2015) *RBA governor Glenn Stevens says Sydney house prices are 'exuberant' but more rate cuts may come*

¹¹ Hutchens (2015)

housing and only for 10 years. This change will have no impact on those who are already planning to buy new housing stock for the purposes of negative gearing.

The change in policy is likely to have a positive impact on the building of new housing. People wanting to invest their money in residential property will find that buying new housing stock has a bigger tax advantage than buying existing housing stock. This could increase the current low rates of investment in new housing for rental.

When changing policies that affect residential investment properties, it is important not to do things that will cause sudden changes in the property market. If negative gearing was immediately restricted to just new properties then it is possible that a large number of investment properties would enter the market causing price instability.

We suggest that grandfathering arrangements should be implemented to give the property market stability during the transition period. These arrangements would allow existing residential properties that are currently being negatively geared to continue for five years. Five years would allow the owners of those properties to make any changes to their investment decisions in a reasonable period of time, while avoiding instability.

An overly long grandfathering period, such as allowing all existing residential properties that are currently being negatively geared to continue until they change hands is not advisable. Such a situation would distort the housing market and encourage investors to hang onto housing.

The proposed policy change for negative gearing is only for residential investment properties and does not include negative gearing for other purposes. For example losses from share market trading and commercial property could still be negatively geared. There does not appear to be widespread use of deliberately negatively gearing other assets apart from housing.

The CGT discount was introduced by the Howard Government in 1999. It replaced the existing system that reduced any capital gain by the consumer price index. This was an attempt to remove inflation from the value of the capital gain. Introducing the CGT discount was a simpler method.

Removing inflation from capital gains tax means that income from capital gains is treated differently from other sources of income. Income earned from interest is taxed at its nominal rate (that is the rate that includes inflation).

There is no justification for why income from capital gain should be taxed differently to other forms of income. In taxing it differently we are preferencing those who earn income from capital gain over those who earn it from other sources such as interest earned on bank deposits.

The proposal then is to end the CGT discount and tax capital gains in the same way as all other sources of income.

Conclusion

Housing policy is a difficult subject in Australia. If house prices rise is that good or bad? The answer to this will be different for different people, depending on what kind of houses they own or don't own. It's good for people who own an investment property people who are looking to downsize their home or if they are moving from a more expensive area to a less expensive area. It's bad for people who are looking to buy their first home or who want to buy a bigger home because they have, for example, a growing family.

This complexity means that changes to housing policy need to be carefully considered. When considering taxation policy a government should consider issues of efficiency and equity. Negative gearing and the CGT discount fail on both those criteria. These two tax policies are highly inefficient as they distort the housing market by encouraging speculation and make it more susceptible to asset bubbles. They are inequitable as they make it more difficult for lower income Australians to buy their own home. The benefits also overwhelmingly flow to high income households.

It is time for the government to make significant changes to negative gearing and the CGT discount. There is a lot to be gained and very little to be lost.

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