Fuel on the fire: negative gearing, capital gains tax & housing affordability

TAX TALKS 2

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Summary

A vital goal for tax reform is to improve the affordability of housing. Australia has among the most expensive housing in the world. From 2002-12, average prices rose by 92% for houses and 40% for flats while average rents rose by 76% for houses and 92% for flats – well above the CPI.

The high cost of housing is caused by too much demand chasing too little supply. Since 2000 there has been an explosion of rental property investment. From 2000 to 2013 lending for investment housing rose by 230% compared with a rise of 165% in lending for owner occupied housing. But instead of improving affordability, it has made matters worse: Investors are bidding up the price of existing homes without building enough new ones.

Tax breaks for housing are not the only cause of high housing costs, but they are an important one. This report focusses on negative gearing arrangements and the 50% discount on Capital Gains Tax for investors. It explains how these tax breaks work, who benefits, how much they cost, and their impact on housing markets and the economy. It proposes reforms to improve fairness and efficiency of federal tax support for housing.

In the last year for which tax statistics are available (2011) two thirds of individual rental property investors – 1.2 million people - reported tax-deductable 'losses' of $14 billion. The Capital Gains Tax discount cost the Federal Budget $5 billion and negative gearing arrangements added another $2 billion that year.

Negative gearing and Capital Gains Tax discounts for investors together encourage over-investment in existing properties and expensive inner city apartments which lifts housing prices and does little to promote construction of affordable housing:

+ Over half of individual taxpayers with geared rental housing investments are in the top 10% of personal taxpayers (earning over $100,000 in 2011) and 30% earned over $500,000.
+ Over 90% of investor borrowing is for existing rental properties, not new ones, so investors are bidding up home prices without adding much to the supply of housing.
+ These tax breaks encourage speculative investment with an eye to capital gains, not patient investment with an eye to rental yields.
+ They reinforce the bias in favour of housing investment by small investors with one or two properties, when we need more investment by institutions such as super funds to stabilise the rental property market and give tenants more secure tenure.
+ They fuel speculative housing price booms that destabilise the economy and make it harder for the Reserve Bank to reduce interest rates when needed. With lending for investment properties rising by 150% in Sydney in the last three years, the Reserve Bank warns that investment housing *bears close monitoring for signs of speculative excess.*[1] Last year APRA issued guidelines to curb excessive lending for rental property investment.

[1] RBA (2014) *Submission to Senate Economics Committee Affordable Housing inquiry.* P3

Tax policy, interest rate policy and bank regulation are pulling in opposite directions. Negative gearing arrangements are adding fuel to the fire - the RBA and APRA are trying hard to put it out.

How do these tax breaks work?

Australia has unusually generous tax treatment for investment in rental property. Unlike most wealthy countries, including the US and UK, our income tax system places no limit on deductions that can be claimed for investment expenses relating to rental properties and other investments producing capital gains such as shares and agriculture. When these assets are sold, the capital gain is only taxed at half an individual tax-payer's marginal rate.

When an investment is 'negatively geared', interest payments on the loan and other investment expenses such as agent fees exceed their rental returns. These 'losses' can be deducted for tax purposes from the taxpayer's other income, including wages. The problem with this is that in most cases, the investors aren't actually making a loss because the value of the property increases each year. These 'capital gains' are not included in the calculation of tax until the property is sold, yet without them property investments would not be viable.

It is the *combination* of the taxation of capital gains at half the normal tax rate when the property is sold, and the ability to claim unlimited deductions for 'losses' in the meantime that drives investors to negatively gear. The tax system encourages people to borrow more than they would otherwise in order to speculate on property values.

What should be done?

Tax reform is only part of the solution to our housing affordability crisis,[2] but it is a vital part.

Along with reforms of State taxes – especially a shift away from reliance on Stamp Duties and towards a broadly based Land Tax – we advocate the following reforms to federal taxes affecting housing markets.

1. Restrict tax deductions for 'negatively geared' property investments''

Income tax deductions for expenses relating to 'passive' investment in rental housing and other assets such as shares and agricultural schemes should only be offset against income received from those investments (including capital gains) and not against other income (including wages). This should apply to all new investments of this type entered into from 1 January 2016, but not to investments which commenced before that date. [Those investments would be 'grandfathered' so that existing rules continue to apply until the asset is sold].

Revenue: $500 million in 2015-16; $1,000 million in 2016-17

2. Use part of the revenue savings to strengthen tax incentives for investment in new affordable housing, including building on the strengths of the NRAS scheme

As a first step, reinstate funding for round 5 of the National Rental Affordability Scheme to finance the construction of 12,000 new affordable rental dwellings and restore investor confidence in the program.

Cost: $40 million in 2015-16; $100 million in 2016-17

3. Increase tax rates on capital gains and reduce them on other investment incomes including interest bearing deposits and rents, to improve equity and reduce distortion of investment decisions by the tax system.

Consistent with reforms advocated in the 'Australia's Future Tax System' Report, a common personal income tax discount should be introduced to replace the current tax treatment for capital gains, housing rents, interest bearing deposits, shares and similar investments (excluding superannuation and owner occupied housing). This should be substantially less than the current 50% discount for capital gains.

[This proposal is not costed as it involves changes to income taxes on a number of different types of investment, but it should be designed so as to save revenue overall]

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[2] *An affordable housing reform agenda*, downloadable at: http://www.acoss.org.au/images/uploads/Housing_paper_summary_March_2015_final.pdf

Negative gearing myths and facts

Myth 1: The Hawke Government's restrictions on negative gearing from 1985-87 resulted in rent increases and had to be reversed.

Fact: The main reasons for rent increases at that time were higher interest rates and a share-market boom which diverted investment from rental property. Even so, this only happened in Sydney and Perth. Lending to rental property investors still rose by 42% across Australia.

Myth 2: Negative gearing can't be responsible for overheating in housing markets in recent years because it's been in place for over 20 years.

Fact: Negative gearing adds fuel to each housing boom by encouraging property speculation. Its impact has grown because investors have easier access to credit. The halving of tax rates on capital gains in 2000 (in place of the indexation of capital gains for tax purposes which was less encouraging of speculative investment) also made negative gearing more attractive.

Myth 3: The benefits of negative gearing mainly go to 'mum and dad' investors on middle incomes

Fact: This is an illusion due to the way the Taxation Statistics break down deductions for rental property investment by *taxable* income, which is itself reduced by negative gearing strategies. Many households that *appear* to be 'middle income' actually have higher incomes before deductions are subtracted. In reality, over half of individual taxpayers with geared rental housing investments are in the top 10% of personal taxpayers (earning over $100,000 in 2011) and 30% earned over $500,000.

Introduction

A national debate about tax reform has begun against a backdrop of some serious economic and social challenges. These include the growing gap between the community's reasonable expectations of government and the resources available to meet these expectations as well as slower economic growth, rising unemployment and an ageing population.

This report focuses on the role of tax reform in meeting another big economic and social challenge: housing affordability. It examines the impact of our current housing taxation settings, in particular negative gearing and Capital Gains Tax arrangements, on housing affordability and the wider economy.

A well-functioning housing market is critical to economic growth and meeting the most basic of social needs. Housing is the largest household expense for low income households and the main form of household wealth.[3]

Australia has among the most expensive housing in the world.[4] A housing price boom is underway in some cities, especially Sydney. This is making the affordability problem worse. It is driven mainly by rental property investment:

'Investor housing loan approvals in New South Wales have increased by almost 150 per cent over the past three years.[5]

1. Australia's housing affordability crisis

Australia has among the most expensive housing in the world. Following steep increases in home prices and rents over the past two decades, we have reached a point where decent housing is unaffordable for low-income households. Sixty percent of low income renters are experiencing housing stress, meaning they are spending more than 30% of income on housing costs and there is a shortage of over 500,000 rental properties that are affordable and available to low income renters.[6]

Home ownership rates are falling for each successive generation. Just two thirds of 35 to 44 year old households live in their own home today compared with three quarters in the early 1980s.[7]

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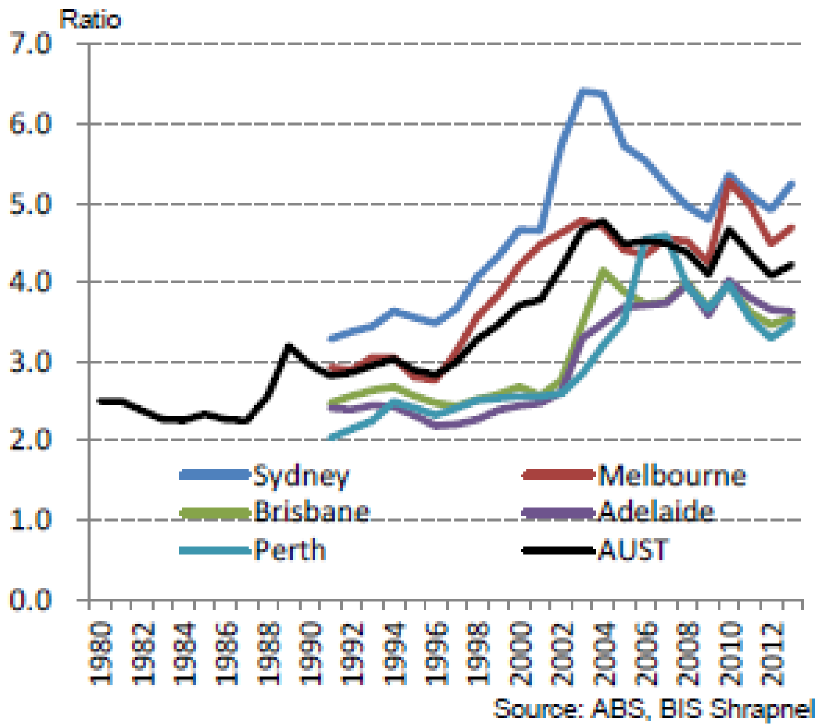
[3] ABS (2011) *Household Expenditure Survey*
[4] André, C. (2010) *A Bird's Eye View of OECD Housing Markets*, OECD Economics Department Working Papers, No. 746.
[5] RBA (2015) *Financial stability review* March 2015.
[6] AHURI (2014) *Submission to the Senate Economics References Committee's Inquiry into Affordable Housing in Australia*
[7] Yates (2013) *Supplementary submission to Senate Economics Committee Affordable Housing inquiry.*

From 2002-2012, average house prices rose by 92% for houses and 40% for flats, shutting many first home buyers out of the market.

Figure 1: House prices as a proportion of annual household after-tax income

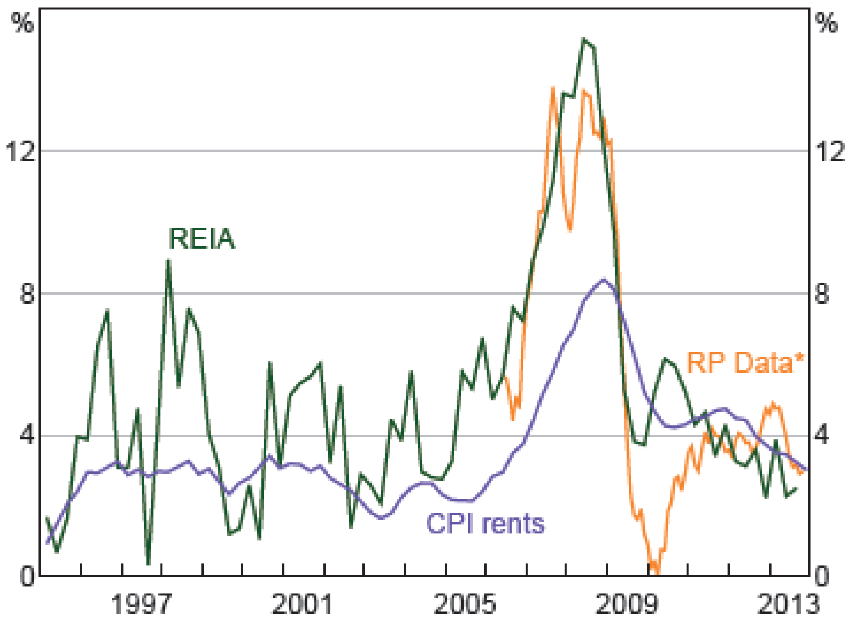


Source: BIS Shrapnel (2014) "Submission to Senate Economics Committee Affordable Housing inquiry."

At the same time, those who cannot afford to buy face escalating rents. From 2002-2012, average rents rose by 76% for houses and 92% for flats, well above inflation and wage and social security payment increases for most tenants.[8]

[8] Kelly (2013), "Renovating housing policy." Grattan Institute.

Figure 2: Annual growth in housing rents



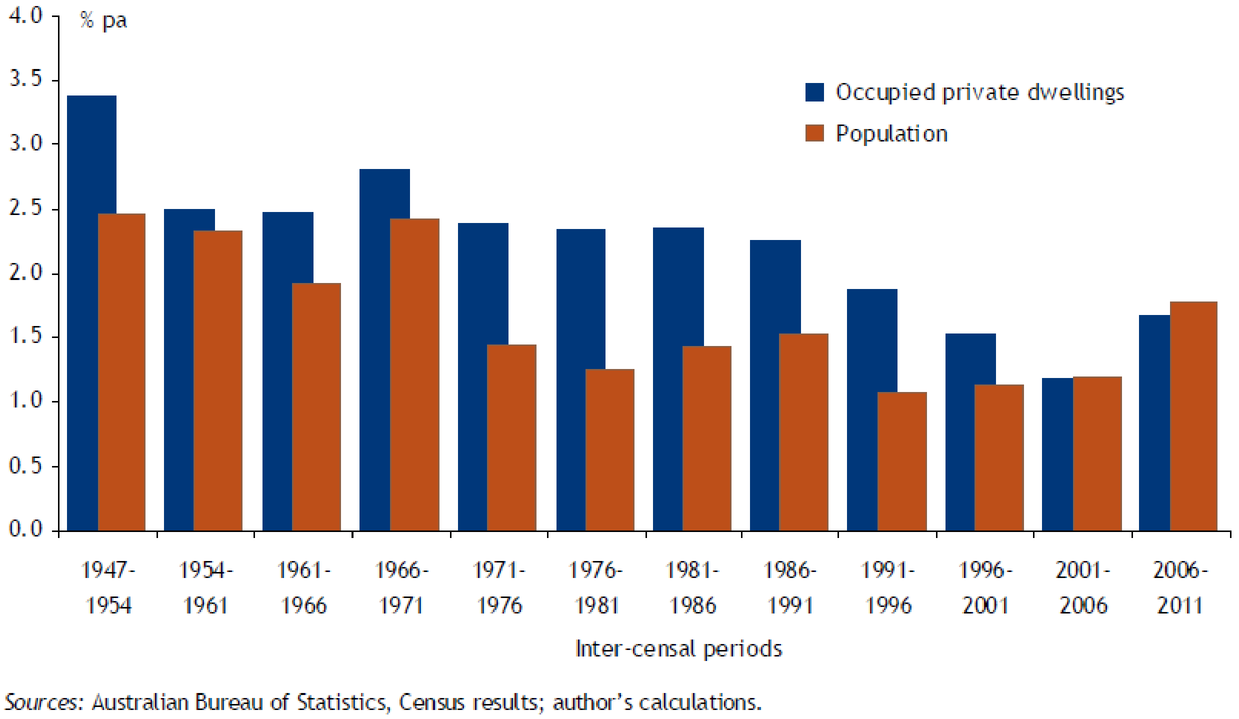
Source: RBA (2014),Submission to Senate Economics Committee Affordable Housing inquiry.

Causes of the crisis

In Australia we spend more on housing than most people in other countries. This is partly due to our historical preference for larger homes on bigger blocks. Yet we are still paying more than we need to for one of life's essentials and people on low incomes struggle to house themselves securely. The main reason for our high and rising housing costs is that demand for housing has outstripped supply. Most experts agree that the main causes of inflation in home prices and rents since the early 2000s are a combination of higher demand brought about by population growth, higher average incomes, easier access to credit, lower inflation, and public policies especially tax arrangements; together with inadequate growth in the supply of housing due to the concentration of our population in large cities, planning restrictions on new land releases and urban consolidation, and chronic under-investment in social housing by Governments.[9] This paper focusses on one of the factors under the direct control of the Australian Government: tax policy.

[9] RBA (2014) *Submission to Senate Economics Committee Affordable Housing inquiry.* Kelly (2013) *Renovating housing policy* Grattan Institute.

Figure 3: Demand for housing outstrips supply



Source: Eslake (2014), Submission to Senate Economics Committee Affordable Housing inquiry.

The tax system at both the federal and state level inflates housing costs, undermines affordability, and distorts the operation of housing markets. Tax settings are not the main reason for excessive growth in home prices, but they are an important part of the problem. They inflate demand for existing properties when the supply of new housing is insufficient to meet demand. Ironically, many public policies that are claimed to improve affordability - such as negative gearing arrangements, Capital Gains Tax breaks for investors, and first home owner grants for purchasers – make the problem worse.

The 'Henry' (Australia's Future Tax System) Review advocated major reforms to the tax system to improve the consistency of tax treatment of housing relative to other kinds of investment. [10]

This paper focusses on the tax treatment of investment property, especially Capital Gains Tax and negative gearing arrangements. It looks at:

+ The revenue costs of these tax concessions;
+ Who benefits from them;

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[10] Australia's Future Tax System review (2009) *Report into Australia's Future Tax System.*

+ Their impact on the housing market and the broader economy;
+ Proposals for reform.

These are not, of course, the only tax policies affecting housing affordability. Of the State Government taxes affecting housing markets, it is widely held that Stamp Duties on home purchases discourage people from moving, and that Land Tax – which in its pure form is an efficient tax – is underutilised by State Governments. Hence, the 'Henry Report' recommends that these Stamp Duties be replaced by a more broadly based Land Tax, and the ACT and South Australian Governments are pursuing this course of action.[11] In their present form, Land Taxes also discourage large-scale institutional investment in rental housing because the value of all of the properties held by an investor is taken into account when applying tax thresholds.[12]

2. Negative gearing and the Capital Gains Tax discount for investment properties

How do these tax breaks work?

Tax concessions for investment housing include a 50% discount off normal individual tax rates on capital gains together with so-called 'negative gearing' arrangements, which allow investors to deduct 'losses' made on rental property investments (including interest on loan re-payments) from other income (including wages).

Deductions can, of course, be claimed for losses on other kinds of investments and this would not normally be regarded as a 'tax concession'. The unique feature of 'negative gearing' for investments in assets such as property, shares, and agricultural schemes is that income from these investments often comes mainly from capital gains – the increase in the value of the asset over time. Under the Capital Gains Tax rules these are only taxed when the asset is sold, and then at half the marginal tax rate. Yet expenses associated with the investment (especially interest payments on loans) can be deducted from tax annually and often exceed rental income. The tax system treats this as a 'loss'. These 'losses' can be offset against other income that would otherwise be taxed at the full marginal rate (mainly wages).

In reality, in most cases the investment is not making a 'loss' because it is accruing capital gains. Otherwise there would be no point investing in these assets. If the tax system properly matched income and deductions, then either capital gains would be taxed each year at normal marginal tax

[11]Australia's Future Tax System review (2009), *op.cit.* SA Government (2015) *State tax review discussion paper* ACT Treasury (2012) *ACT taxation review*
[12] Wood, Ong & Winter (2012), "Stamp duties, land tax and housing affordability: the case for reform", 27 *Australian Tax Forum.*

rates or deductions for 'losses' could not be offset against other income until the capital gains are taxed on sale of the asset.[13]

Whenever deductions for investment expenses are not properly matched with income, there is always a risk that people will maximise 'losses' in order to avoid tax on their other income. This is achieved by structuring debt so that interest expenses on loans to purchase the asset exceed income from the investment such as rent, for instance by using more expensive 'interest only' loans (often with flexible interest re-payments so that investors can ensure their costs always exceed rental income), or by borrowing more to buy second and third properties as soon as the first one turns a 'profit'.

In recent years, since superannuation legislation was amended to allow it, investors have been encouraged to borrow to invest in rental property through self-managed Super funds. A major advantage of this strategy is that capital gains on the sale of assets in Super funds are normally free of tax.

Negative gearing is mainly used for rental property investment because housing is perceived to be a safe investment to borrow against, but it is also used to invest in agriculture (for example pine plantations), and shares ('leveraged equities').

The large-scale use of these tax schemes not only threatens public revenue and faith in the fairness of our tax system. It also reduces the efficiency of investment by encouraging people to invest with tax avoidance in mind rather than to achieve the best return at the least risk. It destabilises the economy by encouraging people to borrow more than they otherwise would and adding fuel to booms in asset prices – which are often followed by recessions. Given that most negatively geared investment is in rental property, these schemes impact especially on housing markets. They encourage borrowing to speculate on housing prices, rather than patient investment in housing to achieve the best long term rental yield.

How widespread is their use?

In the last year for which tax statistics are available (2011) two thirds of individual rental property investors – 1.2 million people - reported deductable losses of $14 billion. When those who reported profits from rental properties are included, taxpayers still claimed $8 billion in net rental losses overall in that year.

Both the overall number of rental property investors, and the proportion who are negatively geared, have risen dramatically since 2000, when tax rates on personal capital gains were halved.

[13] Taxing capital gains annually would require an annual valuation and could give rise to cash flow problems for investors.

Figure 4: Taxpayers with rental income

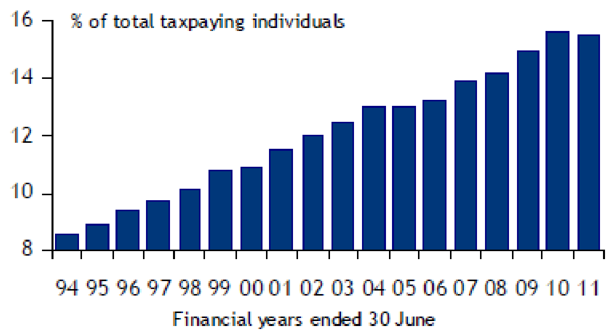


Figure 5: Loss-making landlords as percentage of total

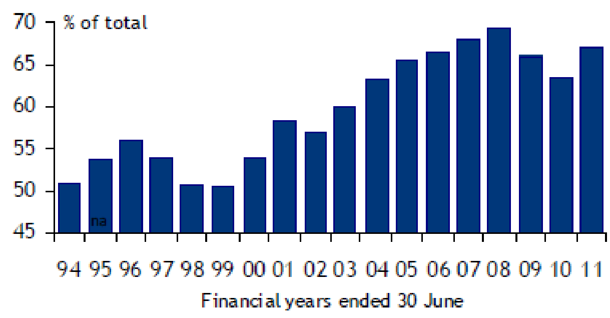
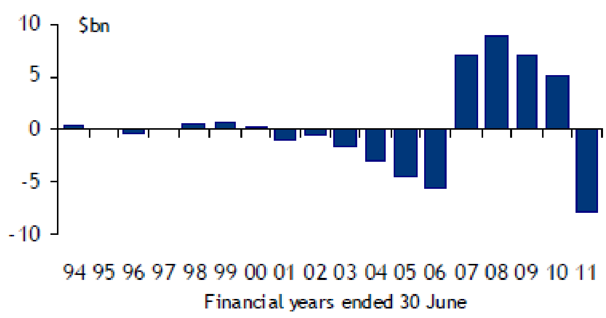


Figure 6: Net rental income



Source (figures 4-6): Eslake (2014) *Op.cit.*

What do they cost and who gains?

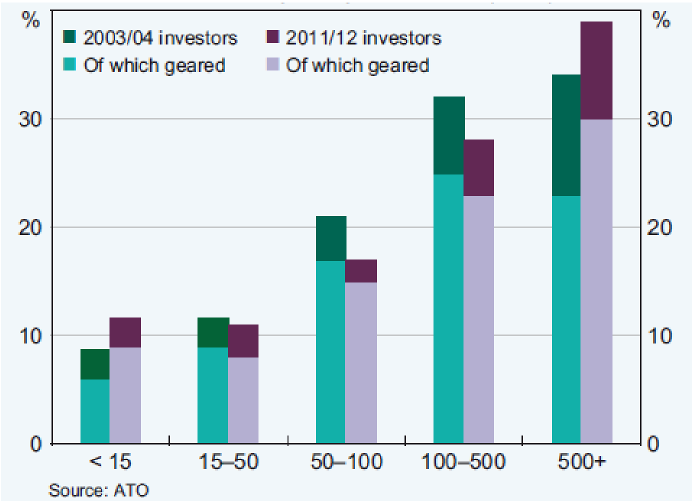
The Grattan Institute calculated that the cost of negative gearing concessions (compared to a regime in which deductions could only be claimed against income from the same investment) was $2 billion in 2011-12. The cost of the 50% discount on Capital Gains Tax for individual investors was $5 billion.[14]

There is a perception that negatively geared investors are mostly middle income earners – so called 'mum and dad investors'. This claim is usually based on the Tax Statistics data on individual taxpayers produced by the ATO. These data should be used with caution as they understate the incomes of negatively-geared rental property investors for the following reasons:

+ Taxpayers are divided according to taxable income, which is artificially reduced by tax deductions arising from negative gearing strategies;
+ Many property investors (especially those with higher incomes) control their investments through private trusts. They are listed in the tax statistics as recipients of trust income rather than direct property investors.

When the Reserve Bank compared investment in rental property by individual taxpayers at different levels of *total income* (rather than taxable income), they found that over half of all geared rental property investors earned over $100,000 (the top 10% of taxpayers in 2011) and 30% earned over $500,000.

Figure 7: Property investors, by total income (2011)

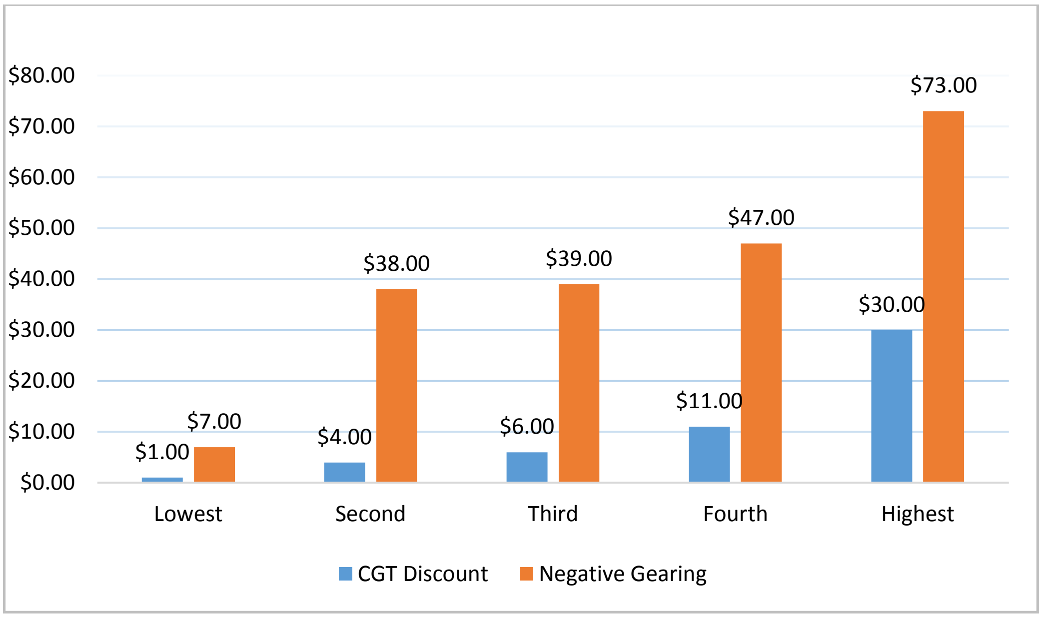


Source: RBA (2014) "Financial stability review, September 2014. Box C: Households' investment property exposures, evidence from tax and survey data."

[14] Kelly (2013) *Renovating housing policy* Grattan Institute. Kelly emphasises that these cost estimates are on the low side.

At the household level, the tax benefits of negative gearing and the Capital Gains Tax discount go mainly to those with high incomes. In 2006, households in the highest income quintile (top 20%) received an average benefit of $73 per week from negative gearing and $30 per week from the capital gains tax discount. When combined ($103 per week), this was twice the benefit received by the middle quintile ($45 per week) and over 12 times what the lowest income quintile receives (a combined eight dollars per week).

Figure 8: Which households benefit from the capital gains tax discount and negative gearing? (average $ benefit pw in 2006)



Source: Yates (2010) in Stewart 'Housing and Tax Policy'. Tax concessions by gross household income quintile, 2006. Weekly benefit from negative gearing is averaged over only those households with negative rental income. Sourced from Melbourne Institute HILDA survey.

More recent research by the Reserve Bank using HILDA data found that 60% of geared rental property investors in 2010 came from the top 20% of households by disposable income.[15]

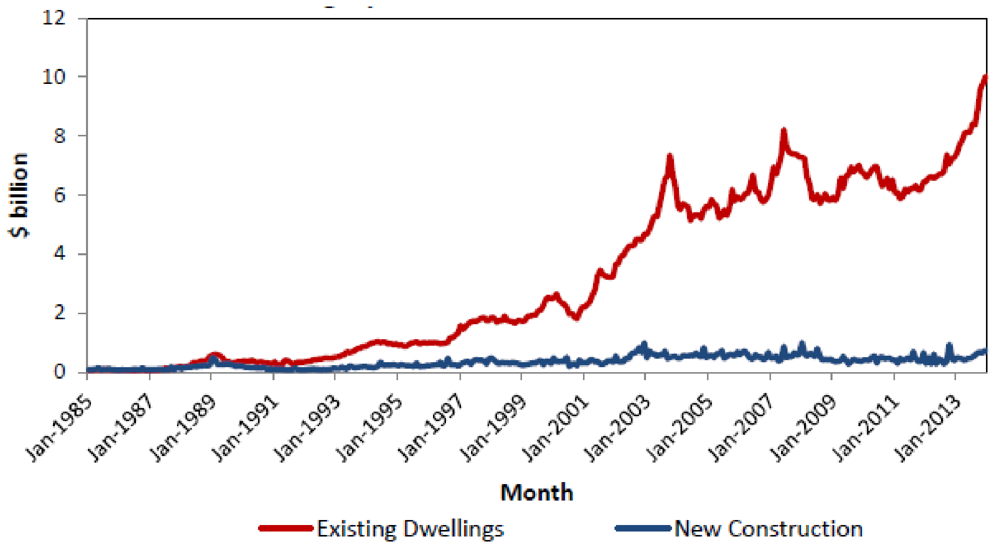
[15] RBA (2014) *Financial stability review, September 2014*. Box C: Households' investment property exposures, evidence from tax and survey data.

3. What is their impact on housing markets and the economy?

Housing impacts

Contrary to claims that 'negative gearing' encourages new investment in affordable housing, over 90% of investment in negatively geared housing stock is in existing properties.[16] This means that, along with other housing subsidies that mainly support the purchase of existing properties, they are more likely to inflate prices than make housing more affordable.

Figure 9: Lending commitments for investor housing ($ billions)

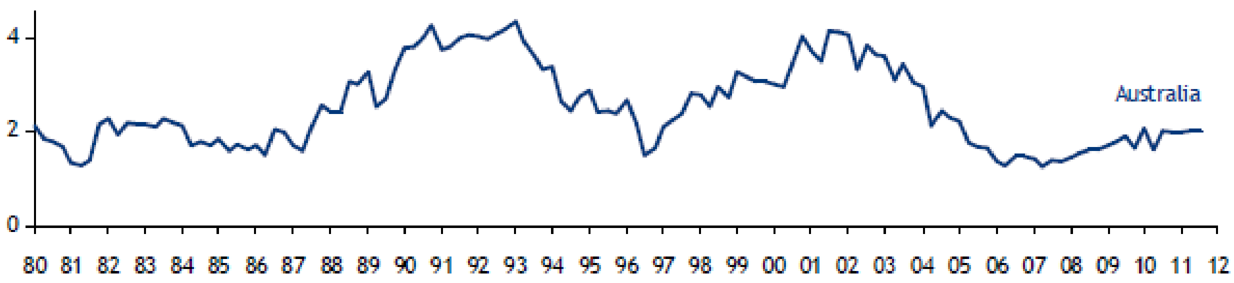


Source: Department of Social Services (2014), "Submission to Senate Economics Committee Affordable Housing inquiry."

For this and the other reasons listed earlier, including population growth, the boom in rental property investment from 1998 to 2004 (see graph above) did not increase rental vacancy rates, which fell from 2001 to 2007 (see graph below).

[16] Eslake, *Op Cit*

Figure 10: Rental vacancy rates



Source: Eslake (2014), "Submission to Senate Economics Committee Affordable Housing inquiry."

It has instead raised home prices, and also distorted the profile of investment properties and housing investors to the long-term disadvantage of low and middle income tenants.

(1) Current tax breaks for investor housing add fuel to housing price booms

Negative gearing and the Capital Gains Tax discount are not the only drivers of inflation in house prices and rents, but they have become a much more important factor as investors have purchased a growing share of dwellings.

It is sometimes argued that these tax arrangements cannot be a cause of the latest housing price boom because they have been in place for many years - across a number of 'housing cycles'. This does not mean that they had no influence on house prices. In its analysis of the causes of the last housing boom in the early 2000s, the Reserve Bank concluded that it was the *combination* of these long standing tax arrangements and easier access to credit that drove higher demand for properties among investors:

"there has always been a large number of investors who were keen to borrow to purchase rental properties. Traditionally, the rental income was a relatively small part of the attraction: prospective capital gains and the ability to negatively gear for tax effectiveness have always been the major incentives for this type of investment. While the public's desire to acquire investor housing was always strong, the extent to which it could actually be realised was limited by the availability of finance. Many lending institutions were not very interested in providing finance for investor housing, and the lending products available were often expensive, inconvenient or hard to acquire. Over the course of the 1990's, however, this progressively changed and the supply of finance increased markedly, making geared investment in rental properties available to a much wider cross-section of the public than formerly."[17]

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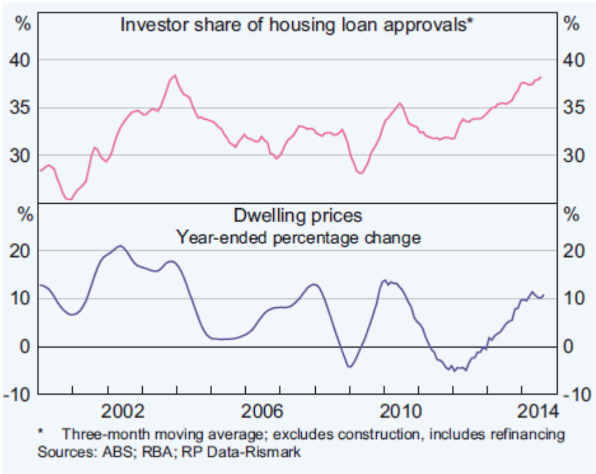
[17] RBA (2002) *Innovations in the Provision of Finance for Investor Housing*. RBA Bulletin December 2002.

There *was* a major change to the tax treatment of investment property in 2000. Tax rates on individual capital gains were halved, while retaining negative gearing arrangements. This made negative gearing much more attractive.[18] The effect of this change was not limited to rental property investment but in practice most investors who use negative gearing invest in housing because it is perceived to be less risky to gear into an investment in bricks and mortar.

As ACOSS warned at the time, instead of ushering in a new wave of investment in information technology as claimed at the time, the 50% Capital Gains Tax discount fuelled an old fashioned Australian property boom. Overall, between 2000 and 2013 lending commitments for investment housing rose by 230% compared with a rise of 165% in lending for owner occupied housing.

Longstanding tax policies such as negative gearing may not be the trigger for housing price booms but they *accentuate* their impact by encouraging investors to borrow more to punt on a further rise in prices. The tax treatment of housing pours fuel on the fire.[19] As in previous housing booms, the Reserve Bank is now concerned that: *speculative demand by investors may amplify the housing price cycle and increase the potential for prices to fall later on.*[20]

Figure 11: Rental property investment amplifies the housing cycle



Source: RBA (2014) "Financial stability review, September 2014. Box C: Households' investment property exposures, evidence from tax and survey data."

(2) Current tax breaks for investor housing skew the profile of investment in new housing towards inner city apartments

[18] Previously, capital gains were adjusted downwards for inflation before being taxed. The replacement of these arrangements with a 50% discount on marginal tax rates made negative gearing more attractive because it rewarded large short term gains. It also looked more generous on paper than inflation adjustment, making negative gearing schemes easier to market.

[19] Yates (2010) *Housing and Tax Policy*. in Stewart (2010) "Housing and Tax Policy."

[20] RBA (2015) *Financial stability review, March 2014*.

Negative gearing arrangements, together with the Capital Gains Tax concession, skew investment towards properties most likely to yield higher capital gains, which are located in more expensive areas.

Cities and regions are increasingly being polarised into inner city areas of rapid capital gain, and outer areas and nonmetropolitan regions of minimal or non-gain. Given the importance of capital gain in the investment decision, it is not surprising that there is insufficient new rental investment in such areas, with supply shortages as an outcome. Even the high rents relative to low levels of initial investment are insufficient to attract investment in such declining areas, with the result of increasing housing hardship, particularly for the many low income households. A related implication is the concentration of investment at the upper end of the market.[21]

To the extent that the rental property investment boom in the early 2000s drove new construction, it was concentrated in the inner city (such as Melbourne's docklands) and holiday resort apartments (such as the Gold Coast). This is of little benefit to people on low and middle incomes searching for affordable housing.

(3) They skew the profile of housing investors from institutions chasing rental returns to small investors chasing capital gains

These investor tax breaks also influence the profile of housing investors. They favour small investors over larger or institutional investors, and are one of the reasons that the rental property market in Australia, unlike many other wealthy countries, is dominated by small investors.

"The potential volatility of funding from individual investors and its observed failure to deliver affordable housing for lower income households highlights the need for a new source of funding less reliant on speculative motives."[22]

Institutional investors are more likely to focus on the longer term and on rental yields, and derive little or no benefit from negative gearing and Capital Gains Tax discounts (which are not available to businesses whose main activity is housing development). Negatively geared investors are twice as likely to sell within 12 months: *Negatively-geared investors are less likely to survive as investors because they are also more vulnerable to adverse shocks.*[23]

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[21] Burke (1999) *Private Rental in Australia.*

[22] Milligan V et al (2013) *Financing rental housing through institutional investment* AHURI final report No 202, p13.

[23] Wood & Ong (2010), p30.

Australia's over-reliance on small investors chasing quick capital gains to provide rental housing is one of the main reasons that tenancies in Australia are shorter and less stable than in other countries, with tenants facing a one in four chance of having to move within 12 months.[24]

Wider economic impacts

Negative gearing and Capital Gains Tax concessions for property investors also have two adverse impacts on the broader economy.

(1) Higher inflation and interest rates

First, by inflating asset prices during asset price booms they may prompt the Reserve Bank to set interest rates higher than would otherwise be the case. In action coordinated with the RBA, late last year APRA announced more restrictive guidelines on bank lending to housing investors, including the use of interest only loans.

Q: Why is there a threshold for growth in investor lending, not total housing credit?
A: There is currently very strong growth in lending to property investors, as highlighted by the Reserve Bank in its most recent Financial Stability Review (FSR). This is leading to imbalances in the housing market; the RBA noted in the Financial Services Review that 'the direct risks to financial institutions would increase if these high rates of lending growth persist, or increase further.[25]

ACOSS does not suggest that the housing boom in some cities has reached "market bubble" territory, but because the setting of interest rates is forward looking, even the strong risk of a 'bubble' can have an impact on interest rates.

Tax policy, interest rate policy and bank regulation are pushing in opposite directions. Negative gearing arrangements are adding fuel to the fire, the RBA and APRA are trying hard to put it out.

(2) Higher household debt levels

Australia's most worrying debt problem is not public or corporate debt but household debt. Our household debt levels are among the highest in the OECD. This could aggravate any future economic downturn. Right now it is discouraging many households from spending more as they give priority to reducing debt. This is retarding economic growth:

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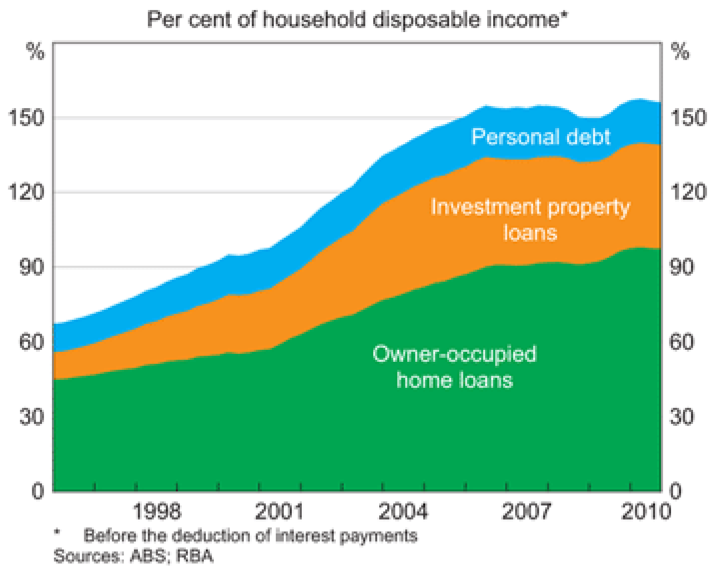
24 Wood & Ong (2010), *Factors shaping the decision to become a landlord and retain rental investments* AHURI Final Report No 142; AHURI Evidence Review 45 (2013), *What motivates landlords to invest or sell up?* at http://www.ahuri.edu.au/housing_information/review/evrev045
25 APRA (2014) *Media release: APRA outlines further steps to reinforce sound residential mortgage lending practices* at http://www.apra.gov.au/MediaReleases/Pages/14_30.aspx

"the transmission of the monetary stimulus does seem to have been different in this episode: economic activity and inflation appear not to have responded as they have in the past. Perhaps the single most important factor explaining this is the very high levels of debt that exist in many advanced economies,"[26]

The steep rise in household debt during the early 2000s came mainly from borrowing to invest in property: *The run-up in household debt is largely accounted for by strong growth in housing-secured borrowing, with investment property loans increasing particularly rapidly in the early 2000s.*[27]

Figure 12: Household debt



Source: Connolly & McGregor (2011), "Household Borrowing Behaviour: Evidence from HILDA." RBA Bulletin March 2011.

Negative gearing arrangements have contributed to this rise in debt for rental property investment, since they both enable and encourage investors to borrow more: *Because interest expenses on investment property are tax-deductible, investors have stronger incentives than owner-occupiers to take out interest-only loans.*[28]

The final report of the Financial System Inquiry raised serious concerns about the impacts of housing tax concessions on the health and stability of the financial system:

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[26]Lowe P, RBA speech

[27]Connolly & McGregor (2011), *Household Borrowing Behaviour: Evidence from HILDA*" RBA Bulletin March 2011. http://www.rba.gov.au/publications/bulletin/2011/mar/2.html

[28] RBA (2014) *Financial stability review, September 2014. Box C:Households* investment property exposures, evidence from tax and survey data."

"The tax treatment of investor housing, in particular, tends to encourage leveraged and speculative investment. Since the Wallis Inquiry, higher housing debt has been accompanied by lenders having a greater exposure to mortgages. Housing is a potential source of systemic risk for the financial system and the economy."[29]

4. What should be done?

Reducing the tax bias towards capital gains: The 'Henry Report' proposals

One way to reduce the tax bias in favour of investment in assets such as housing and shares would be to reduce or eliminate the 50% tax discount for personal capital gains. The 'Henry Report' advocated reducing this discount to 40% to bring the tax treatment of capital gains into closer alignment with other investments such as bank accounts. Importantly, income from housing rents (which is currently taxed at standard marginal rates) would also attract the proposed 40% discount.[30] This would also improve equity since two thirds of capital gains are received by the top 10% of taxpayers and they only pay tax on this income at the rate of 22.5%, compared with the top marginal tax rate of 45%.[31]

If this proposed reduction in the Capital Gains Tax discount was implemented, there would still be a 'mis-match' between the tax treatment of investment income and deductions against wages and other income (which is normally taxed at the *full* marginal tax rate).

To resolve this problem the Henry Report proposed that only 60% of any losses on investment assets such as rental housing can be claimed, which is consistent with its proposed 40% discount for Capital Gains Tax (100% - 40%).

Restricting deductions for investment expenses

Even if the 50% discount for capital gains was removed entirely there would still be a tax advantage in borrowing to invest in assets such as housing that mainly yield capital gains, since capital gains are only taxed once the asset is sold, while deductions can be claimed every year in the meantime. This 'timing advantage' is very important.

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[29] Financial System Inquiry, *Appendix 2, Tax Summary*, available at: http://fsi.gov.au/publications/final-report/appendix-2/.

[30] It is worth noting that there is no Capital Gains Tax discount for companies or for 'active investors' whose main business is real estate investment.

[31] Australia's Future Tax System Review (2008) *Architecture of the Australian tax transfer system*

To resolve this problem (as well as the 'mis-match' of taxes on income and deductions discussed above) many countries including the United States 'quarantine' expenses relating to investments in assets yielding capital gains (such as property and shares) so that they can only be deducted against income from the same class of investment. Where investments are 'negatively geared', this would mean that expenses cannot be offset against other income (such as wages) and can only be fully claimed once a property is sold.

Table 1: Negative gearing for investment housing: an international comparison

Country	Is negative gearing allowed?
Australia	Yes
New Zealand	Yes
Japan	No
United Kingdom	No
Netherlands	No
United States	Restricted
Canada	Restricted
Sweden	Restricted
Germany	Restricted
France	Restricted

Source: O'Donnell (2005), "Quarantining Interest Deductions For Negatively Geared Rental Property Investments. EJournal of Tax Policy 2005/4.
http://www.austlii.edu.au/au/journals/eJTR/2005/4.html#Heading447
Note: Updated for policy changes in Japan which no longer allows deductions for negatively geared investments in housing. New Zealand does not have a Capital Gains Tax.

This is a deferral, not a denial of deductions for investment expenses. The Australian tax system already 'quarantines' losses in other circumstances where investment income is taxed concessionally and unlimited deductions pose a serious risk to the integrity of the tax system, including:

+ quarantining of capital losses against capital gains,
+ quarantining of trust losses within a discretionary trust,
+ quarantining of some active business losses.

Similar quarantining rules have applied for many years to income tests for social security payments such as pensions, allowances and Family Tax Benefits. That is, annual losses from rental property investment cannot be used to reduce the total income that is taken into account for income test purposes.[32]

The Reserve Bank on negative gearing

"The most sensible area to look for moderation of [housing] demand is among investors. While it is not for the Bank to make specific recommendations for changes to the tax system, the work undertaken in preparing this submission has highlighted a number of areas in which the taxation treatment in Australia is more favourable to investors than is the case in other countries. In particular, the following areas appear worthy of further study by the Productivity Commission:
i. the ability to negatively gear an investment property when there is little prospect of the property being cash-flow positive for many years;
ii. the benefit that investors receive by virtue of the fact that when property depreciation allowances are "clawed back" through the capital gains tax, the rate of tax is lower than the rate that applied when depreciation was allowed in the first place.
iii. the general treatment of property depreciation, including the ability to claim depreciation on loss-making investments."[33]

The 'myth of 1985'

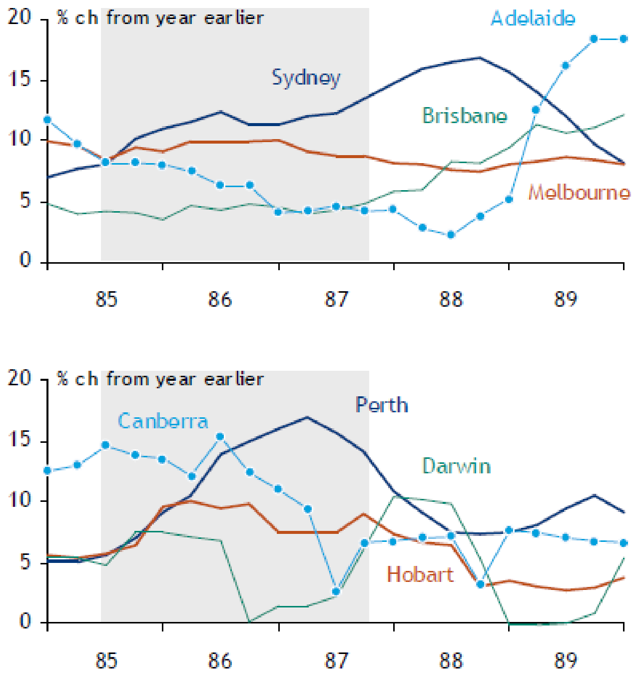
A 'quarantining approach' was adopted by the Hawke Government in 1985 when it effectively 'abolished negative gearing' for rental property investments. For two years after the announcement of the policy, expenses related to rental property investments could not be claimed against income from other sources such as wages. In return for this restriction on deductions, a depreciation allowance was introduced to encourage investment in new rental housing. Existing investments were not affected.

A mythology has grown around the impact of this policy on rental property investment in the late 1980s. It is claimed that the 'abolition' of negative gearing directly led to a rental housing investment 'strike' and that this was the reason the policy was reversed. In fact, a major reason for the policy reversal was political: property lobbyists threatened to campaign against the then New South Wales State Government in a forthcoming election. It is possible that this campaign convinced some property investors in Sydney that it was no longer worthwhile investing in housing – a self-fulfilling prophecy.

[32] DSS, Guide to Social Security Law.
[33] Reserve Bank (2003) *Submission to Productivity Commission inquiry into first home ownership*

In reality, the housing investment 'slump' was restricted to Sydney and Perth, two property markets that were already 'over-heated' at the time that negative gearing was restricted. Nationally, investment in rental property continued to increase with the total value of lending to rental property investors rising by 42% over the period that negative arrangements stopped.[34]

Figure 13": The 'abolition' of negative gearing: rents only rose in two cities



Source: Eslake (2014), "Submission to Senate Economics Committee Affordable Housing inquiry
Note: Annual increase in median rents. Shaded area was the period during which negative gearing was not available.

Apart from the effects of the 'normal' housing cycle in markets that were overheated, the main causes of the property investment slump in Sydney and Perth were higher interest rates (partly designed to prevent a housing investment 'bubble') and the share-market boom of the mid 2000s (which diverted investment from housing).[35] After the share-market crash of 1987, and the easing of interest rates in its wake, housing investment boomed. The 'restoration' of negative gearing is likely to have added froth to this speculative boom which inflated house prices and triggered a steep rise in interest rates, which led in turn to the worst recession since the 1930s.[36]

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[34] Source: RP Data http://blog.corelogic.com.au/2012/12/negative-gearing-and-its-impact-on-the-housing-market/

[35] Badcock & Browett (1991) *The responsiveness of the private rental sector in Australia to changes in Commonwealth taxation policy*, Housing Studies, vol. 6, no. 3.

[36] MacFarlane (1989) *Money, credit and the demand for debt* RBA Bulletin May 1989.

Improving on past policies

In retrospect, the main weaknesses of the 1986 'quarantining' policy were that it was introduced at a time when the housing market was about to deflate of its own accord, and that only rental property investment was targeted (when 'negative gearing' strategies also apply to investment in other assets yielding capital gains such as shares and agricultural investments).

Otherwise, it was a sensible policy response to a serious flaw in the tax system that distorts the operation of housing and other investment markets. Restricting deductions for negatively geared investments to income from the same asset or class of assets is a more comprehensive solution to the problem than other options considered in the past such as limiting 'negative gearing' to investment in the construction of new housing. While these proposals would redirect investment to new housing and ease inflation in home prices, they would not remove the structural flaw in the tax treatment of different investments: the bias in favour of borrowing to invest in assets yielding capital gains, including rental property, shares and agricultural schemes.

There is also a strong case for tackling this problem directly by reducing the inequitable and investment-distorting 50% discount for capital gains. This would best be done as part of a wider realignment of tax rates for different investments - including a reduction in tax rates on rental income as the 'Henry Report' proposes. This could be done in conjunction with 'quarantining' rules to remove the 'timing advantage' discussed above.

These measures should be introduced in conjunction with more efficient tax incentives for investment in new housing, especially affordable housing. The National Rental Affordability Scheme (NRAS), which provides tax credits for such investment, is being wound down before its impact on affordable housing investment can be properly assessed. This is a mistake. Special emphasis should be placed on incentives for long-term institutional investment in housing.[37]

This policy package would be 'pro' not 'anti' housing investment. Investment would be redirected from where it is harming housing affordability towards where it is most needed: the construction of new affordable dwellings.

At the State level, the replacement of Stamp Duties on housing purchases with a broadly based Land Tax (as advocated by the Henry Report) and reforms to Land Tax on rental properties to encourage investment in multiple properties, should be considered.

Policies that strengthen housing supply, including direct public investment in social and community housing and reform of planning laws should also be pursued.[38]

[37] Milligan et al (2013) *Financing rental housing through institutional investment* AHURI final report No 202,

[38] ACOSS, Community Housing Federation of Australia, National Association for Tenants Organisations, and National Shelter (2015) *An affordable housing reform agenda, goals and directions for reform*

These tax and housing reforms would improve housing affordability for tenants on low incomes, ease barriers to first home ownership, and improve the fairness of the tax system as well as the efficiency of investment. It would be good for people struggling to find decent and affordable housing and good for the economy as well.

Attachment

Modelling of Henry Report reforms of the taxation of investor housing

The Henry Report proposes that the tax discount for personal capital gains be reduced from 50% to 40% and for the same discount to extend to other investment income including bank interest and housing rents. For consistency, only 60% (100% - 40%) of expenses on these investment assets (including rental housing) could be claimed as tax deductions.

The impact of this is proposal on housing markets, and particularly rent levels was modelled in two published studies.

Independent Economics:
Independent Economics modelled the impact of these reforms for the Housing Industry Association. They found that they would reduce rental property investment and *increase* rent levels.

The modelling appears to follow the following logic:
- that housing is taxed more heavily than other investment asset classes;
- that the policy changes are equivalent to *an increase in net tax on housing services of $1.4 billion in 2012-13 terms."*[39]
- that this would reduce housing investment;
- that housing supply would respond quickly and in full to such a reduction;
- rents would therefore increase.

These assumptions are questionable. Both owner occupied and investor housing is concessionally taxed compared with most alternative investments. Most of the investment prompted by the CGT discount and negative gearing is in existing properties. Housing supply is unlikely to be as responsive as assumed to changes in investment levels. Further, it is not clear whether the study took account of the proposed new tax discount for income from housing rents.

Wood, Ong & McMurray
Wood and colleagues modelled the impact of these changes on rental property investment and rent levels and found that they would *increase* investment in rental housing and *reduce* rents since the impact of the new tax discount for 'positively geared' rental property investors would outweigh the effect of reduced tax benefits for negatively geared investors.[40] They concluded that in the long run rents would fall by an average of $300 a year and that *"a flight of investors from private rental housing seems unlikely."*

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[39] Independent Economics (2014) *Economic Impacts of Negative Gearing of Residential Property* Report for the Housing Industry Association, p14.
[40]Wood, Ong & McMurray (2011) *The impacts of the Henry Review recommendations on the private rental market - Savings income discount and rent assistance* AHURI Final Report No. 175.