Negative gearing for housing investments

In 2008-09 Australia spent $4.6 billion on negative gearing, a sum of money that could have been used for many other useful purposes, including the provision of more affordable housing.

How negative gearing works

The Australian Taxation Office describes negative gearing in the following terms:

> *A rental property is negatively geared if it is purchased with the assistance of borrowed funds and the net rental income, after deducting other expenses, is less than the interest on the borrowings* (ATO, 2011).

Put simply, if the rent does not cover your interest and other costs you can deduct the excess interest costs against other income to generate a tax credit. In that way other taxpayers help the property investor meet the costs. In the meantime the investor is waiting on the lucrative capital gains that have been associated with residential investments.

Since the costs of producing an income are generally deductable against the taxpayers income, the taxpayer with a negatively geared property can effectively offset some of the interest expense against her other income. In other words the taxpayer makes a loss on property but that loss is tax-deductible against other income, including ordinary wages and salaries. Such losses are also tax-deductable in Canada and New Zealand.

Why would anyone go into a business deal that is expected to make a loss? Generally property investors know that their rental returns are going to fall short of their operating and funding costs but they expect property values will increase sufficiently so that their income losses will be more than offset by their capital gains when they eventually sell the property.

This type of gearing is more favourable to the taxpayer the higher the income of the taxpayer. For example, take a taxpayer with excess interest expenses of $10,000. A taxpayer on a marginal tax rate of 15 cents in the dollar could use that as a loss and so reduce tax by $1,500. But a taxpayer on the highest tax bracket pays 45 cents in the dollar. That taxpayer can reduce tax by $4,500. So the benefits of gearing are higher the higher the relevant tax rate. Since the tax rate is higher for higher income earners, the strategy favours higher income earners (Valentine, 2007).

The ANZ bank currently advertises in the following terms:

> *If you've got money to invest, an option you may consider is negative gearing.*
>
> *With correct financial advice and with the selection of the right property, negative gearing may be a tax efficient investment strategy. That's great if you're thinking about entering the property investment market for the first time or want to increase your investment portfolio* (ANZ Bank, 2011).

While it is uncontroversial for business to offset losses in one part of their business with income in another part, negative gearing in relation to property it is controversial for two reasons. First there is the suggestion that it is implicated in driving housing prices higher than they otherwise would have been. Second, it is seen as a way through which other taxpayers are subsidising property investors. These and related points are taken up below.

The value of negative gearing

Taxation Office figures show that in 2008-09 there were 2.351 million personal taxpayers who claimed loan interest expenses of $18.90 billion relating to their property expenses on rental income properties. Interest expenses are 60 per cent of all the property expenses claimed by property owners, the next highest being council rates at $1.90 billion (Australian Taxation Office, 2011). Overall, property expenses reported to the tax office are $6.5 billion more than the rental income declared. However, many property investors who claim interest expenses would not be engaged in negative gearing. For example, people who rent out properties purchased many years ago would be earning modern rents but paying small interest expenses on old loans. Saul Eslake has estimated the cost of negative gearing at between $4.8 to 5 billion (2011). This estimate is consistent with that of Schwab (2011) who estimated the value of negative gearing tax concessions to be around $4 billion for 2008-09

History

Traditionally taxpayers have been allowed to negatively gear their investment properties. However, in 1983 the Victorian Deputy Commissioner of Taxation briefly denied Victorian real estate investors the deduction for interest in excess of the rental income. However that approach was quickly over-ruled by the federal tax commissioner (see Hanegbi, 2002).

Following the tax summit in July 1985 the Hawke/Keating government disallowed negative gearing interest expenses on properties bought after 17 July 1985. It meant that taxpayers could only offset interest expenses against rental income. It was no longer possible to obtain a tax deduction for that part of the interest expense that exceeded the net income from properties (that is rent less other expenses such as rates, maintenance, etc.). The left over interest costs could not be offset against other income. However, it could be carried forward to offset property income in later years.

Paul Keating, then Treasurer, made it clear that negative gearing did not necessarily encourage more investment when he said

> The Leader of the Opposition would allow all the high income earners to run interest costs against their income, swapping flats on Bondi Beach which were built 40 years ago. That is not adding to the stock of housing or to the stock of rental accommodation, it is not really assisting families who need rental accommodation.

By contrast he pointed out that:

> we have wiped out that outrageous rort and introduced accelerated depreciation for new buildings or major renovations in order to create more rental property and more opportunities for renters (Keating, 1985).

The Hawke government also felt that negative gearing was responsible for higher real estate prices with Minister Assisting the Treasurer and Minister for Immigration and Ethnic Affairs, Chris Hurford, stating:

> Competition for the purchase of residential property between these investors has been reflected in increased prices to the detriment of ordinary homebuyers (cited in Hanegbi, 2002).

The impact of restrictions on negative gearing, along with the new capital gains tax regime introduced in September 1985[1], generated fierce opposition from investment property owners. The political impact was perhaps inevitable.

Following the 1985 initiatives there were large increases in rents in parts of Sydney in particular and there were claims that the price increases resulted from the denial of negative gearing. However, the fact that the increases were confined to Sydney seems to suggest special factors other than the restrictions on negative gearing were to blame.

Nevertheless the result was that following the intense lobbying and the degree of concern with Sydney house prices the government reversed its decision and restored negative gearing under the old rules in September 1987. The lobbyists had claimed that the limits on negative gearing were responsible for a slowdown in the construction of dwellings. The government was able to make the excuse that it was possible to restore negative gearing because the government had reformed the tax system, especially with the introduction of the capital gains tax.

In addition to the changes in negative gearing and capital gains taxation, the depreciation allowance on residential building for property investors is also relevant when considering the support provided by the community to those with investment properties. Included among the allowable deductions is a depreciation allowance of 2½ per cent on new buildings. This had been introduced at 4 per cent in 1985 when the scope of negative gearing was reduced by quarantining the interest cost offset to rental income. The rate was lowered to 2½ per cent in 1987 when the quarantining was removed and full negative gearing restored. It could be argued that houses are an appreciating rather than depreciating asset, or that 2½ per cent overstates any physical depreciation (ie that the average house will last more than forty years) (Senate Select Committee on Housing Affordability in Australia, 2008).

[1] The capital gains tax quarantined all investments made before 1985, capital gains on assets purchased after that were included in assessable income.

The link between capital gains tax and negative gearing

While there is much discussion of negative gearing in the Australian tax reform debate the underlying problem is that capital gains are only lightly taxed. It is the light tax treatment of capital gains which in turn ensures that investors are encouraged into strategies that make losses in the short term but generate long run capital gains.

That is, for a negatively geared property the vast majority of the return to the investor (who has, by definition, been incurring operating losses) most of the returns to residential investment come in the form of capital gains. Even before John Howard introduced a 50 per cent discount for tax paid on income from capital gains the Australian tax system was highly concessional. For example,

- Capital gains were only taxed on realisation. While that may have made sense on practical grounds it did mean that the government was effectively giving an interest-free loan to the taxpayer.
- More importantly the capital gains tax applied only to the inflation-adjusted gain yet the full interest payments were deductable, even though a large fraction of the interest payments just cover the inflation loss the lender would have otherwise incurred.

Arguably it is the concessions granted to income from capital gains tax that is the underlying driver of the growth in negative gearing in Australia. To that extent, limits on negative gearing have the potential to correct for the bias in the tax system that encourage investors to over-invest in rental property.

So long as capital gains are taxed more lightly than cash flows then there is a distortion in the system which seems to have the worst effects when it comes to property investment. Any reduction in the rate of the capital gains tax increases the incentive to over-invest in assets that yield most their income as capital gains (Fane and Richardson, 2005). At the moment realised capital gains are taxed at half the rate of other income which provides an incentive to:

- invest in assets that earn capital rather than ordinary incomes, and
- to disguise labour and other income to look like capital gains (L Burman and D White, 2010).

Any gearing of an asset is only useful if the return on the asset (capital gain and other investment income) exceeds the after-tax cost of borrowing. And that is more likely the higher the relevant tax rate. In other words and as we noted above, since the tax rate is higher for higher income earners, the strategy favours higher income earners (Valentine, 2007).

The impact of negative gearing on housing affordability

There is a strong argument to the effect that rather than necessarily increasing the supply of real estate negative gearing has the effect of increasing the prices of existing real estate. According to Eslake

[negative gearing] does nothing to increase the supply of housing, since the vast majority of landlords buy established properties. Precisely for that reason, it contributes to upward pressure on the prices of established dwellings, thereby diminishing housing affordability for would-be home buyers… The revenue forgone through negative gearing could alternatively be used to build nearly 20,000 new ''affordable'' homes each year, making substantial inroads into the massive shortage of affordable housing(Eslake, 2011).

Hanegbi makes the point that since negative gearing has the effect of increasing prices then it tends to redistribute wealth towards those who own real estate and away from those that do not.[2] That of course favours the already wealthy at the expense of the already poor. That has the effect of worsening the distribution of wealth and resources in Australia.

Furthermore, investors are more likely to want to invest in the inner city areas, buying up old stock, as Keating put it 'swapping flats on Bondi beach'. That does nothing to increase the supply of inner city rental accommodation but increases all property prices. As property prices increase so do rents. By increasing house prices negative gearing also slows down the purchase of houses by owner-occupiers and many of the latter are forced to remain in the rental market for longer.

Of course any tax concession to higher income earners makes the income tax system less fair and negative gearing, in the context of lightly taxed capital gains has to be rated as one of the major inequities in the system.

Despite the views of Eslake and Hangebi some participants in the Australian tax reform debate have put the argument that negative gearing, to the extent that it increases the supply of housing may have the effect of reducing the market price of rents. While there is little empirical evidence to support such a conclusion it is important to note that there are of course much more direct ways of encouraging new housing stock if that is the aim of policy. That is, if the goal of government is to increase the stock of affordable housing then it is highly unlikely that the direct investment of $5 billion per year towards that end would not achieve more noticeable results.

Overall it would seem that the impact of negative gearing is unlikely to add much to the rental housing stock but is likely to have a fairly strong impact on prices and rents.

[2] R Nanegbi (2002) 'Negative gearing: Future directions', *Deakin Law Review*, vol 7, 349-65.

Policy options for reform

On Saul Eslake's figures a policy of denying negative gearing would generate revenue of around $4.8 billion, but as Julian Disney has pointed out:

> *It would be political suicide to …* [limit negative gearing] *tomorrow and not as part of a broader package. We've got an upside down and back-to-front tax system. It's more generous to rich people and others and it hurts you when you're trying to get into the market … [you're] young and [you're] likely to have children. [the tax system] doesn't expect you to contribute in the way that you could, especially when you enjoy windfall gains(ABC Lateline, 2008).*

There are a range of ways in which the Australian tax system could be reformed in order to both increase the equity of the tax system and boost the stock of affordable housing.

1) Rather than simply ban all negative gearing it would be possible to grandfather existing property arrangements but limit future access to negative gearing on subsequent transactions so that second hand purchases of property would no longer be eligible. That would limit negative gearing to newly constructed residential units which would help to ensure that policy was driving additions to the stock of Australian housing rather than driving additions to the price of the existing housing stock.

2) It would be possible to introduce a limit of, for example, one negatively geared property per investor and perhaps with a maximum permitted deductible loss on property. Those who already own investment properties would be prevented from negatively gearing any additional properties.

3) Restoring the tax on capital gains to 100 per cent of the gain (excluding gains on the family home) would have boosted tax revenue by $5490 million in 2010-11 (ATO, 2011, Taxation Statistics). The Howard government provided no strong rationale for its decision to tax only half of the value of capital gains.

4) Alternatively, the capital gains tax concession could be reduced from 50 per cent to 40 per cent, or lower. Every 10 per cent reduction in the capital gains tax concession would raise around $1 billion per year which could be invested in direct or indirect support for affordable housing.

5) The tax benefits of negative gearing could be both reduced, and made more equitable, by reducing the proportion of negative gearing losses that are deductible against other income as other income rises. Such an approach would ensure that the tax benefits of negatively gearing a property would be similar for someone earning $60,000 and someone earning $200,000 per annum. At present, the higher a person's income the greater the tax advantages associated with purchasing an investment property.

Incidentally, option 4 is consistent with the Henry Review[3] which recommended a discount of 40 per cent on the tax applying to capital gains on investment housing. However, that recommendation was included in a complex package that involved similar discounts to apply to other individual investments and any associated interest deductions but would also involve changes to the rent assistance arrangements applying to low income earners. The Henry Review also suggested that the land tax system should apply to *all* land and tax more valuable land at a higher rate.

Expanding NRAS

Another possibility is the expansion of the National Rental Affordability Scheme, both the numbers involved as well as perhaps extending it to smaller development projects. At the moment the Commonwealth is planning to cease funding for the Housing Affordability Fund in 2012-13. Such measures directly contribute to the rental housing stock and so should help to address the high rents in the major cities.

[3] *Australia's future tax system*, December 2009

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