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Switching Gears

Reforming negative gearing to solve our housing affordability crisis

JUNE 2015

Background

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The McKell Institute is an independent, not-for-profit, public policy institute dedicated to developing practical policy ideas and contributing to public debate. The McKell Institute takes its name from New South Wales' wartime Premier and Governor–General of Australia, William McKell.

William McKell made a powerful contribution to both New South Wales and Australian society through significant social, economic and environmental reforms

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His research has been featured in press articles in such outlets as: The New York Times, The Financial Times, the New Republic, and the Daily Kos.

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Foreword

Three years ago, The McKell Institute's first report: Homes For All, highlighted the problems of negatively geared housing assets and non-taxed capital gains.

Since then it has become apparent that Australia's treatment of taxation on investment properties is among the most generous in the world.

Given the growing crisis faced by first home buyers and also the long term budgetary challenges outlined by the Intergenerational Report, it is appropriate that negative gearing is once again back in the spotlight.

Previous estimates have put the cost of negative gearing at approximately $4 billion a year, indicating significant long term savings to be made if the policy was to be abandoned altogether.

However, this is not the first time that negative gearing has been abolished, with the Hawke/Keating government quarantining the concession in 1985 before reinstating it in 1987 following substantial political pressure.

There is a significant amount of debate surrounding the potential impacts that would flow from an outright abolition of negative gearing, with industry sector participants warning full abolition will drive up rents and disadvantage low income households. In addition, Australia's 1.8 million property investors are unlikely to respond with enthusiasm towards any reform that threatens their wealth and retirement security. Australians have been encouraged by successive governments to make long-term investments based on a nearly 20 year-old policy endorsed by both major political parties.

This report attempts to break the current political impasse by provide a range of politically pragmatic proposals that would reform negative gearing without abolishing it outright. In each of these scenarios, existing investors are quarantined, with negative gearing only partially restricted.

In addition, this report has also attempted to identify opportunities that would restructure negative gearing in a way that allows tax expenditure to be more directly targeted towards the creation of new housing supply. Such reforms would help tackle Australia's housing affordability issues while also delivering a notable improvement in the federal budget.

The Hon John Watkins
CHAIR,
MCKELL INSTITUTE

Sam Crosby
EXECUTIVE DIRECTOR,
MCKELL INSTITUTE

Executive Summary

The report considers five different policy options that span the spectrum from the status quo to immediate abolition of negative gearing.

The most economically appealing option is to allow negative gearing for properties that are currently negatively geared ("grandfathering") but allow new negative gearing only for new construction (Scenario 4 in the report). This reform has many appealing features.

First, it allays all reasonable concerns about the treatment of current investors, removes any concerns of "fire sales", and would place no upward pressure on rental rates. Second, it addresses the fundamental issue with housing affordability and availability in Australia: inadequate housing supply. Allowing negative gearing only for new construction would provide powerful incentives for increased housing supply. This would have multiple benefits in the housing market: (i) greater price stability, (ii) increased access for new entrants, (iii) lower rental rates, and (iv) provide a boost in residential construction with an associated boost to employment, economic growth, and taxation revenues.

Options for Reform Summarised

This report considers five policy options for negative gearing, ranging from the status quo to immediate abolition of the current system.

SCENARIO 1:

Business as usual: Under this scenario all current provisions relating to negative gearing would be retained. This is the most expensive option and demonstrates why action is urgently needed. The cumulative tax expenditure over 10 years would be approximately $51 billion.

SCENARIO 2:

Grandfather existing negatively geared properties: Under this scenario existing investors taking advantage of negative gearing would be allowed to continue to do so for the existing properties they own. Newly purchased rental properties would not be permitted to use negative gearing, but would be allowed to use so-called "positive gearing". Over 10 years the cumulative budget impact is between $19.3 billion and $38.7 billion.

SCENARIO 3:

Grandfather existing negatively geared properties plus new participants have access to negative gearing for up to $1 million of property: Here, scenario 2 is augmented with a provision for newly negatively geared properties, but with a cap on the amount for such new properties. The budget impact is greatly reduced and over 10 years the cumulative impact would be a total of $4.7 billion.

SCENARIO 4:

Grandfather existing negatively geared properties plus new negative gearing only for new construction: Under this scenario the only new negative gearing that would be permitted would be for new construction. Taking the base case from scenario 2, this would put the cumulative 10 year budget benefit at $29.3 billion.

SCENARIO 5:

Abolish negative gearing immediately: Under the final scenario we consider, the current tax deductibility of losses on investment properties would be abolished.

Negative Gearing; Expensive and Inefficient

Negative gearing refers to a form of financing whereby an investor borrows money to buy an asset, but the income generated by that asset (net of other expenses) does not cover the interest on the loan. The loss is then deducted against other sources of income, for example labour income.

In the case of housing, if the cost of owning an investment property, including interest on mortgage repayments, is greater than the rental income on that property, then that loss can be used as an offset against other taxable income, including one's salary.

The tax advantage is more attractive to those on higher incomes due to the greater savings accrued through a reduction in income taxed in higher tax brackets. In theory, the incentive encourages investment by reducing the impact of losses in the earlier years of a purchase, at least until an increase in earnings (or rent) and/or a decrease in borrowing costs switches the investment from being negatively geared to positively geared.

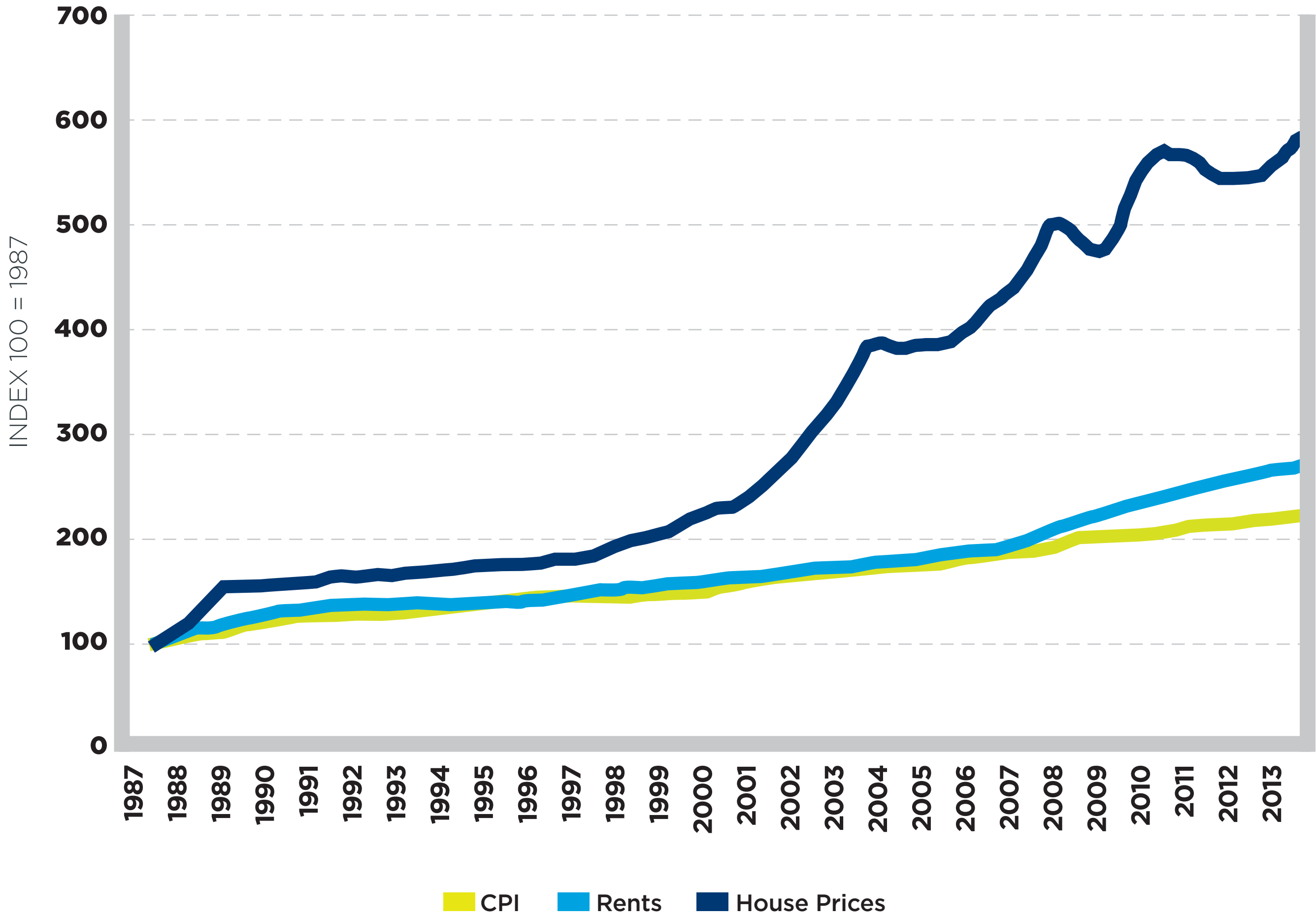
When the asset is sold, it is also likely to have increased somewhat in capital value, providing gains to the investor. The Government recovers some of this through its Capital Gains Tax (CGT), though the revenue raised through this measure was substantially reduced when the Howard Government introduced provisions that halved the rate of tax on capital gains in 1998.

It is important, however, to consider the dual impact of negative gearing and concessional CGT on residential property. The combination of the two makes investments in such property highly appealing to many Australians.

Proponents of negative gearing have argued that the reduction of importance in rental yield has effectively put downward pressure on rents, which would otherwise be higher if rents were increased in line with house prices. Opponents of negative gearing have argued that, in the long run, negative gearing his increased house prices beyond where they otherwise would have been, in turn increasing rents as landlords are forced to increase prices, regardless of the tax offset.

The changes in house prices and rents can be seen in the graph below, with house prices increasing substantially following the Howard government's 1998 changes, and rents rising in excess of inflation since 2007.

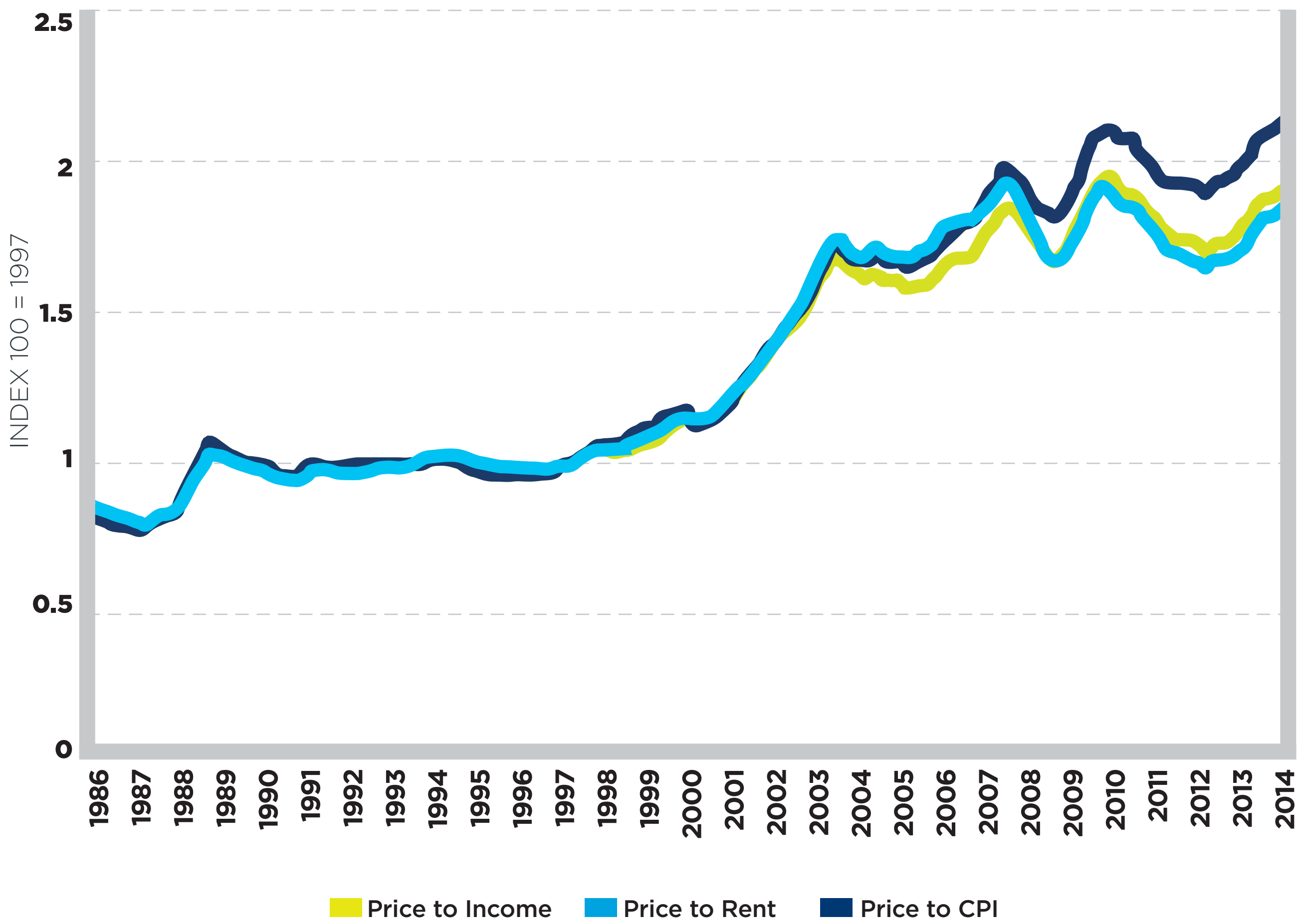
FIGURE 1
HOUSE PRICE AND RENT INDEX (AUSTRALIA) (INDEX 100 = JUNE 1987)



Source: ABS Consumer Price Index and ABS House Price Index

The data would seem to indicate that house prices have increased in value dramatically since the changes to capital gains tax shifted added to the incentives provided by negative gearing. Certainly, post 1998 saw house prices disconnect completely from CPI and rental increases.

FIGURE 2
RELATIVE HOUSE PRICE INDEX (AUSTRALIA) (INDEX 100 = 1997)



Source: ABS Consumer Price Index, ABS House Price Index, ABS Wage Price Index

Whether changes to negative gearing, in combination with changes to capital gains, has been responsible or not for the steep increases in house prices in recent years, the fact that rental prices have not increased by similar levels should be of critical concern for policy makers when considering reforms to negative gearing.

According to the ATO's most recent taxation statistics, in 2010-11 there were approximately 1.9 million property investors in Australia, with 1.26 million of these negatively geared. The average income loss for all negatively geared property investors was just under $11,000, leading to combined losses of approximately $13 billion.[1]

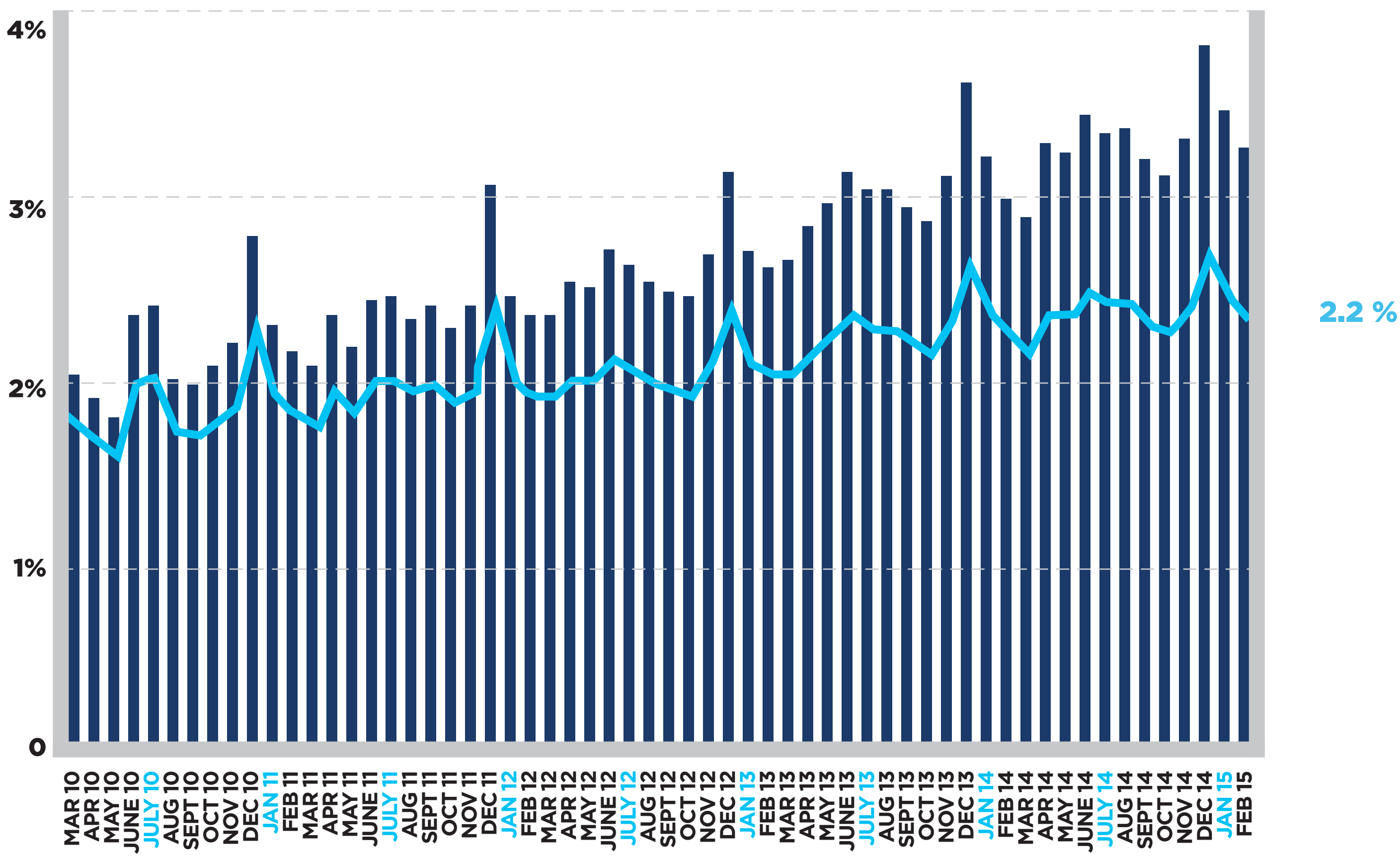
Were these investors to lose the capacity to negatively gear, it is conceivable that a number of them would choose to sell their property rather than absorb such large-scale losses. Others may attempt to reduce the scale of their losses by increasing rents, though their capacity to do this would be determined by the vacancy rates in their area. If the vacancy rate is high, the capacity to increase rents is limited by the likelihood that doing so will make it more difficult to secure a tenant. When the vacancy rate is low, the reverse holds.

Because of search costs, the long-held view has been that a vacancy rate of about 3% represents a balanced market that is neither in favour of landlords or tenants. Anything above that and landlords are forced to offer more competitive rates to attract tenants, whereas anything below that is likely to indicate a rental shortage, shifting the balance towards landowners.

When negative gearing was temporarily abolished between 1985 and 1987, the impact on rents varied from city to city, with only Sydney and Perth experiencing a surge in rents. Although this issue will be examined in some detail in later sections of this report, it is worth acknowledging that vacancy rates in these two cities were substantially below those of other cities.

As policy makers consider reform, it is important to acknowledge that vacancy rates nationally are currently sitting at 2.2%.

FIGURE 3
RENTAL VACANCY RATES



Source: SQM Research

With the exception of Darwin (3.2%), every Australian city is currently experiencing vacancy rates well below 3%. Sydney (1.7%), Canberra (1.6%), Adelaide (1.5%) and Hobart (1.3%) remain the most vulnerable to rental price increases, while Melbourne (2.3%) and Perth (2.6%) also remain vulnerable though somewhat less so.[2]

These figures suggest that property investors in most Australian cities would be well placed to respond to any immediate removal of negative gearing concessions with a potentially steep increase in rents, with tenants already experiencing high levels of competition for a limited supply of rental stock.

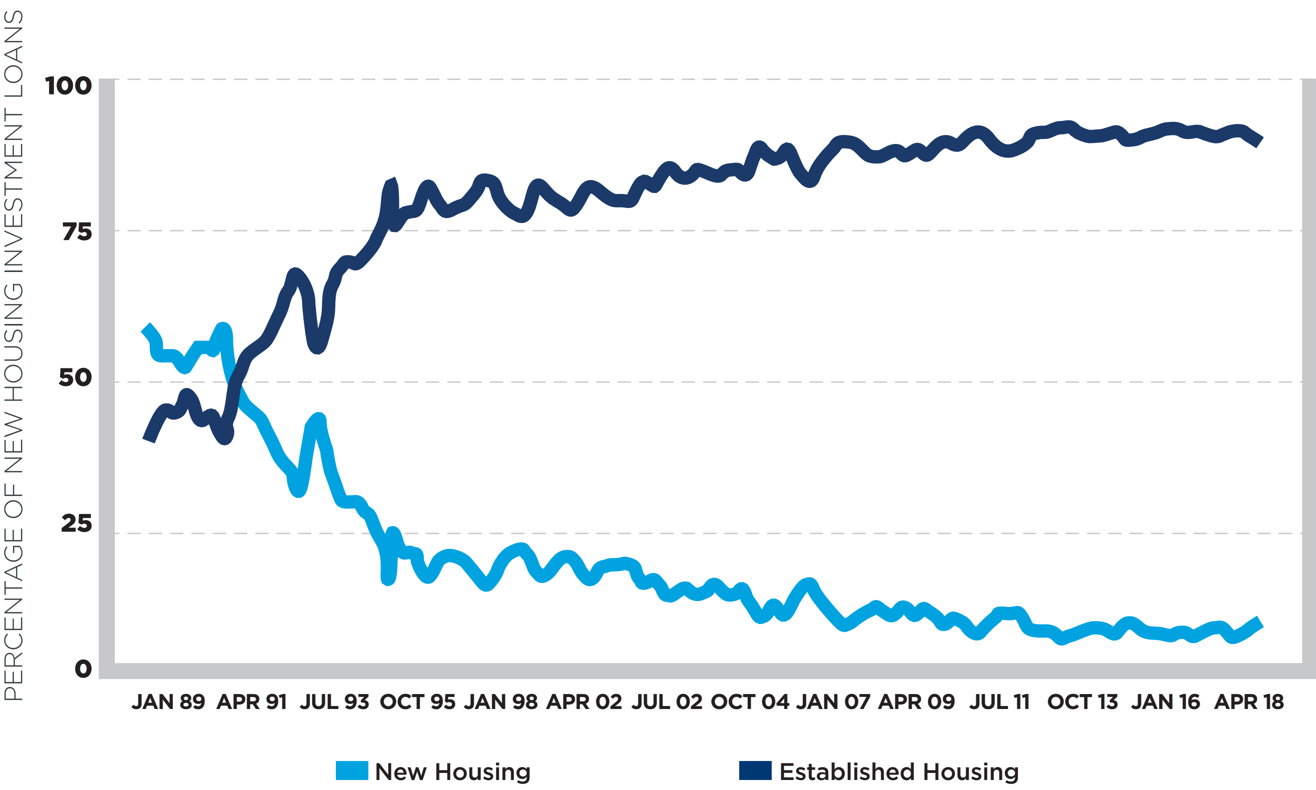
This raises a separate question as to why the existence of negative gearing has not helped to create a stronger supply of rental properties, ensuring that vacancy rates remain at or above 3%.

Opponents of negative gearing argue that negative gearing has largely failed to deliver new housing supply, with the majority of investors preferring to purchase existing dwellings rather than options "off the plan".

ABS data appears to supports this view, with almost 93% of all investment loans today going towards the purchase of existing dwellings.

Over time, a growing proportion of property investment loans have gone towards the purchase of existing dwellings rather than newly created dwellings.[3]

FIGURE 4
% OF INVESTMENT LOANS MADE FOR NEW VS EXISTING DWELLINGS

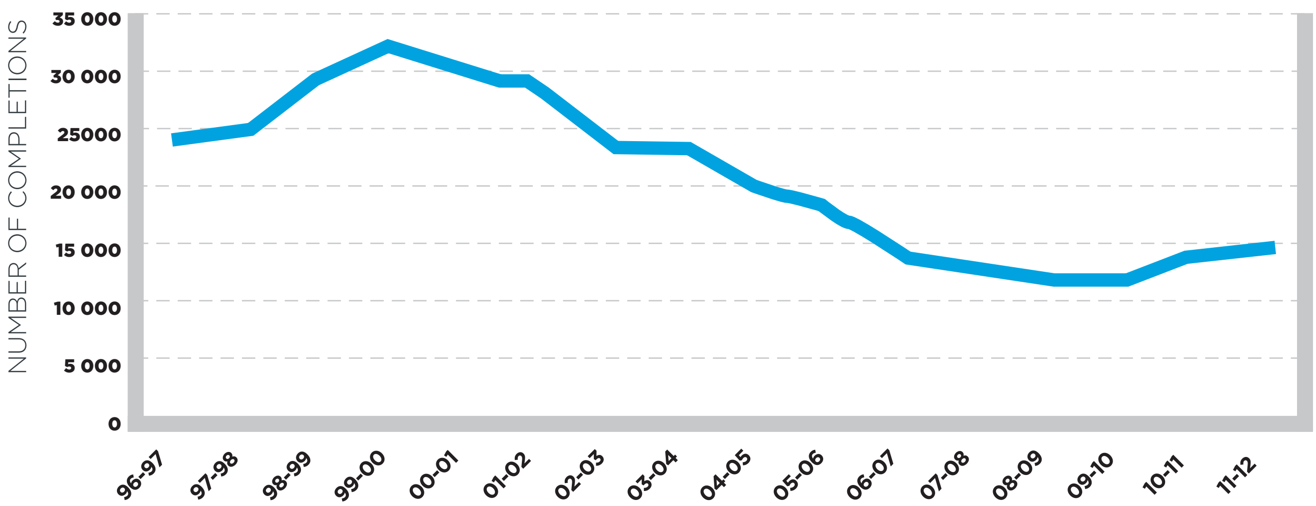


Source: ABS Housing Finance, Australia

There is no obvious reason why existing dwellings are proving to be more attractive to property investors than new dwellings. Nevertheless, it remains clear that the vast majority of the Government's tax expenditure on negative gearing – estimated to cost approximately $4 billion per year – is going towards property investments that are not actually increasing housing supply, undermining negative gearing's original policy intention as a mechanism for reducing rents.[4]

The McKell Institute has written extensively on the issues of housing and rental affordability. The Institute's inaugural report, *Homes For All*, specifically listed a shortage of new housing supply as one of the single largest determinants of rising prices in NSW.[5] In a submission the 2014 NSW Legislative Council's Inquiry into Social, Public and Affordable Housing, the McKell Institute highlighted how new housing supply in Sydney had contracted steeply since reaching a peak in 1999-2000.

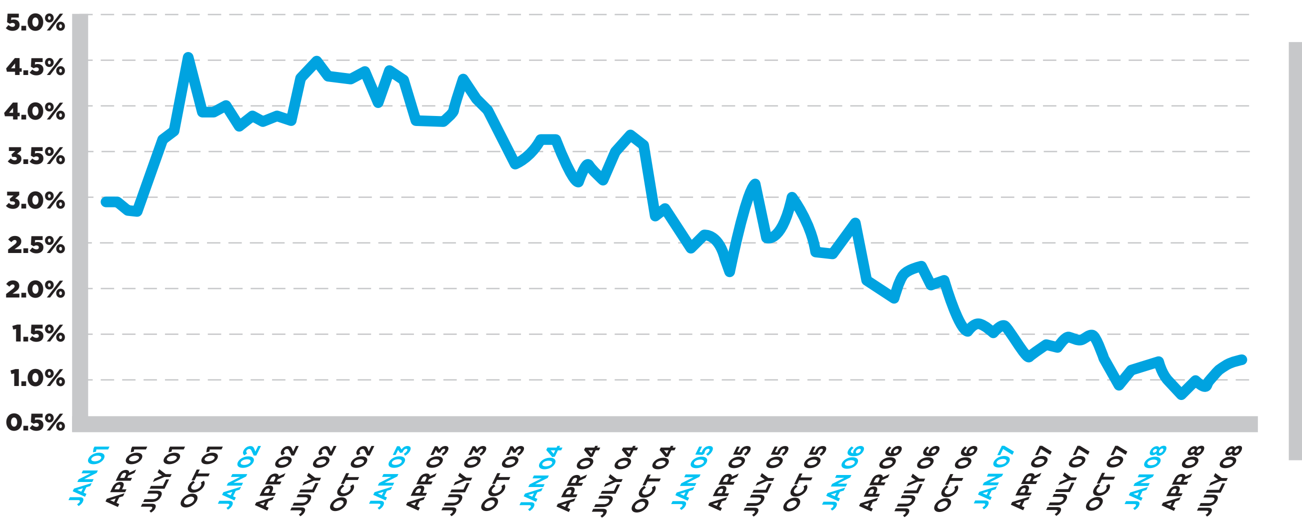
FIGURE 5
SYDNEY DWELLING COMPLETIONS PER ANNUM



Source: NSW Department of Planning, Metropolitan Development Monitor

The National Housing Supply Council (NHSC) estimated that between 2000 and 2010, Sydney had accumulated a total housing shortage approximating 73,700 dwellings.[6] This contraction in new housing supply inevitably spread to the rental sector, which experienced a substantial decline in vacancy rates as the shortage began to accumulate.

FIGURE 6
SYDNEY RESIDENTIAL VACANCY RATES



Source: McKell Institute submission to the NSW Inquiry into social, public and affordable housing

The McKell Institute notes that Sydney's dwelling approvals and completions have increased markedly over the last few years, in large part thanks to persistently low interest rates encouraging investors back into the market.

While dwelling completions are slowly return to their long-term average, the number of new approvals in recent years indicates an exceptionally strong period of new supply on the horizon. Last year, nearly 39,000 new dwellings were approved,[7] which should help reduce the scale of the housing shortage that accumulated across the first decade of this millennium. If some of this new supply is directed towards the rental market, it is likely that Sydney's vacancy rate will improve somewhat.

However, the recent surge in new supply does not automatically imply an easing of housing and rental prices. In 2014, the median price for a detached house in Australia increased by 7.1%, while unit prices increased by some 6%. This was overwhelmingly driven by steep increases in Sydney of 14.1% for houses 10.4% for units.[8] This followed equally large increases of 15.1% and 10.9% the year before.[9] In dollar terms, this means that in just two years, Sydney's median house price has increased by approximately $210,000, while the median price for a unit has increased by just under $110,000.

For now, rents have remained largely constrained despite these significant increases. Sydney's median rent for a detached housing has increased by just 4% over two years, less than the rate of inflation, while the median rent for a unit has increased by about 8.7%, above inflation though nowhere near as excessive as the rise in dwelling purchase price.

They key concern for policy makers as they consider reforms to negative gearing is whether any change to existing rules is likely to result in an increase in rents for cities like Sydney. Any impact is likely to be less notable while interest rates remain at historic lows, though the impact would undoubtedly become more pronounced once interest rates begin to return to their long term levels.

In November 2014, official data revealed that bank loans to property investors were surging at the fastest pace since the global financial crisis, reaching a record total of $475 billion.[10] A 1% increase in the cost of servicing that debt would add almost $50 billion to the repayment obligations of the nation's property investors, a substantial cost that would erode the profitability of the roughly one-third of positively geared investment properties in Australia. For the two-thirds of properties that are negatively geared, the extra costs would either need to be offset through a commensurate increase in rents, or where the market makes that more difficult to achieve, a large tax deduction through negative gearing. Under such a scenario, the current estimates of an annual $2.4 billion cost associated with negative gearing are unlikely to hold, with substantial increases in this burden likely.

The Financial Systems Inquiry (FSI) recently warned policy makers that the boom in property investment was beginning to represent "a potential source of systemic risk for the financial system and the economy". Specifically, the FSI report found that "the tax treatment of investor housing, in particular, tends to encourage leveraged and speculative investment".

Given these concerns, it is appropriate that policy makers now revisit the issue of negative gearing, and that they do so with a careful eye on the impact that any changes would have on debt serviceability, and the potential for rental increases flowing from reform.

What's Changed: The Previous Abolition of Negative Gearing and Today

When determining the most appropriate path forward for a reform of negative gearing, significant insights can be gathered by examining the period when negative gearing was abolished between 1985 and 1987, as well as the period immediately following it.

Despite some similarities between that period and today, including low vacancy rates in most Australian cities, it is important to acknowledge that there are several critical differences that separate the previous period and the current one.

This section of the report will consider both periods, before drawing some conclusions that would be noteworthy for policy makers considering change.

In June 1985, the Hawke Government released its tax white paper, which among other recommendations, included a proposal to reform negative gearing rules so that losses on property investments were quarantined and could not be used to reduce the tax bill from other income streams.[11]

The reform was expected to save approximately $475 million in today's dollars, and was largely created in response to concerns that individuals on the highest tax rate – 62.5% including the Medicare Levy surcharge – were using the mechanism to rapidly reduce their taxation burden.

At the time, the vast majority of home loans were capped at 13.5%,[12] though a substantial number of loans issued after April 1985 were also being issued at even higher rates. There was a concern that the deductions were costing the budget substantial amounts of money at a time where it was struggling to contain inflation and higher costs of borrowing.

As part of the same reform package, the Government also introduced a Capital Gains Tax, which applied to all assets except the family home. In a bid to supply new investment in housing supply, the Government also introduced a 4% depreciation allowance on housing investments.[13]

By October 1986, it had become apparent that the reforms had failed to generate sufficient new investment in housing supply. The NSW Government argued that lending to building societies had dropped by some 35%, and suggested that Government increase the depreciation allowance to 8% to attract badly needed investment in rental properties.[14]

Around this time, the Housing Industry Association (HIA) began to ramp up its campaign against the reforms. The HIA released data that showed that more than one-fifth of all renting households in Australia were forced to pay 35 per cent or more of their gross weekly income on rent. The HIA also pointed out that "public housing queues are growing rapidly in every State".[15]

Treasurer Paul Keating insisted at the time that the overwhelming factor deterring potential investors was high interest rates, needed to counter high inflation. By December 1986, the interest rate on loans to building societies had reached 15.5%,[16] with NSW particularly hard hit, as new dwelling commencements decline by some 28% on the previous year.[17]

By February 1987, the Real Estate Institute (REI) of NSW joined the HIA in blaming negative gearing for contributing to a "rental crisis" in Sydney. Though vacancy rates were already low in Sydney prior to the quarantining of negative gearing, REI NSW pointed out that many suburbs were now languishing with vacancy rates of just 0.5%, well below the 3% required for a balanced market.[18]

In March, the Master Builders Federation of Australia released figures showing that Sydney rental prices had skyrocketed by 25% in the previous 12 months.[19] The NSW REI predicted that rents would rise a further 20% over the next 18 months, a concern also shared by the NSW Tenants Union.[20]

By April, BIS Shrapnel released data showing that the level of new dwelling constructions had plummeted to a 10 year low, and was forecasting that levels would decline a further 13% over the next year. BIS Shrapnel pointed out that the reduced capacity to negative gear had impacted the capacity of investors to service their loans, and that banks were requiring larger deposits to compensate for the increased risk. It was estimated that the quarantining of negative gearing had increased the average deposit required to buy a unit from around $45,700 to $114,200 (2014 dollars).[21]

By June 1987, the Liberal Party announced that if elected, it would replace Labor's prohibition of negative gearing on rental properties with a system allowing deductions from taxable income on interest incurred on borrowings up to 80 per cent of the value of the rental property.

This received immediate support from the Confederation of Australian Industry (CAI) and the NSW REI,[22] but was sternly criticized by the Tenants Union (TU) of NSW.

TU spokesman Tracy Goulding argued that negative gearing had "not had the impact on the supply of housing as the REI would have us believe." Goulding argued that "These taxes aren't directly responsible for the housing crisis. The rental crisis is an ongoing thing, there was a shortage of rental properties before negative gearing was introduced; there has been a 10-year shortage."[23]

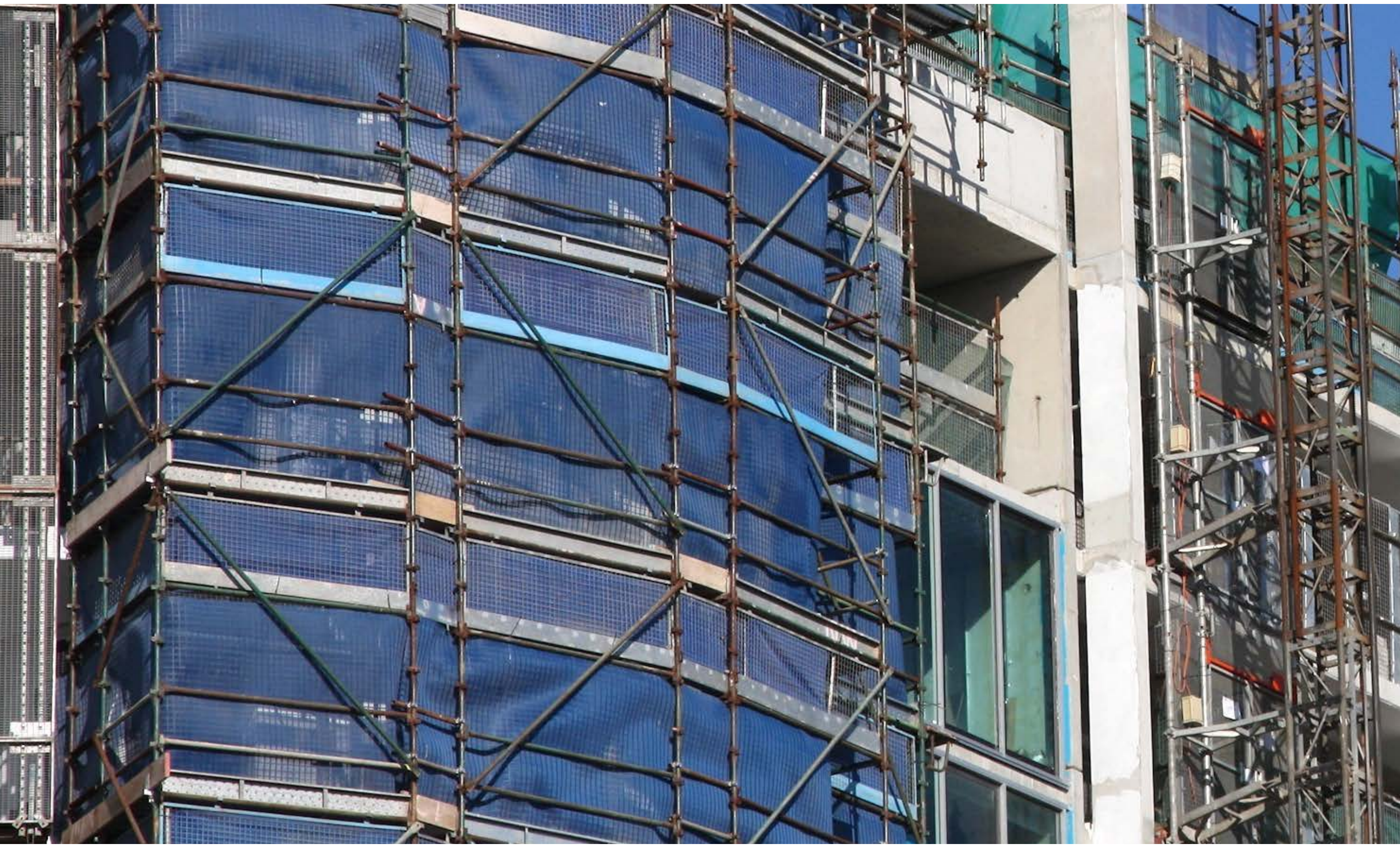
Nevertheless, the Coalition began to ramp up its attacks on negative gearing as contributing to higher rental prices and longer public housing waiting lists. The Hawke Government had been hoping that dwelling approvals would begin to recover before the election, but ABS data showed that NSW dwelling approval figures continued to decline in June.[24]

At this stage, the REI started a public campaign for the reinstatement of negative gearing, and sent questionnaires to all candidates in marginal Sydney seats. The REI also released data showing that there were now 300,000 households in the private rental market under the poverty line because of the rents householders have to pay.[25]

To combat a growing concern that the rental crisis could cost the government the election, Bob Hawke officially announced that his government would review negative gearing, while also acknowledging "the particular problem in Sydney in relation to the rental market".[26]

Despite the Prime Minister's insistence that negative gearing might be reinstated, Paul Keating later went on to downplay the possibility of reforms, before making a strong argument that the current crisis was caused predominantly by high interest rates. Keating argued that he didn't "think negative gearing ever added to the stock of housing accommodation. Had there been a whole stock of rental housing, we would have had better vacancy rates than we had". Instead, Keating suggested that investors were not engaging because they were receiving an average 4 per cent return on money for which they had had to pay 16 to 17 per cent.[27]

The conflicting narratives on negative gearing arguably hurt the Hawke Government's election performance in NSW. Premier Barry Unsworth pointed out that some of the party's worst results



were in Western Sydney seats suffering through high rents,[28] with political commentators also pointed out that there had been large swings in both Wollongong and Newcastle, two areas that were also suffering through a rental crisis.[29]

In August, the NSW REI released new figures which showed that Sydney rental prices had increased by 66% in the previous 12 months, with an new prediction that they could increase by a further 30% in the coming year.[30]

At this point, the West Australian Government began lobbying the Prime Minister to reform negative gearing so as to reintroduce it but for new housing only. The proposal was that the benefits should operate for the first five to seven years in a bid to stimulate construction of rental houses. The acting WA Premier, Mr Mal Bryce, said that the shortage of private rental accommodation was a major concern in the community, but also urged the government to not reintroduce the incentive for existing houses on the basis that it would drive up prices and eventually increase rents.[31]

There was a growing concern within the Labor Party that the worsening rental crisis in Sydney was presenting a growth threat to the re-election of a state Labor Government. Premier Unsworth was set to go to the polls soon, and the crisis had become so bad that it became necessary for him to publicly lobby the Prime Minister to reinstate negative gearing.[32]

Under growing pressure from his political base in NSW, the Treasurer began to consider several options for reform, including:[33]

- Allowing investors to claim interest expenses against gross rental income before deduction of operating expenses, which would allow more interest to be claimed as a tax deduction and increase returns to investors;
- Allowing interest costs on up to a set percentage of borrowings, effectively setting an equity limit below which the negative gearing rules would not apply;
- Setting a borrowing limit on interest deductibility; and,

- The West Australian Premier's proposal to restrict negative gearing to new supply.

To make matters more complicated, new figures had emerged showing that Sydney's median dwelling price had increased 12%, while vacancy rates remained at a very low 0.9%.[34] The MBFA also released new data showing that the construction of "other dwellings" – including the more likely to be rented dwellings such as units, town houses and duplexes - had decreased 35 per cent since the cancellation of negative gearing by the Federal Government in July 1985.[35]

In September, Treasurer Paul Keating took to cabinet a proposal that would allow investors to claim interest expenses as a tax deduction against gross rental income -a concession on the existing system which allows deductions only against net rent after allowing for operating costs such as maintenance, but cabinet was split and no decision was made.[36]

Eventually, the Treasurer's preferred approach was rejected, and the Government revealed that it would reinstate negative gearing in its entirety. To offset this change, the depreciation allowance on property investments was decreased from 4% to 2.5%.[37]

Comparing our current situation to history, we have record low mortgage interest rates, extremely low vacancy rates and historically low gross rental returns. Low vacancy rates indicate that an immediate outright abolishment of negative gearing would result in an increase in rents in most cities. Record low interest rates indicate that even if negative gearing is phased out over 5 years, an increase in rents remains likely in the medium term as interest rates normalise.

We are also faced with alarmingly high property prices driven by insufficient housing supply. When taken together, it becomes clear that existing investors need to be quarantined indefinitely to prevent sudden rental price increases, while future investors should be restricted to only using negative gearing on newly constructed properties so as to create new housing supply and improve affordability across all markets. This would represent a substantially different approach to the one put forward by the Hawke/Keating government in 1985.

Options for Reform in Detail

Principles of tax deductibility:

The fundamental principle that should govern tax deductibility of expenditures is that all asset classes should operate on a level playing field. The introduction of negative gearing adhered to this principle. Why should real estate investments be treated differently to share market investments?

The ensuing years have answered this question. Investment in residential property is already privileged in a number of ways. First, and most importantly, it is much easier for individuals to borrow money to purchase an investment property than to invest in other asset classes. It is relatively easy to obtain finance to purchase an investment property with 90 percent debt and 10 percent equity. The same cannot be said of other asset classes. An individual wishing to purchase equity securities with 10 percent equity faces much higher hurdles: both in terms of the transaction costs of obtaining the loan and the particulars of the loan (such as margin calls if the equity securities fall in price).

Negative gearing of rental property, in light of this, arguably does not provide a level playing field. There are also revenue considerations in term of the federal budget. These twin considerations underlie much of the recent discussion about proposed changes to negative gearing. We consider five different scenarios for addressing negative gearing.

SCENARIO 1:

Business as usual. Under this scenario all current provision relating to negative gearing would be retained.

SCENARIO 2:

Grandfather existing negatively geared properties. Under this scenario existing investors taking advantage of negative gearing would be allowed to continue to do so for the existing properties they own. Newly purchased rental properties would not be permitted to use negative gearing, but would be allowed to use so-called "positive gearing". That is, interest and other deductions would be permitted, but could not be offset against other income.

SCENARIO 3:

Grandfather existing negatively geared properties plus new participants have access to negative gearing for up to $1 million of property. Here, scenario 2 is augmented with a provision for newly negatively geared properties, but with a cap on the amount of such new properties.

SCENARIO 4:

Grandfather existing negatively geared properties plus new negative gearing only for new construction. Under this scenario the only new negative gearing that would be permitted would be for new construction.

SCENARIO 5:

Abolish negative gearing immediately. Under the final scenario we consider, the current tax deductibility of losses on investment properties would be abolished.

In analysing these scenarios we focus solely on direct negative gearing impacts on the budget and abstract from potential capital gains tax or other taxation implications.

Analysis of the five scenarios:

SCENARIO 1: BUSINESS AS USUAL

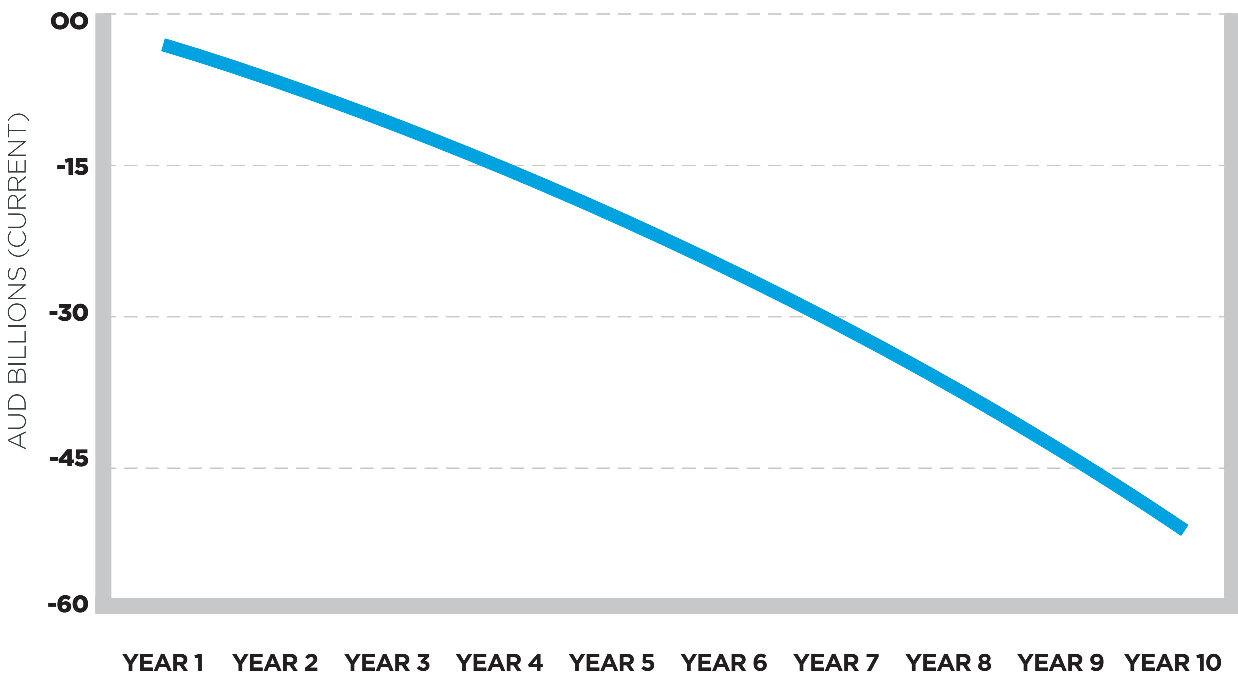
The key driver of the cost of the current negative gearing arrangements going forward is the growth of deductible interest payments and other deductions on existing and newly negatively geared properties. Another important factor is the mix of taxpayers who make use of negative gearing, since those on higher incomes face a higher marginal tax rate

As the historical background above makes clear, it is hard to discern a smooth trend in growth rates of negative gearing. Although the current mix of tax brackets among negatively geared properties is known, it is unclear how this mix may change going forward, even with policy changes.

Furthermore, although it is straightforward to calculate the amount by which negative gearing reduces taxable incomes (so-called "tax expenditure"), it is hard to know what the behavioural response would be by investors to policy changes. In the absence of a clear counterfactual information many commentators simply quote the tax expenditure number. Although one should be very cautious in interpreting such calculations, they do form a baseline for certain comparisons.

To get a sense of the potential growth in the tax expenditure "costs" going forward one can assume a 5% annual growth in negative gearing deductions overall, no changes to marginal tax rates, and no bracket creep. Under these assumptions the tax expenditure 5 years hence is $4.9 billion, compared to $3.9 on latest figures. The cumulative tax expenditure over 10 years would be $51 billion under these assumptions.

SCENARIO 1: **CUMULATIVE TAX EXPENDITURE**



SCENARIO 2: GRANDFATHER EXISTING PROPERTIES

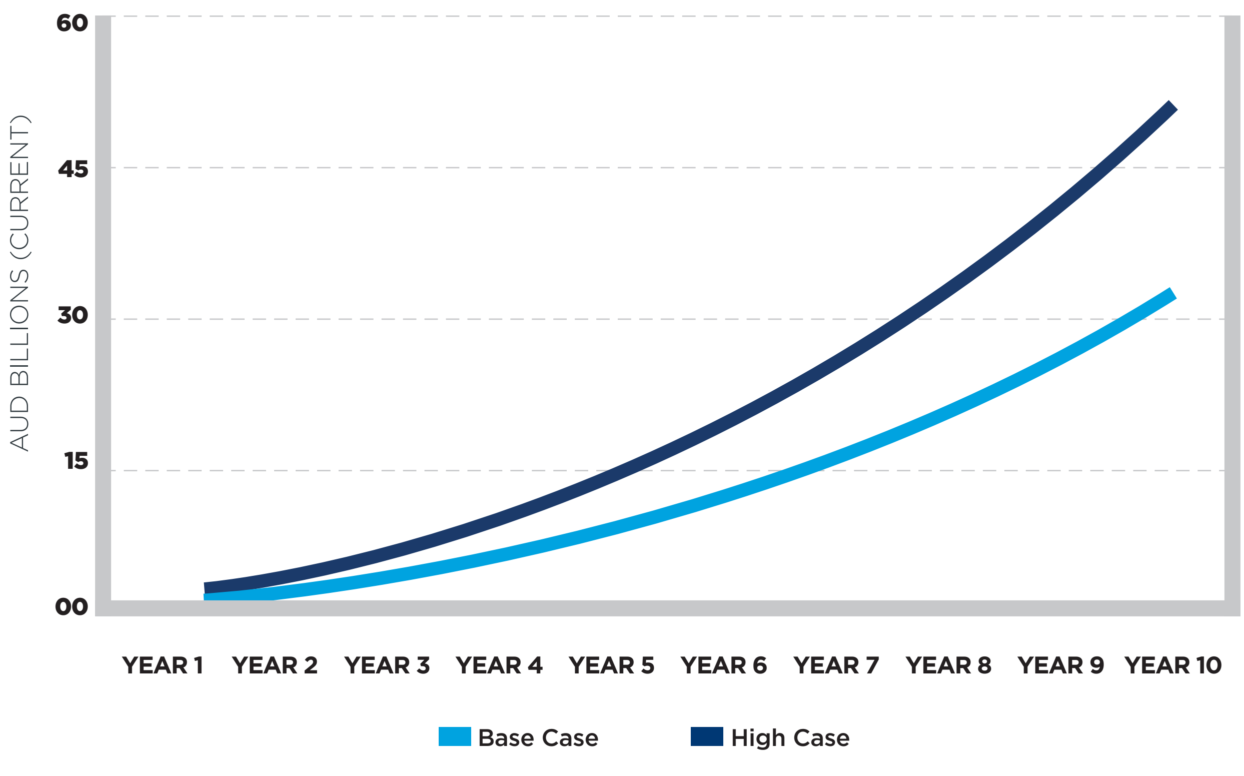
A key question under this scenario is how much of the existing tax deductions on existing properties would be reduced over time. If owners of grandfathered properties pay down the principle on their loans then a major (though not the only) driver of negative gearing deductions, totalling $24.1 billion in 2011-2012.[38] The rate of principle pay-down depends on the amortisation schedule of existing loans, and how those schedules may change yet be respected under this scenario. For instance, some investors may shift from amortising to interest-only loans in order to preserve the maximum interest deduction.

One policy option would be to prevent changes to existing amortisation schedules as part of the grandfather provisions. This, however, may be considered arbitrary and against the spirit of such a plan. On the other hand, if grandfather provisions apply to individual taxpayers, then those taxpayers will eventually lose the benefit of deductions as their other income declines over the lifecycle—and of course, would lose it completely upon death.

Given the range of policy implementations and endogenous responses of both borrowers and lenders, it is wise to consider three cases that span the likely possibilities of decline in loan balance and hence interest deductions. A base case involves a 20-year aggregate pay-down of loan balances. A high case involves a 10-year aggregate pay-down. A conservative, low case assumes zero pay-down.[39]

Under the low case there is no budgetary impact since the existing stock of interest deductions is assumed to stay in place. Under the base and high cases the reductions are significant. The year 1 budget benefit under the base case is $350 million, rising to $1.76 billion 5 years out—for a total deficit impact of $5.27 billion over the five years. In the high case these numbers are doubled[40] the year 1 budget benefit is $700 million, rising to $3.52 billion in year and representing a $10.55 billion deficit impact over 5 years. Over 10 years the cumulative base case budget impact is positive $19.3 billion and the high case is $38.7 billion.

SCENARIO 2: **BUDGET BENEFIT RELATIVE TO STATUS QUO**



SCENARIO 3: GRANDFATHER EXISTING PROPERTIES AND ALLOW A $1 MILLION CAP ON TOTAL PROPERTY PRICES PAID PER PERSON FOR NEW NEGATIVE GEARING.

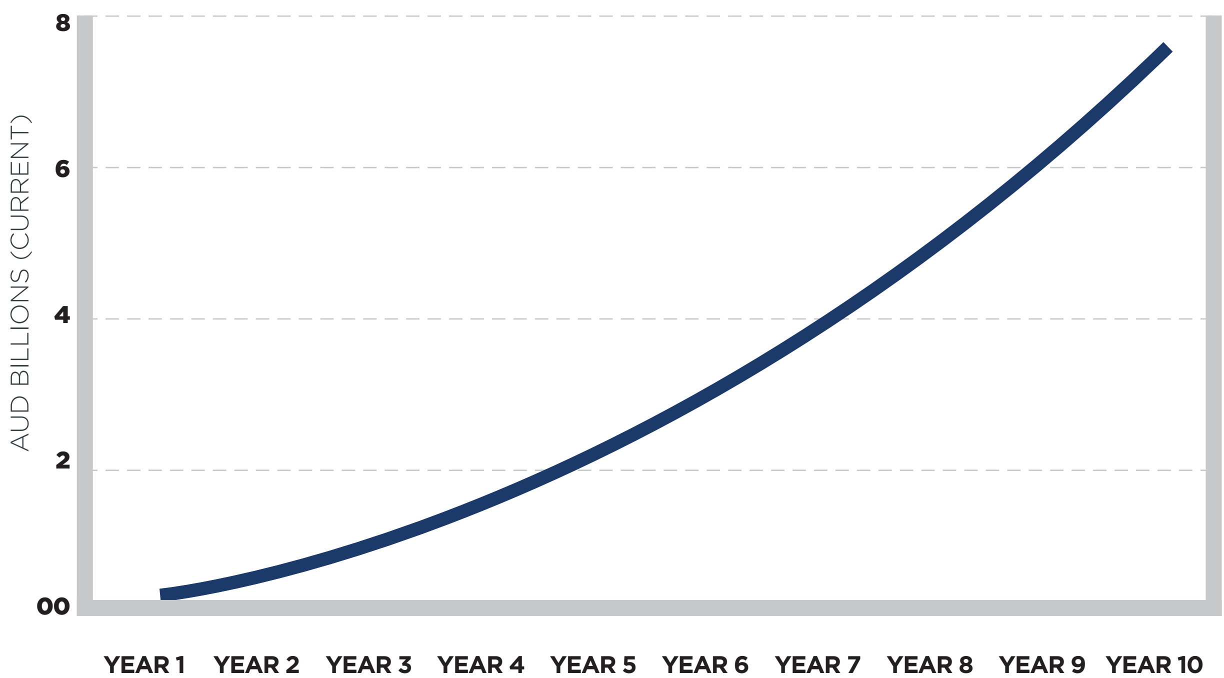
The key question in this scenario is how a capped allowance for new negative gearing would replace the attrition from existing gearing contemplated in scenario 2. This depends on the extent to which the cap would be binding measured against the underlying growth in scenario 1 (business as usual).

To understand this better it is useful to look at the distribution of negatively geared properties across individuals. Of the 1.76 million individuals with ownership of rental properties 1.28 million had one property interest, 318,295 had 2 and 96,991 had 3. Approximately 65,000 individuals had 4 or more.[41]

This suggests that a cap at a $1 million level would only be binding for a relatively small number of new investors even if their mix was the same as existing ones. Moreover, any cap could make that number salient and lead to greater negative gearing by new investors than would otherwise have been the case. On balance this scenario is likely to be closer to the business as usual scenario than any other. There may be some reduction in tax expenditures going forward, but they would be likely be slow to materialise at best, and it is unclear that they would be large in magnitude.

Using the current mix of the number of rental properties owned it is plausible to think that the cap would only bind for those with 3 or more properties. These represent approximately 24.3% of the existing stock.[42] One can think of the potential benefit here as being 24.3% of the scenario 2 cases. For example, in the base case the potential 10 year cumulative impact could be 24.3% of $19.3 billion for a total of $4.7 billion. Relative to the status quo where negative gearing is growing the 10 year cumulative impact is more than $7.7 billion over 10 years.

SCENARIO 3: **BUDGET BENEFIT RELATIVE TO STATUS QUO**



SCENARIO 4: GRANDFATHER EXISTING PROPERTIES AND ALLOW NEW NEGATIVE GEARING ONLY FOR NEW HOUSING STOCK.

The first part of this scenario is identical to scenario 2 and the budgetary impact is therefore identical. The second part of this scenario is allowing negative gearing for new housing stock only.

One important benefit of this scenario is that it provides tax incentives for the provision of new housing. It is widely recognised that—particularly in certain markets such as Sydney—supply constraints are an important driver of the high housing prices.[43] Incentives for additional supply can come from many sources, such as new land releases and relaxation of zoning restrictions.

The current portion of negatively geared property in new housing is around 5%.[44] Hence, given the overall magnitude of negative gearing—in 2010-11 there were 1.2 million individuals with negatively geared properties—a shift in tax incentives toward new construction has the potential to have a material impact on housing supply.

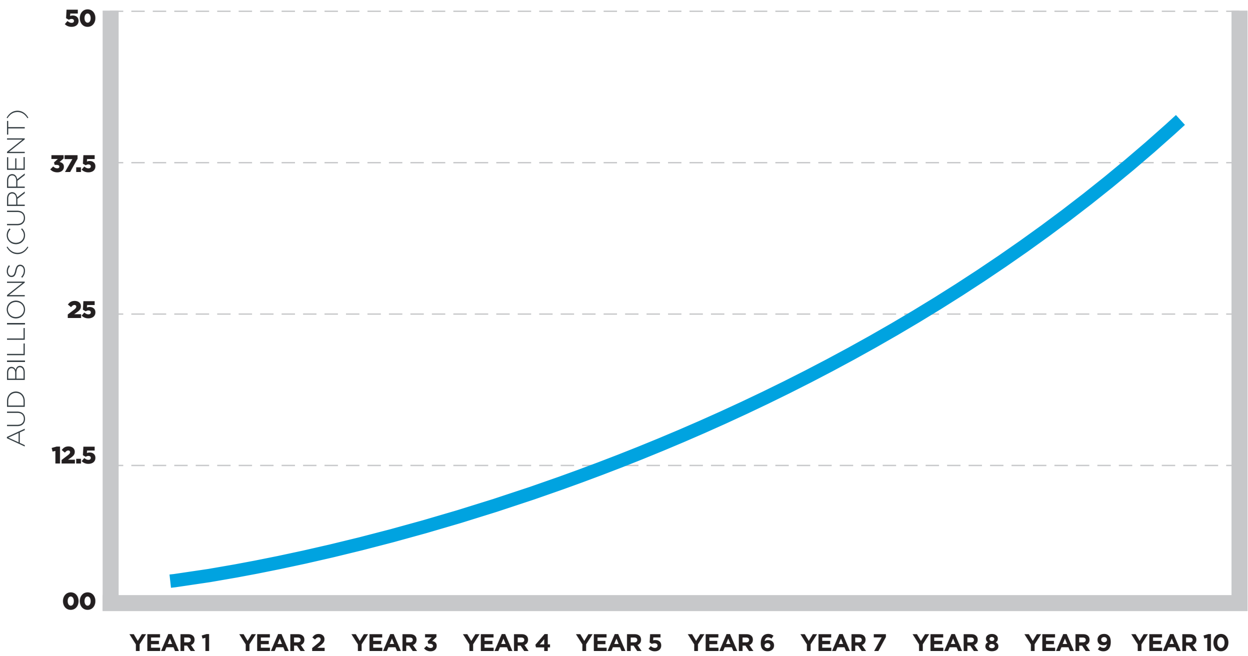
Of course, any new housing supply that is subject to negative gearing provides tax benefits to investors and reduces the budgetary benefits from the grandfather provisions in scenario 2. It is therefore important to weigh up the benefits that come from increased housing supply and construction, with the opportunity costs (relative to scenario 2) of continued tax deductibility.

An important consideration in this scenario is, of course, what is meant by "new construction". This raises a number of questions and possibilities. A stringent policy would permit negative gearing only for construction on newly released land. At the more permissive end, the demolition of an existing property followed by new construction on it would qualify. Since an important part of the benefit of new housing is increased capacity, not merely increased quality, it would seem natural to limit the availability of negative gearing to new housing which increases the number of people accommodated by a certain amount.

In addition to the important benefits that would flow from incentives for increased housing supply, this scenario has the additional benefit of boosting the construction sector. The Housing Industry Association estimates that nationwide around 185,000 new homes need to be built each year to meet both population growth and demand for new housing.[45] According to the ABS, the current annual value of new residential construction is around $45 billion. Although it is beyond the scope of this report to provide a detailed estimate of the amount this would increase due to the tax incentives involved in this scenario, a plausible estimate is that a net 10 percent increase could occur.

Were this to occur it would add $4.5 billion to GDP. If the current overall tax-to-GDP ratio of 25.8 percent applied this would lead to an increase in tax revenues of $1.2 billion annually. This would more than offset the "lost" revenue on the 5% of currently negatively geared new construction properties relative to scenario 2. Indeed, based on the assumptions above and no incremental growth it would lead to an additional annual budget benefit of approximately $1 billion per annum. Taking the base case from scenario 2, this would put the cumulative 10-year budget benefit at $41.7 billion.

SCENARIO 4:
BUDGET BENEFIT RELATIVE TO STATUS QUO (BASE CASE)



SCENARIO 5: END NEGATIVE GEARING IMMEDIATELY

This is the most radical policy proposal of the five considered here. A naïve account of the budget impact of such a policy is that the existing $3.9 billion in net deductions[46] would become an immediate improvement in the budget bottom line.[47] Of course, there are a variety of endogenous responses that would surely occur as investors in rental properties change their financial arrangements.

Faced with the loss of valuable tax deductions, investors currently negatively gearing properties would have a strong incentive to move to other asset classes where tax losses could continue to be offset against other income. Although it is easier for most individuals to take advantage of these tax advantages on residential properties, under this scenario that may no longer be the case. Lenders would have an incentive to make lending more easily available on other asset classes (such as shares), and financial planners would also have incentives to change their recommendations. Thus there would be incentives on the demand side, the supply side, and from intermediaries for a shift from negative geared property to other tax advantaged investments. Any such shift would reduce the potential benefit of ending negative gearing – and could do so to a material degree.

There is also the question of whether ending negative gearing would increase rental prices. The Grattan Institute argues that this would not be the case:

> *The belief that negative gearing keeps rents low seems to be a folk memory from when the Hawke Government temporarily abolished negative gearing in the 1980s. Rents rose rapidly in Sydney and Perth. But rents were stable in Melbourne and Brisbane and the rate of growth fell in Adelaide. In Sydney and Perth population growth and insufficient new housing, not tax policy, were pushing up rents. Economic theory predicts that abolishing negative gearing shouldn't change rents. Every time an investor sells a property to a renter, there is one less rental property, and one less renter – in other words, no change to the balance between supply and demand of rental properties.*[48]

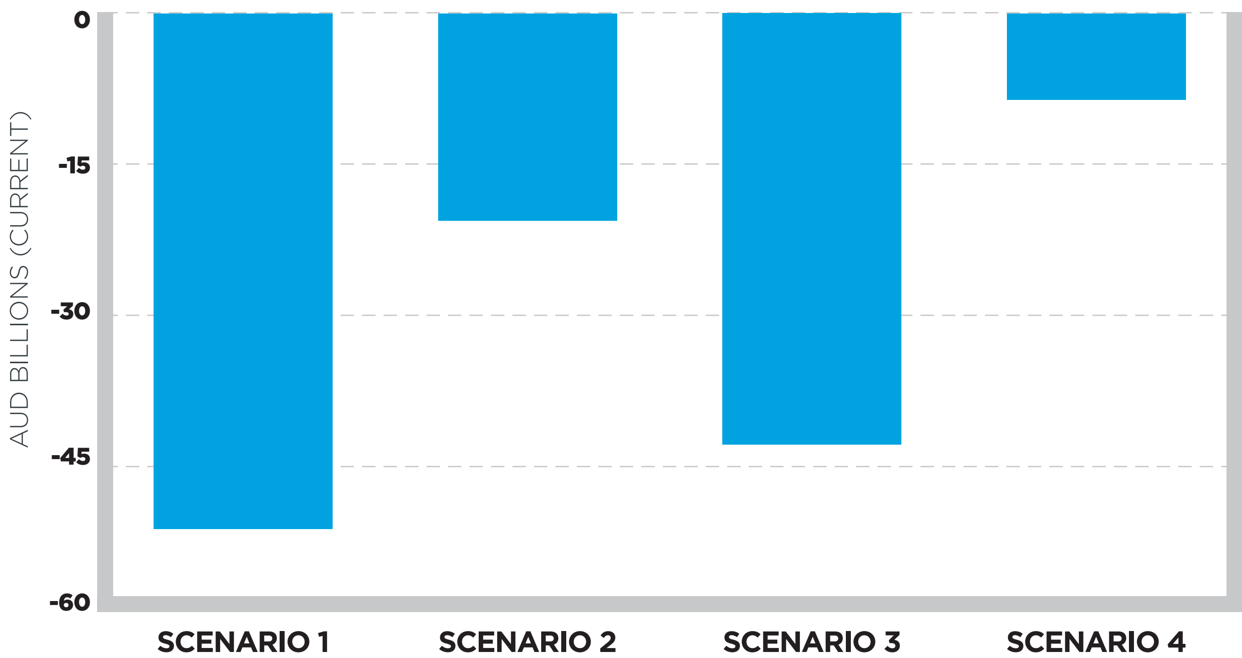
It is dangerous to simply look at events after a policy changed and attribute a causal effect to the policy change – many other things are typically going on, and indeed those factors sometime cause the policy change themselves.[49] Looking at the difference between two markets before and after the change (e.g. the difference in Sydney before and after compared to the difference in Melbourne before and after) is more information.[50] Yet the small sample anecdotal evidence offered in the above quote is not compelling. It is an open empirical question as to whether negative gearing decreases rents or not. Finally, the claim that "economic theory predicts that abolishing negative gearing shouldn't change rents" is not as clear as claimed. Differences in household size and composition between investors and renters of the same properties. This may or may not be the case, but it is an implicit assumption in the above claim.

Perhaps the most serious concern regarding ending negative gearing immediately is the impact on financial distress and the possibility of forced selling. Nearly 60% of investment properties loans are interest only.[51] Although borrowing on an interest-only basis is not a necessary marker of being financially constrained, it does indicate a clear desire not to make principal repayments on the loan(s). Although it is an open question as to how borrowers would respond to a significant decrease in their post-tax income due to the abolition of negative gearing, one possibility is that there could be a large number of existing properties placed on the market in a short space of time. Such correlated selling would place downward pressure on property prices and potential result in lower realised sale prices. Such an erosion of financial position could cause material financial distress for a non-trivial number of existing investors. It is, of course, impossible to say what the probability or a large-scale negative event is, but it is worth noting that scenario 5 is the only scenario considered here that entails such a risk.

It is worth noting that some proponents of this scenario, such as the Grattan Institute, suggest that it may be phased in over five years.[52] This may smooth the impact of some of the factors discussed above, but investors would anticipate the phased-in-changes, and selling pressure may be front-ended in such circumstances.

The following chart compares the 10 year cumulative impact of scenarios 1-4 as detailed above. Because of the existing nearly $4 billion tax expenditure cost, and the potential growth in negative gearing scenario 1 (do nothing) represents a $51 billion cumulative impact. Scenario 3, grandfathering plus a cap on new negative gearing makes relatively little difference. The most appealing option is scenario 4 which has a potential budget improvement of $41.7 billion cumulatively over 10 years. Scenario 5 is sufficiently radical and entails such risks that we have not sought to put a number on its impact.

FIGURE 7
POTENTIAL 10 YEAR CUMULATIVE BUDGET IMPACT



Conclusion

Negative gearing was introduced with the purpose of providing a level-playfield for all classes of assets in which individual Australian payers may invest. Over time, however, developments in capital markets such as financial innovation and lower real interest rates affecting returns to deposit savings, combined with the structure of the Australian banking system, and also the economic psychology of investors, have shifted the playing field.

Making all investments equal from a taxation perspective does not make sense if there exist other forces that systematically advantage one asset class. It has become increasingly clear over recent years that there are negative externalities that could be, at least in part, internalised into the price system by changes to negative gearing.

Of the five scenarios considered here, the one which would likely be most effective in doing so, while minimising the negative consequences of removal is scenarios 4: grandfathering existing negative gearing but only allowing new negative gearing for new construction. This would help tackle the serious issue of constrained housing supply, allow for a smooth transition for existing investors, and have important indirect benefits in the housing construction sector. It would also have a material and positive impact on the federal budget which could easily be more that $5 billion over 5 years.

Footnotes

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5. Mckell Institute, *Homes For All*, http://mckellinstitute.org.au/wp-content/uploads/2012/04/McKell_HomesForAll_A4.pdf

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38. ATO Taxation Statistics 2011-12

39. For simplicity we assume that this taxes place linearly, so that, for example, the 20-year pay-down involves a 5% reduction of the current outstanding aggregate balance each year.

40. Note the impact of the linear pay-down assumption for the timing of benefits.

41. RP Data and ATO

42. This assumes that the average number of properties in the 4 or more category is 5.

43. See: Kulish, Mariano, Anthony Richards and Christian Gillitzer, (2011) "Urban Structure and Housing Prices: Some Evidence from Australian Cities", *RBA Research Discussion Paper*, available at http://www.rba.gov.au/publications/rdp/2011/pdf/rdp2011-03.pdf

44. ABS (2013) *Lending Finance*, Canberra.

45. Housing Industry Association, *Housing Australia's Future*, https://hia.com.au/~/media/HIA%20Website/Files/IndustryBusiness/Economic/publications/ExtractHousingAustraliasFuture2014.ashx

46. Note: uses 2010-11 amounts of deductions by tax bracket with adjustment to 2014 tax rates. Source: RP Data, ATO, http://blog.corelogic.com.au/2013/05/there-were-1213595-individuals-with-a-negatively-geared-property-over-the-201011-financial-year/

47. This assumes that "positive gearing" is still permitted. An alternative would be to remove the interest tax shield (currently around $24 billion) completely, but then presumably rental incomes would not be taxed, either to avoid a serious inconsistency in policy. Thus, it seems sensible to consider removing the "negative" part of gearing in this scenario.

48. *Sydney Morning Herald*, March 17 2015, http://www.smh.com.au/comment/negative-gearing-the-economic-reasons-why-government-must-kill-this-sacred-cow-20150317-1m14s4.html

49. In the language of economics, there is both omitted variable bias and reverse causation.

50. This is known as a "difference-in-differences" approach to causal inference. See, http://www.mostlyharmlesseconometrics.com

51. RBA Financial Stability Review, 2015. http://www.rba.gov.au/publications/fsr/2015/mar/pdf/household-business-finances.pdf

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