DEBUNKING THE NEGATIVE GEARING MYTHS

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With the aim of bringing some objectivity and robust analysis to the debate on negative gearing the Real Estate Institute of Australia (REIA), together with the Property Council of Australia, engaged economic consultants ACIL Allen Consulting to undertake an economic assessment on the impact of any change to the current arrangements for negative gearing and the CGT treatment of property investment.

The first thing to note is that negative gearing is not a special concession for property. It is a legitimate deduction of expenses in the course of earning income from investments in all asset classes (including shares, other investments and business ventures) until the investment generates a positive income stream in the future. The ability of investors to gear and use debt is a crucial part of investing and fostering economic growth. The ability to deduct the cost of debt and losses against income is necessary to ensure that investments are not taxed punitively.

Similarly the 50 per cent discount on capital gains replaces the previous indexation of capital gains which was put in place to ensure that only real capital gains are taxed – the change being made for administrative ease – and is also applicable to all asset classes.

Dispelling the myths that have gained currency the ACIL report shows that negative gearing and the capital gains arrangements are helping to boost the supply of new homes, put downward pressure on prices, keep rents lower and give ordinary Australians a better chance of entering the property market which in many cases supplements savings for retirement purposes.

ACIL found that the provision of negative gearing in conjunction with the CGT arrangements promote investment in rental properties and increases the supply of new housing. Around a third of all new dwellings construction is financed by investors every year and the absolute amount of investor loans committed to new housing has increased by more than seven-fold since 1986. Thus refuting the popular arguments that negative gearing makes renting less affordable and does little to improve the supply of housing.

ACIL added that an increase in rental supply means higher rental vacancies and lower rents than would otherwise be the case. The benefit to renters from improved rental affordability was directly recognised by the Henry Tax Review (2010) which noted that "the current tax advantages available to highly geared investment can operate as a subsidy to renters by placing downward pressure on rents".

The report found that negative gearing provides all individuals with an opportunity to invest in property, not just those in higher income brackets. Seven out of ten property investors who benefit from negative gearing earn a taxable income of less than $80,001 a year. Furthermore, while individuals with incomes higher than $80,001 claim around 40 per cent of losses on investment property, those earning less than $80,001 a year claim the majority of rental losses (above 60 per cent of all losses).The data also shows that the majority of investors own only one property and this has not significantly changed over time.

Further, the report shows that property is not the investment class that benefits the most from the CGT arrangements. The majority (around 60 per cent) of the capital gains are sourced from shares, while capital gains from real estate investments (which include residential and other types of property) represent approximately 26 per cent of the total capital gains of taxable individuals.

The latest statistics from the ATO released last week show that based on 2013-14 tax returns the amount claimed

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in interest deductions by Australia's two million property investors declined by 9 per cent, while earnings from rents were flat. With that, the "cost" to the federal budget of negatively geared rental property deductions has fallen 12.5 per cent to the lowest level in four years. The proportion of property investors showing net losses has declined to 62 per cent.

ACIL also analyse some of the "solutions" that have been proposed by various commentators including quarantining of expense deductions from other income such as wages, removing negative gearing and the CGT arrangements for investment in existing residential property and having it apply to only newly constructed housing and limiting negative gearing to a maximum number of properties per taxpayer.

On these the report concludes that:

- Quarantining of expense deductions against corresponding income would primarily only affect the timing of tax payments, and as such would not result in a large tax collection increase for the Government
- A policy of removing negative gearing and the 50 per cent discount on CGT for investment in existing residential property would probably increase investor demand for new dwellings, displace owner occupier buyers and induce capital flight from investment in established dwellings
- Limiting negative gearing to a maximum number of properties per taxpayer would be highly distortionary, notwithstanding the practicality of determining an acceptable upper limit.

Whilst the ACIL research does not specifically analyse the Opposition's policy to limit negative gearing to newly constructed investment properties to improve both the supply of housing and housing affordability some pointers are nevertheless there.

The proposal fails the general principle of good taxation policy that it should not favour particular investment classes. Limiting negative gearing to new dwellings will add a distortion.

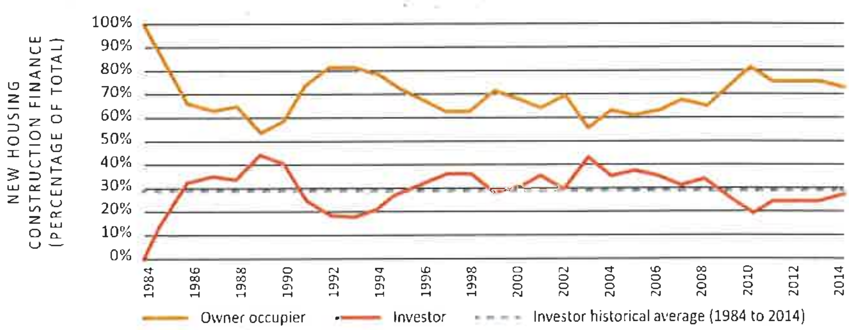
Whilst supply is acknowledged by all as critical in resolving the affordability problem the proposed changes will do nothing to address it. Supply is constrained by a number of longstanding challenges including regulatory and zoning constraints. These factors are not addressed in the policy.

As a consequence it is highly unlikely that there would be the supply response anticipated by the Opposition and instead many investors would exit the rental property market resulting in higher rents.

The policy is built on the popular perception of the amount of investor loans committed to new housing construction being relatively small.

ACIL's research shows that around 27 per cent of all loans for the construction of new housing in 2014 were to investors and that this proportion has remained relatively constant over the last 30 years (refer to the graph below). The absolute amount of investor loans committed to the construction of new housing has increased by more than seven-fold since 1986.

FIGURE 1 *Historical housing finance commitments for the construction of new dwellings*



Source: ACIL Allen Consulting based on ABS cat 5609.11

The ACIL report, *Australian Housing Investment: Analysis of Negative Gearing and CGT Discount for Residential Property*, is available here.