Distributional Modelling of Proposed Negative Gearing and Capital Gains Taxation Reform[1]

Research Note

Ben Phillips

Associate Professor

ANU Centre for Social Research and Methods

February 2016

[1] This work was not funded by any external sources and is an independent analysis. The views are those of the author alone.

Contents

Overview

In the 2012-13 tax year around 1.2 million persons were invested in negatively geared properties in Australia. Around 330,000 persons included capital gains in their taxable income where a 50 per cent discount was applied.

Australian taxation law allows investors (including rental investors) to offset the losses from negative gearing against their other income, not just their rental income as is the case in some other countries. This effectively treats rental losses in the same way a tax deduction or business income loss would be deducted against other income.

A separate, although often related element of taxation law is that capital gains, once an asset is offloaded, are halved before being counted as taxable income. This provides a significant concession relative to other forms of income.

The Federal Opposition have proposed a number of new policies that would alter the taxation law in these areas and this research attempts to understand the distributional consequences of such changes.

For negative gearing the Federal Opposition proposes to quarantine negatively geared investments to newly constructed dwellings only. Negative gearing would no longer be allowed for existing dwellings or a range of other investment classes. There are a number of exemptions in this policy though for business investment classes.

They also propose to reduce the concessional treatment of capital gains taxation from 50 per cent to 25 per cent. The existing concessional treatment for small business and superannuation would not change.

The analysis here is considered over the ‘long run’ and does not attempt to model behavioural changes such as investors changing their investment portfolios, carrying losses forward or altering their taxation affairs and behaviour to minimise the impacts of these policies. As such we expect these estimates are upper limits with regard to total impacts for the policies modelled. The general pattern of the distributional modelling should not be greatly affected.

Modelling Methodology

The modelling in this research note is largely based on the ATO Taxation Statistics 2 per cent unit record data. This file provides detailed information on individual taxpayers and provides information relating to negative gearing, capital gains taxable income and a wide range of other elements of personal income taxation.

The file is based on a 2 per cent sample of the 2012-13 tax year and includes only persons who filed a tax return. This means that a relatively large number of persons, mostly very low income persons and pensioners are not included in the file. The base population for this analysis is therefore only those persons who paid income tax or were required to fill in a tax return for 2012-13.

The policy changes announced by the Opposition relate to the 2017-18 tax year so our analysis attempts to 'age' the 2012-13 data to 2017-18. We take a relatively simple approach here by growing all incomes and all relevant dollar variables for negative gearing and capital gains by 3 per cent per year. The population is grown by 1.5 per cent per year and the tax system, such as the existing tax scales and thresholds are unchanged. For the purposes of negative gearing modelling we have reduced the interest deduction in line with the lower interest rates of February 2016 and assume these rates remain on hold through to 2017-18.

For negative gearing we simulate the tax savings as the difference between the amount of income tax an individual would have paid with and without the negative geared portion of rental income. For capital gains we estimate the tax that would have been paid had the discount applied at a 25 per cent rate and at the current 50 per cent rate. The difference is the extra tax that would be paid under the proposed, less concessional capital gains tax arrangement.

With the full details of the unit record data we are able to estimate the extent of negative gearing and capital gains tax expenditures by income deciles for both individuals and equivalised family income[2].

[2] The tax file provides spouse family income and taxable income for the reference person. Our estimate or equivalised income for the 'family' is therefore an approximation only and does not account for the number of children as that information is not provided.

Negative Gearing distributional analysis

The following analysis provides an overview of the existing population of taxpayers who negatively gear their rental investment properties. A number of families will also negatively gear other investments such as shares. This analysis focusses on the rental investors – the majority of investment by families in Australia.

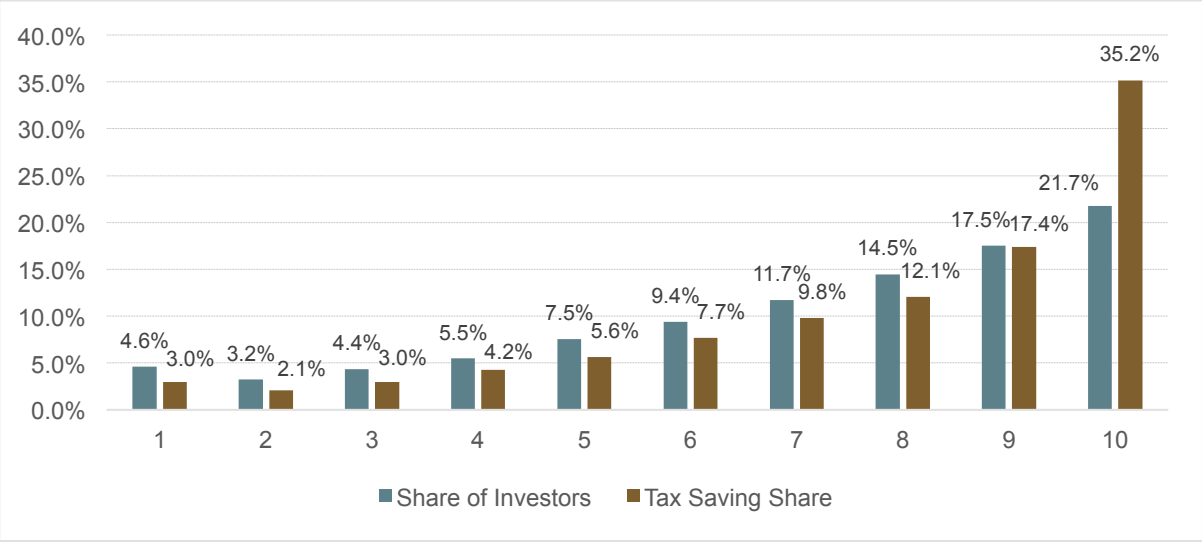
We expect by 2017-18 the median income of a negatively geared investor would be $69,900 per year while the rest of the population has a median income of $46,600. The negatively geared investors have an income that is 50 per cent larger than the remainder of the population. Where we add the negatively geared portion of income back onto taxable income their median 'adjusted' taxable income increases to $78,200.

We expect that around 22.4 per cent to have a taxable income of over $100,000 per annum in 2017 compared to 10.1 per cent of the remaining population. While negatively geared investors do typically have larger incomes it is also true that their spread of incomes covers low, middle and high incomes. Some of these investors will have a low taxable income on account of a large number of negatively geared properties and therefore a large tax deduction owing to negative gearing.

Figure 1 provides the share of negatively geared investors and their tax savings by income decile of family taxable income. The top decile accounts for 21.7 per cent of investors and 35.2 per cent of all tax savings[3]. The top 20 per cent makes up 52.6 per cent of all tax savings.

[3] For ranking incomes our preference is family income as we believe that is a better definition of income for the living standards of the entire family than individual income and families will naturally attribute the negatively geared income to the higher income earner in the family to maximise tax savings.

Figure 1 Negative Gearing by Taxable Family Income Decile, ATO, ANU, 2017-18



We estimate that in 2017-18 the total tax savings from negatively gearing properties is $4.3 billion. Under the Opposition plan these tax savings would only apply to newly constructed investment properties and all investments made prior to July 1 2017 would be grandfathered. Such exemptions would mean that the initial tax gains to the Commonwealth would be relatively small but would grow quickly.

Statistics on the share of investment housing that is devoted to new housing is not well understood in Australia. A partial measure is the ABS *Housing Finance* series which suggests around 7 per cent of rental investment finance flows to newly constructed dwellings. In the mid-80s this figure was above 50 per cent. It could well be expected that restricting negative gearing to new housing only would increase the share of investment housing devoted to newly built housing. There is little basis for estimating the impact on new housing but a ballpark figure that the share would increase to somewhere between 10 and 20 per cent would not seem too unrealistic. This would mean that the increase in tax revenue would be less than the $4.3 billion – somewhere between $3.4 and $3.9 billion per year in the longer term. In terms of number of persons affected the likely number would be between 1.0 and 1.1 million persons – with roughly 100,000 to 200,000 persons opting to purchase a newly constructed dwelling and therefore retaining negative gearing.

Table 1 Rental Losses and tax savings distribution (Negatively geared properties) 2017-18

$ Annual	*Median*	*Mean*	*90th Percent*	*95th Percent*
Rental Loss	$5,600	$9,300	$20,600	$29,300
$ Tax Saving	$1,800	$3,500	$8,000	$11,800

The typical tax savings for negatively geared individuals is $1,800 per year but the top 10 cent save at least $8,000 per year and the top 5 per cent save $11,800. The distribution of rental losses expected for 2017-18 show that the typical losses are $5,600 per year but the top 10 per cent are losing $20,600 per year and the top 5 per cent lose $29,300 each year.

An alternative to removing negative gearing (amongst several) is to cap the rental losses. We find that capping rental losses at $20,000 in 2017-18 would impact only around 10 per cent of negatively geared investors but increase tax revenue by around $1 billion each year. Capping losses at $50,000 would yield $300 million in extra taxation revenue[4].

The Henry Tax Review recommended a 40 per cent discount on all investment earnings. We have not modelled this policy.

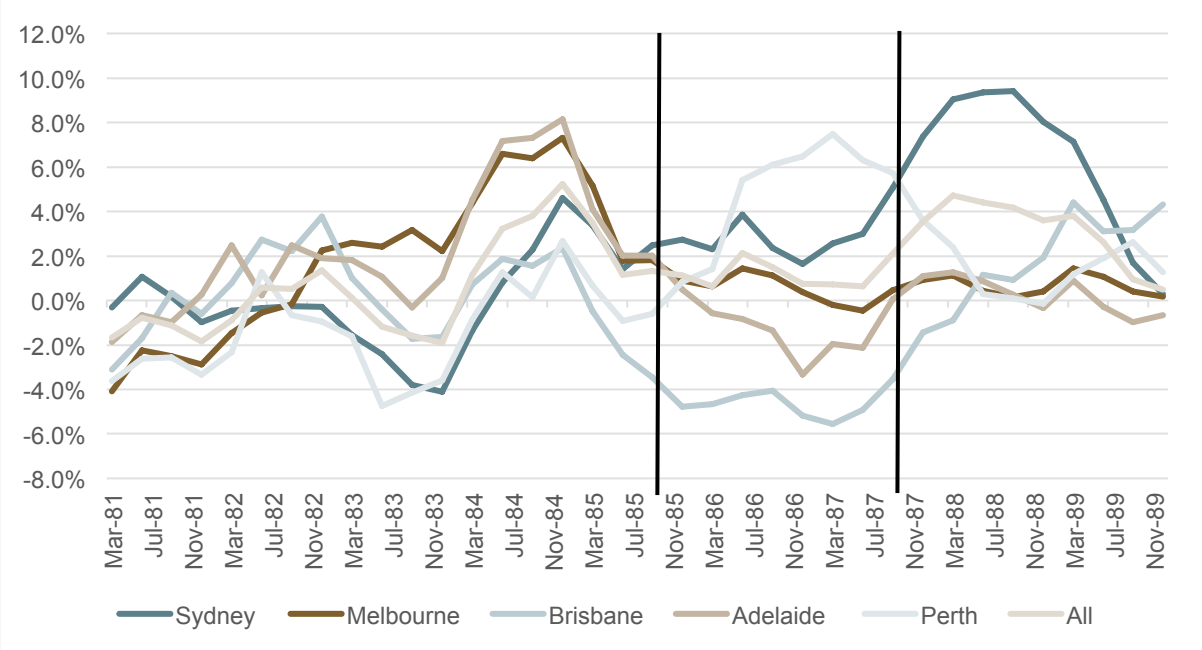
[4] The analysis here only considers individual taxpayers and does not consider any behavioural change particularly in this instance with regard to behaviour within the income unit.

Negative Gearing – potential impacts on rents

A common concern relating to the removal of negative gearing is the influence on the rental market. With rental investment being less attractive it may be the case that the supply of rental stock may decline. Helping to at least partially offset this force would be that those same dwellings would become owner occupier stock and therefore reduce demand for rental properties.

Between September 1985 and September 1987 Australia did exempt new investments from negatively gearing. Existing investments were quarantined from such changes (grandfathered). During the 1980s rent CPI grew at a rate of about 1.4 per cent above all groups CPI. For the removal of negative gearing to have increased rents we would expect real increases beyond this amount (all other things equal). We only find that Perth and Sydney (marginally) were above their decade average during this two year period. We find that Melbourne and Brisbane and Adelaide were all below their average real rental increases. Across all capital cities we find that real rental inflation was very marginally lower than average during the two year period that negative gearing was removed. It should be noted, however, that the housing market in the mid-1980s was very different to the one that exists today and that negative gearing is a much more significant part of rental investment today than 30 years ago. It is therefore difficult to infer much about any particular impact today from a similar policy change 30 years ago.

Figure 2 Rent CPI - real annual change 1980 to 1990



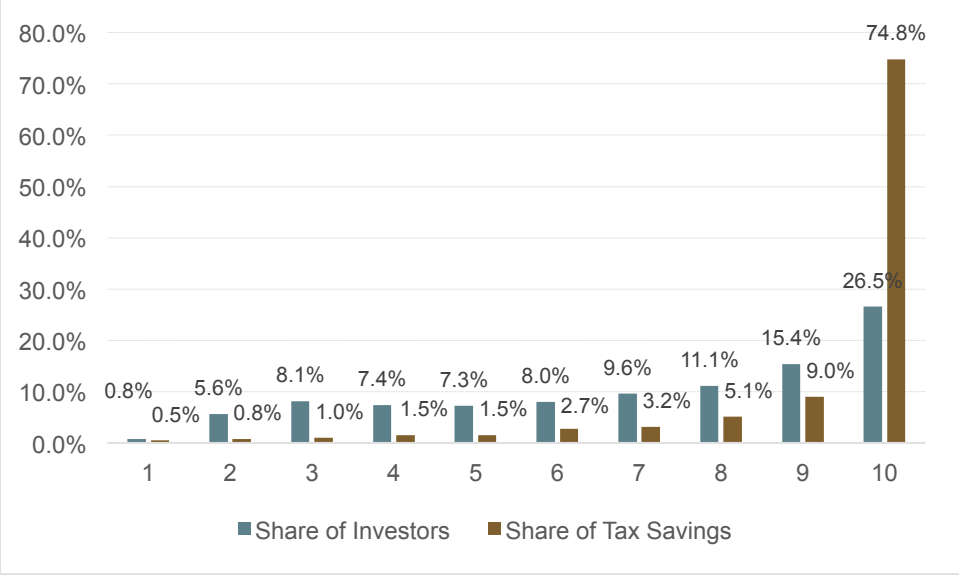
It should be remembered that negative gearing in and of itself is not a successful investment strategy. Negative gearing implies making a loss on your investment in simple income terms. Negatively geared investors are really chasing the capital gains and negative gearing allows investors to minimise their income taxation in the process. This next section considers the capital gains savings under the Opposition's plan to halve the capital gains tax discount from 50 per cent to 25 per cent.

Capital Gains distributional analysis

The following analysis provides an overview of the existing population of taxpayers who benefit from the discount on capital gains across all asset classes. The 50 per cent discount was first applied in 1999 and replaced the previous system which taxed the capital gains on an inflation adjusted capital gain. Mathematically, when the nominal capital gain is more than twice the rate of inflation then the 50 per cent discount approach is more generous and the reverse is true when inflation is more than 50 per cent of the nominal capital gain. During the 70s and 80s in particular inflation was very much higher than we have become accustomed to and the 50 per cent discount has now become very much concessionary compared to the pre-1999 method.

In aggregate, the most benefit goes to the top 10 per cent of income earners with 74.8 per cent going to the top decile. Figure 3 also shows that in terms of those who actually receive a capital gain benefit through the tax concession over 26 per cent are in the top 10 per cent.

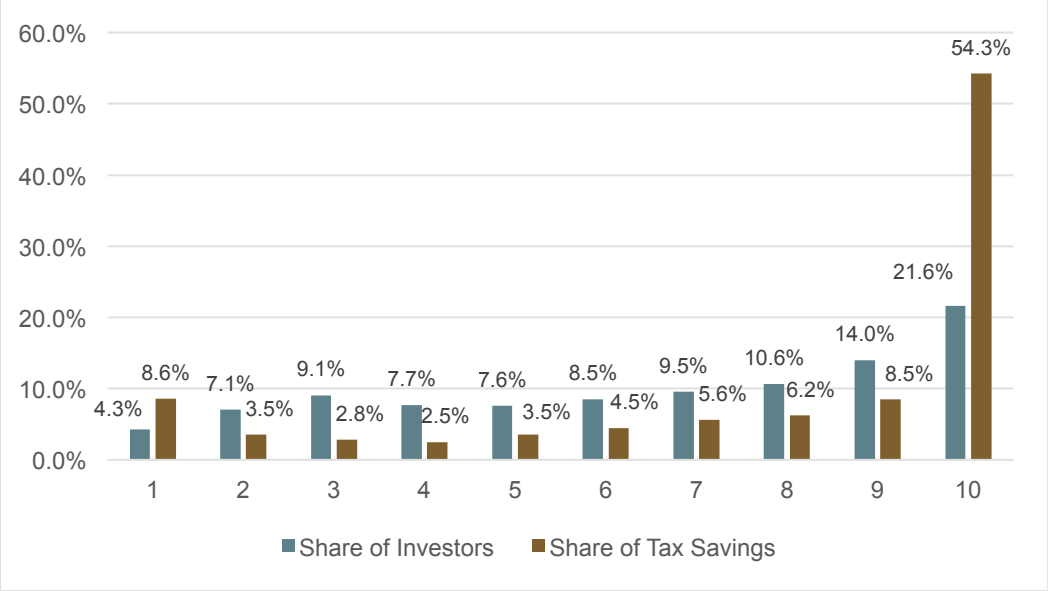
Figure 3 Capital Gains Discount Savings by Taxable Family Income Decile, ATO, ANU, 2017-18



A problem with this analysis is that capital gains are often a large one-off benefit and this can skew incomes temporarily. When we remove net capital gains from the taxable income – with the expectation of finding a more sensible view of the income distribution the distribution is less skewed with 54.3 per cent of the benefit received by the top 10 per cent. Of those in the bottom 10 per cent of income (net of capital gains) there is also a large share (8.6 per cent) of capital gains savings that flow to the bottom decile income families.

On balance, the reality is probably somewhere between these two results in Figure 3 and Figure 4 but still with most of the benefits received by the top 10 per cent of income families.

Figure 4 Capital Gains Tax Savings Distributional Analysis – net capital gain deducted, ATO, ANU, 2017-18



In total we find that the capital gains discount reduction proposed by the Federal Oppostion will, in the long term save around $2 billion per year in 2017-18 dollars. Clearly, with a grandfathering arrangement in place the savings will take a substantial number of years to reach this level. We have not considered any behavioural changes from this policy and have considered the capital gains tax policy change in isolation from the negative gearing policy change.

Conclusion

We estimate that the removal negative gearing will increase taxation revenue in the long run between $3.4 and $3.9 billion dollars a year depending upon the increase in new housing construction that flows from the exemption for new housing. This analysis only include rental investments and does not include a number of other asset classes also impacted by the policy. Rental investments are easily the largest component impacted so we expect the overall impact will only be moderately larger than that estimated here.

Our modelling shows that negative gearing benefits high income families with 52.6 per cent of the benefit going to the top 20 per cent of incomes. Only 5.2 per cent of benefits go to the bottom 20 per cent of incomes. This result is mostly driven by high income families being more likely to negatively gear, having larger negatively geared deductions and a progressive tax system that magnifies the gains for higher income persons.

We find that the typical amount of net rental loss is around $5,600 for a tax saving of $1,800. Negative gearing is heavily skewed with the top 5 per cent of net rental losses of $29,300 for tax savings of $11,800. Capping losses at $20,000 per year would cover around a quarter of the tax savings with only around 10 per cent of persons with negatively geared property affected.

Reducing the capital gains discount from 50 per cent to 25 per cent as proposed by the Federal Opposition would increase tax revenue by an estimated $2 billion in the long run in 2017-18 dollars. This is likely to be around a half of that obtained by the removal of negative gearing as also proposed.

The capital gains discount overwhelmingly benefits high income families with the top 10 per cent enjoying nearly three quarters of the tax savings. By removing capital gains income from the decile income rankings we find that figure drops to 54.3 per cent flowing to the top 10 per cent of families as ranked by income.

Overall, we would expect significant long term savings from the proposal to remove negative gearing and to halve the capital gains tax concessions. Somewhere in the order of $3.5 to $3.9 billion per year in 2017-18 dollars for the negative gearing changes and $2 billion per year for capital gains tax changes. The two polices have been modelled in isolation and do not account for any potential interaction.

The vast majority of the additional revenue would be at the expense of the top 10 per cent of earners in Australia. Roughly two thirds of the tax revenue would come from the removal of negative gearing and the remainder from the halving of the capital gains discount to 25 per cent.

ANU Centre for Social Research and Methods

+61 2 6125 0904

ben.phillips@anu.edu.au

The Australian National University

Canberra ACT 0200 Australia

www.anu.edu.au

CRICOS Provider No. 00120C