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Negative Gearing: Is It a Tax Concession?

Introduction

Negative gearing is a phrase used in Australian tax policy debates, typically in regard to rental property investments. It is claimed to be a tax concession that an investor receives a tax deduction for interest expenses that contribute to a current loss on a rental property investment, and can combine that with wage income for tax purposes. The deductibility of interest for tax purposes, though, is simply part of the general provisions of the tax act, ie that expenses incurred in earning of assessable income are deductable for tax purposes.[1] So where does the idea that this is a tax concession come from?

It is also said, often in the same debate, that there is a housing crisis in Australia, including that there is a shortage of affordable rental accommodation. Basic economics tells us that a policy change that increased tax on investments in rental properties would most likely lead to fewer rental properties and rent increases. So where does the idea that increasing tax on investments in rental properties will help with the housing crisis come from?

Housing Market Tax Issues

What is Negative Gearing?

There are two words in the phrase "negative gearing". The second word "gearing" simply means that borrowing is used in the financing of the investment. Typically, a mix of equity and debt will be used to finance a substantial investment such as a property. The first word "negative" describes a situation where the current expenses of an investment, eg interest and maintenance, are greater than the current income from that investment, eg rent. That is, the investment is making a loss in the current financial year (with a presumed accruing capital gain). So, a negatively-geared investment is one that uses debt in its financing and the current expenses are greater than the current income.

In common Australian parlance, the negative gearing phrase is generally used in regard to investments in rental properties. The expenses consist of interest on a loan to help finance the property purchase and other costs such as property maintenance, depreciation and other taxes – all deductable in the current financial year.[2] The returns can be categorised in two parts: current income in the form of rent, which is taxable in the current financial year; and an accruing capital gain, which is taxable only upon sale of the property and generally with a 50 per cent discount.

While a rational investor will expect to make a positive return over the life of an investment, that can be consistent with making a loss in the current financial year (current income minus current expenses), with the accruing capital gain expected to turn that into a positive overall return.

Capital and Labour Income

The second aspect of the negative gearing tax policy debate is that current losses on investment income are generally able to be combined with an individual taxpayer's other taxable income, eg wages. This is consistent with the general schema of the Australian tax system. A fundamental

[1] Contrary to some public perceptions, there is no "negative gearing" provision in the tax law.

[2] Land tax and property rates are generally deductable for income tax purposes. Stamp duties are generally not deductable (except in the ACT with its leasehold arrangements).

principle underlying a progressive income tax is that it seeks to make an assessment of a taxpayer's ability to pay.[3] Those who are better off, ie have a greater ability to pay, should pay more tax, while those who have an equal ability to pay should pay the same amount of tax.[4]

Income is taken as a proxy for assessing a taxpayer's ability to pay tax.[5] A taxpayer's net income for the year is thus taken as the basis of their taxable income. This is equivalent to a business, where profit is taken as the basis for their taxable income. In the Haig-Simons[6] tradition, a comprehensive measure of net income is required to establish a good basis for assessing a taxpayer's ability to pay tax – all income, regardless of source, form or use, should be included.[7]

While capital income and labour income have in the past in Australia been taxed differently[8], and there remain significant elements of that[9] (and see discussion of schedular systems used in other countries below), it is those very differences which represent departures from a comprehensive income tax benchmark. Combining an individual's capital income and labour income is what is required to assess their comprehensive income and ability to pay tax.

Rental Property Investments

The tax policy issues around negative gearing are relevant to any taxable investment. The purchase of any asset, eg shares, can be financed with borrowing (geared), and where the current costs (including interest) are greater than the current income, eg dividends, it can be said to be negatively geared. But as the public discussion of negative gearing in Australia largely relates to investments in rental properties, that will be the focus of this paper.

A key difference with property investments, compared to other investment options, is that in addition to income tax, several other taxes apply (conveyance duty upon purchase, annual land tax, and annual property rates) which amount to a heavy impost on the financial viability of rental property investments in particular. This paper, though, will focus mainly on the income tax issues.

Property also differs from other assets in its form. A property consists of a building (which generally depreciates in value) and land (which generally appreciates in value). Further, in addition to being an investment vehicle, a property is also a home, giving it some special social status.

To recap then, we are looking at investments in rental properties that are financed with a mix of debt and equity. Relevant to our consideration is that investors will pay interest on the debt and face other costs such as maintenance of the property and various additional taxes. In return investors will receive rental income and on sale of the property expect to realise capital gains.

Comparison with Owner-Occupied Properties

[3] The main alternative principle for establishing equitable tax liabilities is the benefit principle which would connect tax liabilities to the benefits taxpayers receive from government.
[4] To assess income tax, the individual is taken as the tax unit (with some variations for families) and a year is taken as the time period for assessment (generally 1 July to 30 June in Australia).
[5] Wealth and consumption are the main alternative metrics for assessing ability to pay.
[6] American economists who developed a measure of income for tax purposes.
[7] See discussion in chapter 3 of *Mixed Fortunes*.
[8] The tax rate differential between property and personal exertion income was removed in 1953.
[9] Apart from capital gains, most substantively in regard to superannuation and owner-occupied properties.

It is important to understand the differences between the tax (and transfer system) treatment of investments in rental properties and in owner-occupied (O-O) properties - the other main part of the private housing market. For a given overall supply and demand in the private housing market, it is the split between these two that is fundamentally at stake.

As Table 1 shows, both investments are made out of after-tax income, but there are differences in the taxation of returns. With O-O properties, neither the imputed rent[10] from living in the house nor the capital gain upon ultimate sale are taxable. With rental properties, there is full taxation of rents and partial taxation of capital gains. Consequently, no tax deductions are allowed for O-O property expenses (interest, maintenance, etc.) while full deductions are allowed for rental properties.

There are also differences in the transaction and recurrent taxes faced by rental and O-O properties. Purchases of both rental and O-O properties are subject to stamp duty. Property rates also apply to both. Land tax, though, applies to rental properties but not to O-O properties. Further, O-O properties are largely exempt from transfer system means tests (eg pensions)[11].

Table 1: Taxation of Rental v Owner-Occupied Properties

	Rental Property	**O-O Property**
Purchased out of after-tax income	Yes	Yes
Taxation of returns	Yes (CGT 50%)	No
Deductibility of expenses	Yes	No
Stamp duty	Yes	Yes
Land tax	Yes	No
Property rates	Yes	Yes
Inclusion in pension means test	Yes	Partial

This comparison shows that O-O properties are generally treated significantly more concessionally in the Australian tax/transfer system than rental properties. While rental properties benefit from the inclusion of just 50 per cent of capital gains in taxable income, the returns on O-O properties are completely tax exempt, they are not liable for land tax and they receive more generous pension means test treatment.[12] The existing tax/transfer system is tilted heavily in favour of O-O housing.

Alternative Savings Vehicles

Housing is one of a number of available investment options. The main savings options for an individual investor are bank accounts, shares, O-O properties, rental properties and superannuation. For all of these, except superannuation, the initial investment is made out of after-tax income. The returns, though, are taxed quite differently. The returns on bank accounts are taxed in full, O-O property returns are not taxed at all, while for rental properties and shares there is full taxation of part of the return (rent or dividends) but only partial taxation of the other part (capital gains).

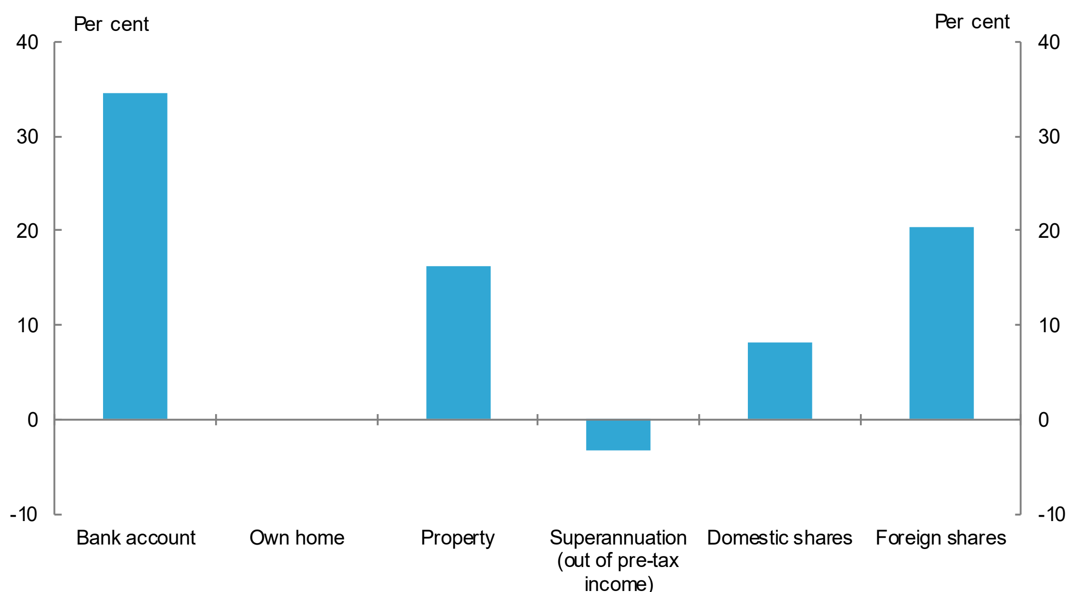
[10] The equivalent of the actual rent paid by a tenant in a rental property. Taxation of imputed rent was part of the Australian income tax law from 1915 to 1923, and is still applied in some OECD countries.

[11] The asset means test thresholds, though, are set lower for home owners.

[12] There are also other measures that favour O-O housing, eg the 2018 measure that allows people over 55 to deposit part of their home sale proceeds into their superannuation, over and above their contribution cap.

The 2015 *Re:think Tax discussion paper* produced estimates of effective tax rates (ETRs) for the main savings vehicles in Australia, against a nominal income tax benchmark,[13] incorporating just the income tax effects.[14] See Figure 1.

Figure 1: Effective Marginal Tax Rates for Australia's Main Savings Vehicles (MTR = 34.5%)



Source: Re:think, p60.

There is an extensive literature on the appropriate level and design of taxation arrangements for savings. While the overall level of savings is not considered to be very responsive to the level of taxation, there are likely tax-driven distortions between the choice of savings vehicles, making an argument for taxing different savings vehicles at similar levels.[15]

Other Parts of the Housing Market

Holiday houses are another part of the housing market. Where used solely for holiday purposes, so not earning taxable income, expenses are not immediately tax deductable. Capital gains will be taxed upon sale, with expenses such as interest and maintenance able to be carried forward and added to the cost base.

Public housing is another important part of the housing market, but as tax issues are generally not relevant, this paper will focus on the private housing market.

Tax Treatment of Housing in Other Countries

As context for considering Australia's approach to the taxation of housing, it is instructive to look at the approaches taken by other countries. In fact, a broad range of tax treatments apply across OECD countries, particularly for O-O properties.[16] See Table 2.

[13] The Henry review provides equivalent estimates for real effective marginal tax rates (Henry, p.33).
[14] These estimates do not include the impact of transaction taxes and recurrent taxes on property investments.
[15] See discussion in the TTPI paper *The Taxation of Savings in Australia*, pp.22-8.
[16] The 2018 OECD paper (chapter 2) provides descriptions, eg see Table 2.1 (p.27) and Table 2.9 (p.48).

Most countries tax rental income from rental properties, while only a small number tax imputed rent on O-O properties. Capital gains on rental properties are taxed to some extent by a majority, but capital gains on O-O houses are generally tax exempt. A majority allow tax deductibility of interest on investments in rental properties and about half do so for O-O housing.

Some countries tax capital and labour income together comprehensively at progressive tax rates, while others tax capital income separately at a flat tax rate (a schedular approach). Australia is in the former group, as are the US, the UK[17], Canada and New Zealand.[18] Attachment A describes these alternative approaches to taxing labour and capital income.

Transaction taxes upon purchase (eg stamp duties) are applied in a majority of countries for both rental properties and O-O properties. Recurrent property taxes of some sort are applied in all countries for both rental properties and O-O houses (eg Australia's land taxes and property rates). A small number of countries apply general wealth taxes.

Table 2: International Comparison

	Rental Property	**O-O Property**
Tax Rent/Imputed Rent	Most	Small number
Tax Capital Gain	Most to some extent	Most exempt
Deductibility of Interest	Most	Half
Transaction Taxes	Most	Most
Recurrent Taxes	All	All

So, while there is a range of tax treatments of housing across OECD countries, Australia is not one of the outliers. In particular, Australia's taxation of investments in rental properties takes a similar approach to that of other OECD countries we normally compare ourselves to.[19]

Is Negative Gearing a Tax Concession?

With the above housing market context, it is time to directly address the question of whether negative gearing can be considered to be a tax concession. To do that, a benchmark is needed.

Benchmark

Whether something is a tax concession needs to be assessed compared to some benchmark of an ideal treatment. Departures from that ideal might be considered concessions (or penalties).

The general benchmark for income tax in Australia is net nominal income, with the *Tax Expenditures and Insights Statement* using a version of the Haig-Simons income definition. That benchmark adopts a comprehensive measure of income (labour and capital) and provides deductions for expenses incurred in earning that income.[20]

Consistent with this, the Income Tax Act states "your assessable income includes the ordinary income you derived directly or indirectly from all sources, whether in or out of Australia, during the income

[17] With some restrictions.
[18] OECD (2018), p.27.
[19] Greater differences across countries exist in the taxation of O-O housing and retirement savings.
[20] See discussion at *Tax Expenditures and Insights Statement*, January 2024, pp.191-6.

year"[21] and that you can deduct from that expenses "incurred in gaining or producing your assessable income".[22] That is, the benchmark for the general schema of the Australian income tax law is net nominal income.

Subsequent parts of the Australian income tax laws, though, depart from this general schema. Most significantly, and relevant to our negative gearing question, the tax treatment of savings contains some substantial departures. As previously discussed, there are major departures in the areas of O-O housing, superannuation and capital gains. These departures call into question whether the general schema of net nominal income is really the intended benchmark.

The most obvious conceptual alternative to income as a benchmark is consumption, ie it also provides a proxy for ability to pay. Under a consumption tax benchmark, the returns on savings would not be taxed at all. There is an extensive literature on the question of whether income or consumption provides the better tax base, but for our purpose the main observation is that the difference between income and consumption is savings - and it is the taxation of savings where we see the main departures from a comprehensive income tax base (see Figure 1).

Another key issue is whether we wish to use a nominal or real benchmark for returns on savings vehicles. It is arguably just the real return that provides an indicator of ability to pay. Adjusting for inflation, though, adds complexity and proxy approaches are generally used.

Without going into great detail, these benchmark issues are key to assessing whether a particular tax treatment can be considered to be concessional. Given the overarching general schema of the Australian income tax act is a net nominal income tax benchmark, I will proceed on that basis but acknowledge along the way the implications of alternative benchmark choices.

Analysis of Australian Tax Treatment of Rental Property Investments

To analyse the tax treatment of negatively-geared investments in rental properties in Australia, I will first examine the expense and income sides of the transaction separately, then consider any asymmetry between them.

Looking at the expense side of the transaction, there is nothing unusual about the tax treatment of investments in rental properties. First, expenses incurred in earning assessable income are deductable under the general provisions of the income tax act and this is the treatment applied to expenses for investments in rental properties.[23] Second, current gains or losses associated with a rental property investment are combined with other income, eg wages, to calculate a taxpayer's total taxable income. This is consistent with the general objective of income tax, being to assess a taxpayer's total taxable income and hence ability to pay tax.

Looking at the income side of the transaction, there are two components: rent and capital gains. Rent is treated like other current income; it is included in the taxpayer's assessable income for that financial year. Capital gains, however, are treated differently. While an ability-to-pay approach in the Haig-Simons tradition would call for the accruing capital gain to be included in each year's assessable income, the practice is to only apply capital gains tax (CGT) upon sale (realisation) of the asset.

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[21] Income Tax Assessment Act 1997, s6-5(2).
[22] Income Tax Assessment Act 1997, s.8-1(1)(a).
[23] This includes providing depreciation deductions each year, ie on an accruals basis.

Further, under the current Australian income tax law only half the nominal capital gain is included in assessable income for that year.

It can be seen, then, that there is an asymmetry in the tax treatment of the expense and income sides of investments in rental properties. The expense side of the transaction is consistent with the nominal income benchmark (full Haig-Simons). The income side of the transaction, though, is not. From a benchmark perspective, then, everything except the capital gain receives net nominal income tax treatment. So, on this benchmark, to the extent there is a tax concession associated with investments in rental properties, it has nothing to do with the deduction of interest (negative gearing), it is about the income side of the transaction and the tax treatment of capital gains. **Importantly, this is the case whether the property is negatively geared or not.**

Re:think made this point. "Allowing investors to claim deductions for interest expenses ensures consistent tax treatment between debt and equity financing" and "any tax advantage for individuals investing in property does not come from borrowing" but rather "on the income side from the taxation of the capital gain"[24].

Capital Gains Tax

As the treatment of capital gains is the main divergence from full income tax treatment in regard to investments in rental properties, it is worth examining that issue further. An important consideration is the issue of whether a nominal or real benchmark for the taxation of capital income is adopted.[25]

Since 1985 in Australia, capital gains on appreciating assets have been subject to a comprehensive tax regime. Assets purchased after 19 September 1985 were subject to CGT on any **real** gains, but only on a realisations basis (sale). To achieve this, the cost base of the asset was indexed for inflation, and upon sale the difference between the sale price and the indexed cost base was included in taxable income.[26] From 1 October 1999 these indexation arrangements were replaced with a 50 per cent discount of the **nominal** realised capital gain, that is just half of the nominal capital gain was included in taxable income. At the time of the change, it was argued this would simplify the CGT arrangements and improve investment incentives.[27]

There are two elements of concessionality in the tax treatment of capital gains in Australia.

First, the inclusion of only half the gain is a concession compared to a full nominal benchmark. Part of this exemption can be justified as an attempt to tax only real, not nominal gains, although this is a poor proxy for indexation. Further, if it is desired to move back to a real benchmark this should be done comprehensively across asset classes and on both the income and expense sides of transactions (see discussion of reform options below).

Second, gains are only taxed upon sale of the asset. This provides a deferral advantage for the tax liability and also creates a lock-in effect whereby taxpayers have an incentive to delay the sale of assets, possibly to a time in their life where they have a lower tax rate, eg retirement. Conceptually, capital gains should be taxed annually as they accrue, akin to how depreciation on assets is allowed

[24] Re:think, Box 4.2, p.66.

[25] The difference being the component of returns that merely compensates for general price inflation.

[26] Paul Keating, *Reform of the Australian Tax System*, 19 September 1985.

[27] Peter Costello, *The New Business Tax System*, 21 September 1999.

as a tax deduction annually. It is claimed there are valuation and cash difficulties with an accruals CGT, although these issues are probably less significant now than in the past.

Overall, then, it can be argued that the CGT treatment of investments in rental properties, as with other appreciating assets, is concessional.[28] As such, any reform of the tax treatment of rental properties is best considered in the broader context of reform of Australia's general approach to the taxation of capital income. The Henry review, for example, proposed a 40 per cent discount for tax purposes on the net return from a range of asset classes including rental income and capital gains (but not including O-O properties and superannuation).[29]

Second Best?

Reforming CGT, though, is a difficult task. First, there is the general question of whether the benchmark for taxing capital income should be nominal or real. Real is the conceptually preferred approach, but there are practical difficulties achieving that. It is argued that indexation of the cost base has administrative challenges, so a discount on the nominal gain can be used as a simpler but imperfect proxy.[30] 50 per cent, though, is probably more than can be justified as allowing for the average effect of inflation with the generally low inflation of recent decades. If a single flat discount is to be used, 40 per cent is considered to be a more realistic inflation adjustment given Australia's recent inflation history.[31]

So, if it is not possible to reform the CGT treatment of investments in rental properties, an argument might be made that as a "second best" approach an offsetting distortion on the expense side of the transaction could be put in place. That is, some restriction on the tax deductibility of expenses such as interest could act as an offsetting distortion to the under-taxation of capital gains. Or more precisely, given the deferral of part of the tax on the income, there could be a matching deferral of the tax deductions for the expenses.

This approach would achieve a closer alignment between the tax treatment of the income and expense sides of rental property investments. A better approach, though, would be to address the under-taxation of capital gains directly.

Expressed another way, there is an asymmetry in the tax treatment of the income and expense sides of the property investment transaction. There are two ways to fix this asymmetry: tax the income side more fully; or reduce the allowable expense deduction. Which of those you prefer will depend on your view of the appropriate benchmark.

Other Taxes

The discussion to date has honed in on CGT as the source of asymmetry and potential under-taxation of investments in rental properties (noting that the taxation of O-O housing is significantly more concessional). Property investments, though, also face other transaction and recurrent taxes.

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[28] Australia's CGT approach is broadly comparable to most other OECD countries (see discussion in the TTPI paper *The Taxation of Savings in Australia*, p.26).

[29] Henry, Overview, p.33.

[30] The inflation component of asset price growth will vary with the rate of inflation and the time that the asset is held for. A single flat discount, therefore, can only be a crude on-average approximation.

[31] See discussion at Henry, Volume 1, Part 2, p. 72.

In Australia, stamp duties are applied as a transaction tax by state and territory governments on the purchase of both O-O and rental properties.[32] Recurrent taxes are then applied on an annual basis. Land tax is applied by state and territory governments annually on rental properties[33], but not to O-O properties. Property rates are applied by local governments to both rental and O-O properties.[34]

These taxes add substantially to housing costs. For rental property investments in particular the three additional taxes of stamp duty, land tax and property rates are a sizable impost that needs to be considered alongside the concessional CGT treatment (see effective tax rates discussion below).

These taxes also present reform priorities. As transaction taxes, stamp duties impede a more efficient allocation of housing by creating a disincentive to re-allocation (downsizing, upsizing, moving for a new job). They are also inequitable in that they discriminate against those who need to move more frequently for work. Recurrent taxes, such as land tax[35] and property rates[36], are far more efficient taxes. They can be seen as a form of rent tax and being unrelated to any specific transactions are largely economically neutral. An obvious reform direction is a tax mix switch away from stamp duties to a broad-based land tax.[37]

Effective Tax Rates

To understand the combined impact of taxes on housing, effective tax rate estimates seek to incorporate the total impact of taxation, ie income tax, transaction taxes and recurrent taxes. The OECD has developed a methodology for calculating effective tax rates of different savings vehicles. Their methodology and results for Australia are provided in Attachment B. The highest effective tax rates are for investments in rental properties, a consequence of the additional taxes (stamp duties, land tax and rates) more than offsetting the CGT 50 per cent discount.

Other Issues

As flagged, the CGT realisations basis provides opportunities for individuals to delay the sale of an asset to a time with a lower tax rate, eg retirement. Even if negative gearing itself is not a tax concession, borrowing can help leverage access to such taxable income delays.

There are many other non-tax issues at stake in the housing market. In particular, various regulatory policies play a substantial role in regard to both rental and O-O properties.

Most substantive, though, are the policies and real-world constraints that impact on overall housing supply and demand. On the supply side, these relate largely to state, territory and local government planning policies and to issues in the building industry.[38] On the demand side, they relate largely to population growth, household formation and investors' expectations of asset price growth (capital

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[32] Conveyance duties apply above a threshold of around $1m at rates of around 1% to around 6% of the property purchase price. The purchase of a $1m house might incur stamp duty of around $40,000 - $50,000.

[33] Land taxes apply above a threshold of around $0.5m at rates that range from around 0.5% to around 2.5%. A $1m rental property might have an annual land tax bill of around $4,000.

[34] Property rates apply at around 4% of net annual values. A $1m house might have an annual rates (and other council charges) bill of around $6,000.

[35] Land tax can be thought of as a rent tax.

[36] Property rates can be thought of as a benefit tax.

[37] OECD (2022), p.7.

[38] The RBA research paper *A Model of the Australian Housing Market* models the impacts of a rise in housing construction, including reductions in rental vacancy rates and rents.

gains). While not the focus of this paper, where total housing supply lags total housing demand, there will be upward pressure on house prices. Australia faces this situation as the root cause of current housing price and availability pressures.

Assessment

Assessed against a net nominal income tax benchmark, negative gearing is not a tax concession. There is a tax concession with rental property investments, though, on the income side of the transaction with the partial and deferred taxation of capital gains. That is, there is an asymmetry in the taxation of rental properties that generates a tax concession.

It may be that assessed against an alternative benchmark, negative gearing could be considered a tax concession. Under a benchmark with only partial taxation of capital income, eg in the ballpark of Australia's current CGT, the full deductibility of interest and other property expenses could be considered concessional (and the full taxation of rents as punitive). But it would remain the case that the tax (and transfer system) treatment of O-O housing is even more concessional.

On the question of whether capital income (or losses) should be able to be combined with labour income for tax purposes, or whether a more schedular approach should be adopted with capital income taxed separately at a flat tax rate, there are arguments for and against. To make a comprehensive assessment of an individual's ability to pay, though, combining the two is appropriate to enable the application of progressive rates to the individual's total income and ability to pay tax. The exploitation by high-income earners of the flat-tax approach to superannuation in Australia provides a cautionary note.

Consequences of Increasing Taxation of Investments in Rental Properties

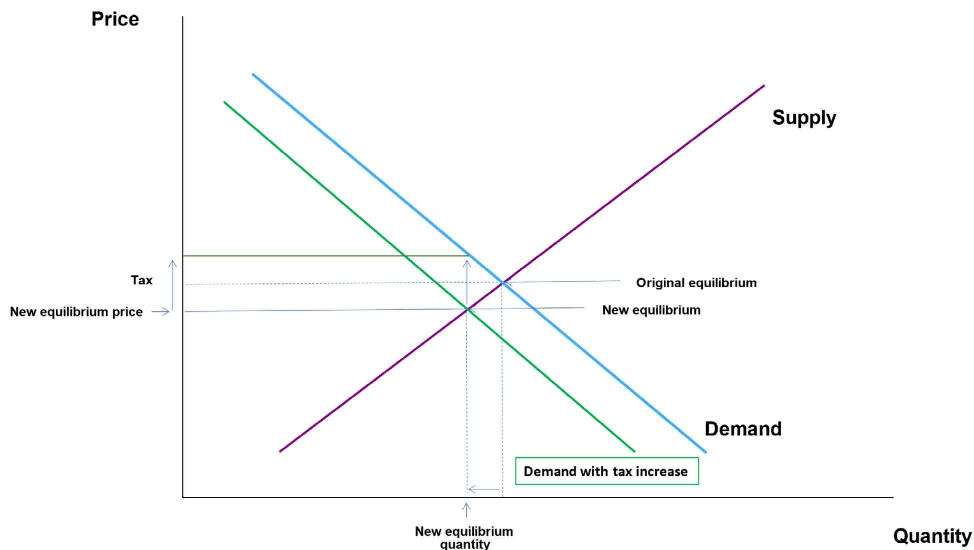
In this paper I have sought to demonstrate that assessed against the standard income tax benchmark negative gearing is not a tax concession, but that Australia's CGT design does provide a tax concession. I have also contrasted the tax treatment of rental properties with that of O-O housing where there is no taxation of the net return, no land tax and substantive exclusion from the pension means test.

It is worth examining, nonetheless, what the consequences would be of an increase in the taxation of investments in rental properties, for example through a tax restriction on negative gearing or an increase in CGT (with O-O housing taxation unchanged).

Such an increase in the taxation of investments in rental properties would add to investors' costs, tilting the balance further in favour of O-O purchasers (which may be a deliberate policy objective). For a given overall supply of housing, an increase in the taxation of rental property investments would likely mean there would be more O-O properties and less rental properties.

Figure 2 illustrate this with a simple supply and demand curve diagram for the rental property investment market. Taking the total supply of housing as given, the split between O-O housing and rental properties is determined in the market place. From the initial equilibrium price and quantity, the tax increase on investments in rental properties would lower the after-tax demand curve of rental property investors (as some investors switched to non-housing assets). The new equilibrium would be at a point of lower price and quantity of rental properties. That is there would be a shift in the market split away from rental properties (and to O-O properties). At the margin, some individuals who were renters would become owner-occupiers.

Figure 2: Supply and Demand for Rental Property Investments



Note: This diagram is showing just the market for rental properties, so a quantity decrease here is assumed to be matched by a quantity increase in O-O properties. The housing market in total is assumed to have inelastic supply in the short term.

While the tax increase on rental property investments falls initially on investors, they will seek to pass that through to tenants in higher rents. There is a distinction between the legal and economic incidence of taxes – the rental property investor has the legal incidence of the tax increase, but they will seek to pass the actual economic incidence of that tax increase onto the tenants.

Figure 3a depict the rental accommodation market to illustrate this. The rental property investors are now the suppliers of rental accommodation, with tenants the demanders for that accommodation. The effect of the tax increase is to raise the investor's/landlord's cost structure and so shift the supply curve left. But with the matching increase in O-O housing there will be some reduction in the quantity of renters, so the demand curve also shifts to the left by an equal amount. The market will find a new equilibrium with a reduced quantity of rental accommodation and a new price (rent).

Figure 3a: Supply and Demand for Renting of Rental Properties

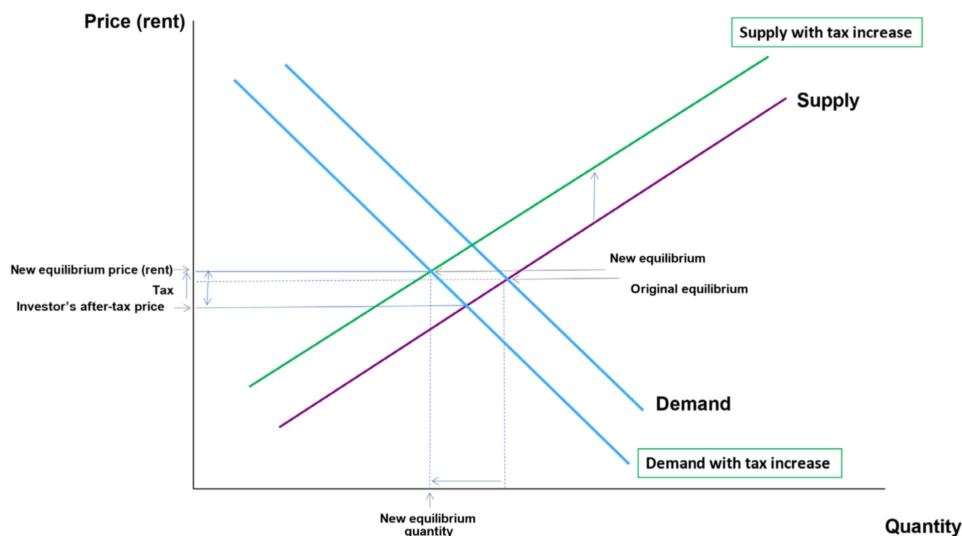
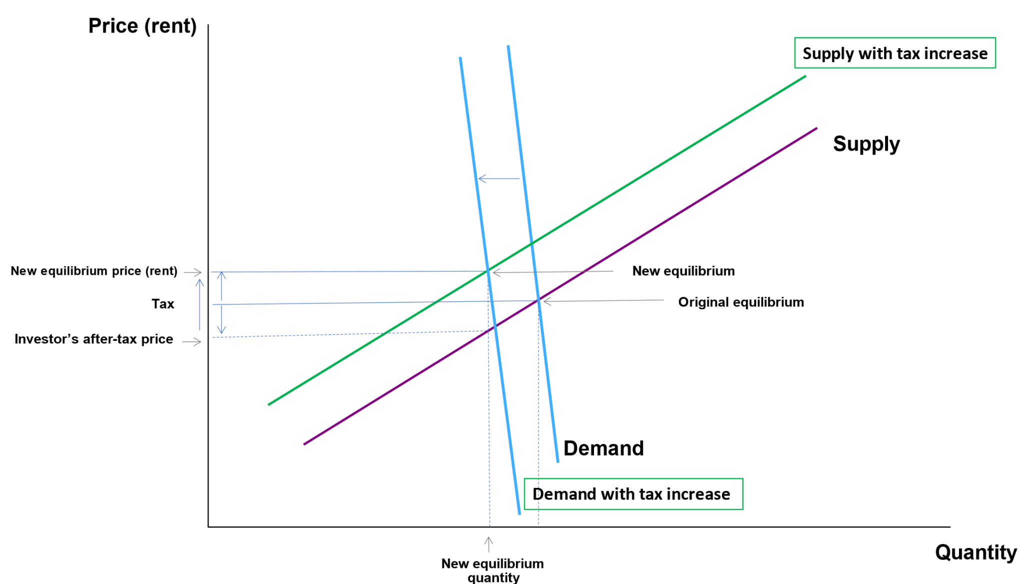


Figure 3a illustrates that part of the tax increase may be absorbed by the landlord as a decreased after-tax return and part may translate to increased rents (the split of the difference between the new equilibrium price (rent) and the investor's after-tax price). This split of the economic incidence of the tax increase between the landlord and the tenant will depend on their relative market power – in economic terminology on their price elasticities. The more inelastic, ie the lower their market power, the greater will be their share of the tax increase.

In a tight rental market, tenants have limited alternative accommodation options and it is likely they will have relatively low market power, ie the more inelastic demand. Keeping in mind this is a tax increase on just one asset class, investors have other investment opportunities to achieve their required after-tax rate of return, ie more elastic supply. This situation is illustrated in Figure 3b which depicts a situation with a relatively inelastic (steeper) demand curve for rental accommodation.

Figure 3b: Supply and Demand for Renting of Rental Properties (Inelastic Demand)



What this analysis shows is that the consequence of a policy action to increase the taxation of rental property investments would be a reduction in the quantity of rental properties and likely some increase in rents. Conversely, there would be an increase in the quantity of O-O properties (at the margin some renters would become owner-occupiers). The magnitude of these changes would depend on the size of the tax increase and the realities of investor/tenant market powers.

Policy Lessons and Directions

Tax issues are probably not the main driver of housing investment decisions, with other issues around overall demand and supply for housing more relevant. In regard to the tax issues, though, some observations can be made.

First, assessed against a nominal income tax benchmark, negative gearing is not a tax concession. To the extent there is a tax concession associated with investments in rental properties, it lies with Australia's CGT arrangements which provide a 50 per cent discount and apply only upon sale of the

property – and this is the case whether the property is negatively geared or not. It is also clear that the tax/transfer treatment of O-O properties is already more concessional.[39]

Second, for a given total supply of housing, an increase in the taxation of rental properties will tilt the balance further in favour of O-O housing, with an increase in its market share. Further, the economic incidence of any tax increase on investments in rental properties will likely be partly borne by renters in the form of higher rents.

There are some major problems in the Australian tax system, including ones that impact on the housing market, that are sorely in need of reform efforts. Increasing taxes on housing is not the way to increase supply.

The taxation of capital income warrants review. As Figure 1 showed, the main forms of savings in Australia are taxed very differently. Achieving some greater consistency of approach, including in regard to CGT, would reduce distortions in how individuals save. The Henry review proposal for a 40 per cent discount on the taxation of net returns from capital investments, or a return to indexation, would be good starting points for that consideration.

A more radical approach may be to provide rental property investments with the same income tax treatment as O-O properties. As illustrated in Attachment C, with total tax deductions approximating total taxable income, there may not be a significant revenue impact from such a move.

In the housing market, the most obvious tax reform initiative is a transition away from the stamp duty (a transaction tax) to a broad-based land tax (a recurrent tax). The negative gearing discussion is an unfortunate distraction from more genuine tax reform priorities.

Conclusions

Tax is probably not the main issue in housing policy considerations, but to the extent it does play a role two main conclusions stand out.

First, assessed against the standard income tax benchmark, negative gearing is not a tax concession. The CGT treatment of investments in rental properties, though, is – that issue is best considered as part of a broader consideration of the taxation of capital income in Australia. The most obvious tax reform priority in the housing market is a switch away from stamp duty to a broad-based land tax.

Second, increasing taxes on investments in rental properties will reduce their quantity, with a corresponding increase in O-O properties. While the target for any such tax increase may be the rental property investors, the reality of rental markets is that the true tax incidence would likely be partly borne by those left in rental accommodation in the form of increased rents.

There are some major reforms that would help alleviate housing pressures in Australia. Negative gearing is not one of them. Australia faces some major tax reform challenges. Negative gearing is not one of them.

[39] O-O housing is favoured in the tax systems across OECD countries (OECD (2018), p.52).

Attachment A

Capital v Labour Income

There are broader questions about the best way to tax returns on savings (capital income). There are good arguments for taxing returns on savings at a lower rate than labour income.[40] There are two ways to do this.

The first is to retain the comprehensive income approach that combines labour and capital income to be taxed under one rate scale, but provide some discount for income from savings, either a flat discount, eg 40% or a return to indexation. The OECD countries that Australia typically compares itself to most closely, the US, UK, Canada, New Zealand, use this approach.

The second is to adopt a schedular tax approach, with labour income taxed under a progressive rate scale and returns from savings taxed under a separate, probably flat, rate scale. A number of OECD countries, including most of the European countries, use this approach. This approach facilitates simplicity but compromises equity and invites distortions as high-income earners seek to channel income through that source.

While Australia generally uses the comprehensive approach, with various concessions for returns from savings, it uses the schedular approach for superannuation, which facilitates simplicity but suffers from a lack of equity with large tax concessions going to high-income earners. It hence requires an extensive system of caps to limit those concessions.

[40] See discussion in chapter 2 of the TTPI paper *The Taxation of Savings in Australia,* pp.10-36.

Attachment B

OECD Effective Tax Rate Methodology

Across several reports, most notably in 1994, 2018 and 2022, the OECD has produced estimates of effective tax rates applying in member countries to savings vehicles, including housing. This analysis includes all substantive taxes across different levels of government.

Such modelling requires a range of assumptions, such as the time period for the investment, the rate of inflation, the marginal tax rate of the investor and how to spread the impact of transaction taxes. Comparisons of debt v equity financed investments also require an assumption about the opportunity cost of equity in order to make the scenarios comparable.

In its 1994 *Taxation and Household Saving* report, the OECD first developed its methodology for calculating effective tax rates of different savings vehicles, taking into account all the different taxes and using a benchmark of real income.

The 2018 OECD report *The Taxation of Household Savings* used this methodology to provide updated estimates of marginal effective tax rates (METR) of alternative savings investments. That approach assumes a fixed real rate of return and calculates the METR as the difference between the pre- and post-tax rates of return divided by the pre-tax rate of return. Table 3 provides results for Australia.

Table 3: OECD METR Estimates for Australia (Average Earner), 2016

Savings Vehicle	METR
Bank Account	66.0%
Government Bonds (issued at par)	66.0%
Shares (50% distribution)	21.1%
Superannuation (pre-tax contributions)	-27.2%
O-O Housing (equity-financed)	14.7%
O-O Housing (debt-financed)	64.2%
Rented Housing (equity-financed)	88.2%
Rented Housing (debt-financed)	88.2%

Note: Australian average earner marginal income tax rate was 34.5% in 2015-16.

These METR estimates are above the statutory tax rate for a number of asset classes as they are calculated against real income, while tax rates apply to nominal income, eg bank accounts and bonds. The lower METR for shares results from the combination of Australia's dividend imputation and the 50 per cent CGT discount. The negative METR for superannuation is a consequence of the flat 15 per cent tax applied to contributions and earnings.

The low METR for equity financed O-O housing result from the non-taxation of imputed rent and capital gains, partially offset by the conveyance duty and property rates. The higher METR for debt-financed O-O housing is a consequence of the modelling methodology - where an investor chooses to use debt rather than equity financing, they are assumed to use the equity they had available to invest in an alternative savings vehicle that is fully taxed, eg a bank account.

The highest METRs are for investments in rental properties. This is a consequence of the additional taxes (stamp duties, land tax and rates) more than offsetting the CGT 50 per cent discount (and noting the METR is assessed against a benchmark of real income). In this analysis, the METR is the same for equity-financed or debt-financed investments.

In 2022, the OECD did a further report *Measuring Effective Taxation of Housing*, which changed the METR methodology in regard to the opportunity cost of equity invested in housing. In the 2018 report “the opportunity return … is assumed to be the after-tax return on savings in a bank deposit”.[41] In the 2022 report it is assumed that the “opportunity return is consumed by the household, rather than invested in an alternative asset” with the report saying that the former approach “improved comparability between equity- and debt-financed scenarios, as the taxpayer invested some savings in both cases, but the assumption led housing ETRs to be a function of the tax rate on bank interest.”[42]

The 2022 report presents charts to illustrate the METRs (see below). For Australia, the large METR difference in between O-O housing and rental properties remains. The changed assumption regarding the opportunity cost of equity, though, changes the results for debt v equity financing. For investments in rental properties, debt-financed investments now have a lower METR than equity-financed investments (see chart in attachment). Transaction taxes and recurrent property taxes remain significant drivers of the high METRs, particularly for investments in rental properties.

Figure 3. Marginal effective tax rates, all housing investment scenarios, all countries, 2016

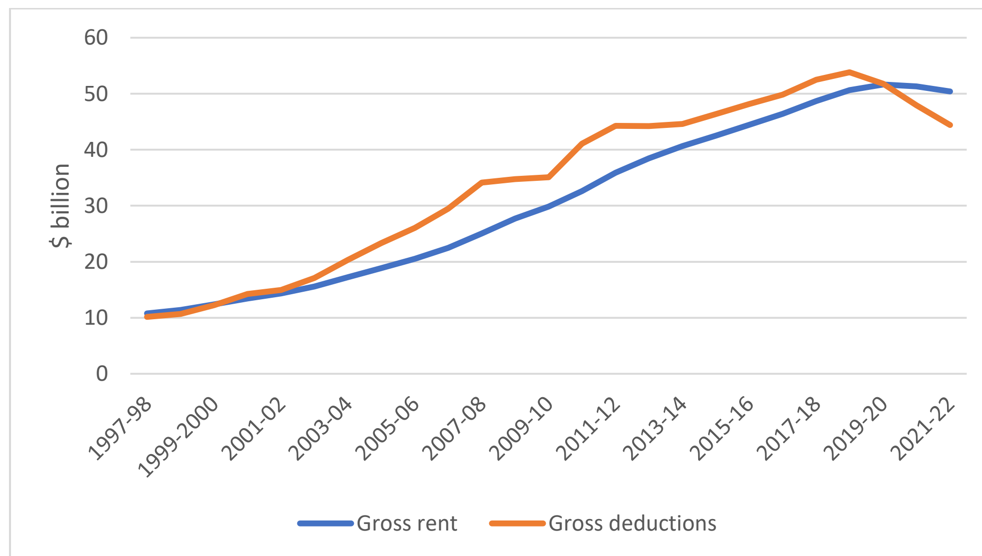
[41] OECD (2018), p.200.
[42] OECD (2022), p.8.

Attachment C

Net Income Tax

As Figure 4 shows, for much of the last 25 years, total current tax deductions for rental properties have been greater than total current taxable income. The fall in deductions in the last years of this chart are mainly a consequence of falling interest rates, while the slight fall in gross rent is related to the COVID period.

Figure 4: Rent v Deductions



Source: ATO Taxation Statistics, 2021-22.
Note: Gross rent does not include CGT receipts.

With total current deductions generally exceeding total current income[43], moving the taxation of investments in rental properties to the O-O treatment, that is complete removal of returns (income and expenses) from the tax net, would therefore probably not have a significant revenue impact.

There is also an interesting behavioural economics point here. Even if negative gearing is not a tax concession, the fact that many people think it is probably drives behaviour. Taking all taxes into account, the returns on investments in rental properties are marginal, with a large capital growth required to make it a worthwhile investment.[44]

[43] Not including CGT receipts.
[44] Over the medium to long term the growth of property values is similar to other asset classes such as shares.

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