What politicians need to know about negative gearing

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Executive Summary

- Low and middle income earners benefit most from negative gearing. To abolish negative gearing would make investment more difficult for low and middle income earners.
- 80 per cent of Australians who utilise negative gearing have an income of under $150,000, and the median income of Australians negatively geared is $88,751.
- Changing negative gearing will make it more difficult for these Australians to provide for themselves in retirement.
- Negative gearing is not distorting the Australian taxation system – it reflects efforts to make the tax system neutral across asset classes.
- The Labor Party’s proposal would result in barriers to entry for those who would be forced to buy new expensive housing stock instead of potentially cheaper existing housing stock.
- The Coalition’s policy to reduce “excessive” negative gearing is contrary to their philosophy of encouraging investment and entrepreneurial growth.
1. Introduction

That any expenditure incurred in the production of taxable income is itself deductible is not a controversial feature of the tax system. This relates directly to the “ability to pay” principle of taxation. In Australia, however, one aspect of the ability to pay principle has become controversial – so-called negative gearing. Australia is the only country in the world to refer to the mortgage interest deduction as negative gearing and many Australians have come to believe that the concept itself – as opposed to just the name – is unique to Australia.

Income from investment properties in Australia is taxable as normal income tax and capital gains are taxable too. Expenses incurred in the production of that taxable income, including the capital gains, is deductible. Being a Landlord – owning an investment property – should be viewed as being in business and treated like any other business. In fairness the tax system does, more or less, treat being a Landlord as being in business, but political rhetoric and public discourse does not. Becoming a Landlord involves an individual making a large initial capital investment in an illiquid asset and then renting it for an income. As with any business making large capital investments, Landlords rely on debt to finance their activities.

Negative gearing is defined as the situation where the Landlord’s interest coverage is less than one. In this instance the interest payments that the Landlord must make is greater than the rental income received from the property. It is hardly unusual or controversial that a business should make a loss on its business activities. In other situations the business would have a loss carry forward and would deduct the loss form any other future income the business might earn. In Australia Landlords tend to be individual taxpayers and are able to deduct investment losses from any other taxable income. This feature is somewhat rare in the world. Other jurisdictions tend to allow investment losses to be offset against other investment income and not any taxable income. Tax neutrality, however, is a strength of the Australian tax system and should not be undermined.

Of course, negative gearing isn’t the only reason why a Landlord might make a loss but it is the reason that does seem to excite many observers. It is simply not possible to legislate profitability. Profits must be earned and risks undertaken. Increasing taxation revenue by ignoring the ability to pay principle is bad for business and poor public policy.

In this paper I demonstrate that low and middle income earners are the greatest beneficiaries of negative gearing – the ability to deduct interest payments before taxation. There is good reason to believe that low and middle earners would be greater beneficiaries than high income earners. An individual wishing to make a substantial investment needs to raise the initial capital to do so. Taking on debt allows individuals to make large investments, however, financial institutions are loathe to make large loans for stock market investments. Low and middle income earners can save for a deposit and borrow large sums of money to invest in the property market but would be unable to borrow a similar amount to invest in the stock market or even to start up their own business. Becoming a Landlord enables low and middle income earners to take on leverage and effectively start up a business. Full deductibility of early losses (that any new business must incur) ensures that these new businesses remain viable in the short run. This allows Landlords to defer their tax liabilities into the future when they are better able to pay them. It is important to understand, however, that this is not a unique tax break to Landlords – any business in Australia is able to deduct its interest expense and either carry tax losses forward, or offset them against other income.
As it happens the number of low and middle income earners entering the Landlord industry has grown rapidly over the past 25 years – high initial capital requirements have generated large interest deductions. At the same time residential prices have increased too – further increasing the initial capital requirements and the interest deductions. So growth in the industry and a more expensive capital base have resulted in tax losses. Understandably both the government and the opposition are concerned; current taxation revenue is at risk. Politicians being short-sighted are unable to appreciate that tax liabilities are simply being deferred into the future.

I have used Australian Taxation Office (ATO) data to illustrate my arguments. Critics often argue that the ATO data are biased. I show that despite the possibility of bias in the ATO data that the conclusion that low and middle income earners benefit most from negative gearing is robust to that source of bias.

Finally, I critique both the government and opposition’s proposals to reform negative gearing. Both proposals are logically flawed. Ironically the government is correct in its critique of the Labor Party policy, but its own policy is vague and ill-defined. The Labor Party policy would very likely result in illiquidity in the rental market resulting price volatility and short-term business losses and failures. It would also add barriers to entry for new Landlords and ultimately would restrict supply in the market. At present there are few details on what the government proposes, but early indications appear to suggest that the government proposal would penalise successful Landlords by limiting their ability to expand their businesses.
2. Being a Landlord

The business of being a Landlord has grown very rapidly over the past 25 years. In 1989-90 some 696,355 individuals declared receiving net rent on their annual tax return. By 2012-13 (the latest available data) that figure had grown to 1,967,260 individuals. That represents 4.4% growth per annum. By contrast the total number of companies as reported by the ATO grew at 3% per annum over that period, and the population grew at 1.3% per annum. The growth in the number of stock market investors has outstripped the number of Landlords (see figure 1\(^1\)). This is very likely due to the privatisations that occurred in the 1990s. It is likely, however, that most of the increase in the number of shareholders is due to individuals buying a small number of shares.

![Figure 1: Growth in Landlords and Stock Market Investors](source)

Figure 1 shows the proportion of individuals who declare net rent on their tax return as a percentage of the individuals who lodged a tax return in each year and the proportion of individuals who declared receiving a franked dividend as a percentage of the individuals who lodged a tax return in each year. Clearly the number of Australians undertaking investment activity (broadly defined) has increased dramatically since the early 1990s.

Given the massive growth rate in the Landlord business sector, it is unsurprising that upfront tax deductions should be high. Being a Landlord is highly capital intensive with the Landlord, in the very first instance, having to acquire a residential property for lease. Since June 2004 the ABS Residential Property Price Index\(^2\) has increased from 70.6 to 127.8 – that represents a 5% growth rate per annum. So not only have we seen a massive increase in the Landlord sector, we have also seen a massive increase in the value of their trading stock. Figure 2 shows the proportion of Landlords that report earning a profit.

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\(^1\) The number of shareholders is proxied by the number of individual taxpayers declaring receiving a franked dividend.

\(^2\) Australian Bureau of Statistics, Residential Property Price Indexes: Eight Capital Cities, Sep 2015, Cat. 6416.0, Table 1.
It is important to understand that Landlords do not only claim interest deductions – the business of being a Landlord includes maintaining the property, and also improving the property. Those expenses are also deductible.[^3] The Interest expense component has made up a variable amount of the total expense – increasing from 48% in 1997-98 to 61.9% in 2007-08 before falling to 58.9% in 2010-11 (see figure 4).

[^3]: The ATO describe all these expenses as follows: “Expenses could include advertising for tenants, bank charges, body corporate fees, borrowing expenses, council rates, decline in value of depreciating assets, gardening and lawn mowing, insurance, land tax, pest control, property agent fees or commissions, repairs and maintenance, stationery, phone, water charges, and travel undertaken to inspect the property or to collect the rent.”
Finally, Figure 5 shows the gap between Gross Rent and Net Rent. It is this graph that is concerning to those politicians who wish to raise more revenue from taxation. Until 2001-02 being a Landlord more or less broke even in a macro-taxation sense. Since that time, however, the federal government has been unable to gain taxation revenue from the sector overall as tax deductions have exceeded gross rental income. This has generated tax losses for individual Landlords who are able to offset those losses against other forms of income.
3. Who Benefits from Negative Gearing

The question as to who benefits most from negative gearing is very topical. It is frequently claimed by some (including myself) that negative gearing benefits low and middle income earners. While others claim that negative gearing mostly benefits “the rich”. The difficulty with assessing the latter claim is what exactly is meant by the term “the rich”. “The rich” could either be individuals on very high levels of income – the so-called 1 per cent – or “the rich” could be individuals with large stocks of assets that may or may not generate large income flows. The best source of information relating to income in Australia is the Australian Taxation Office. Unfortunately the ATO does not provide detailed information relating to assets, but rather only to income. This is due to the Australian taxation system mostly targeting income and not wealth per se.

When looking at ATO data for taxable income it is clear that negative gearing mostly benefits low and middle income earners.

Figure 6 shows the distribution of net taxpayers and the distribution of individuals claiming a rent-interest deduction over various levels of taxable income. The data reveals that 80% of net taxpayers have taxable income of less than $90,000 while 80% of Landlords claiming an interest deduction have a taxable income between $100,000 and $150,000. That may sound like a high level of taxable income, yet in that financial year (2012-13) the top 1% of income earners had taxable income of $312,000.

![Figure 6: Distribution of Net Taxpayers and Landlords claiming interest](Source: ATO Taxation Statistics)
We then turn our attention to the distinction between those Landlords who earn a profit on their rental properties in that year and those who do not. Figure 7 shows the break up by taxable income.

Figure 7: Profitable Landlords by taxable income

The first thing to notice is that those Landlords with a taxable income below $37,000 tend to be profitable on average (with the exception of those with taxable income less than $6000). Then there are “spikes” in the data – most pronounced at $100,000 to $150,000 and less so at $60,000 to $70,000. This does suggest that some tax planning activity is occurring – however, it should also be noticed that the patterns for profitable and unprofitable Landlords are similar. This, in turn, suggests that the decision to become a Landlord may be driven by other factors – such as income and not tax planning factors.

If we then turn our attention to the cumulative distribution of Landlords (graph not shown) 82% of profitable Landlords have a taxable income of less than $100,000 and 78% of unprofitable Landlords have a taxable income of less than $100,000. In that financial year 85% of income earners had taxable income of less than $100,000. In other words, the distribution of profitable and unprofitable Landlords is not that much different from the distribution of taxable income generally.

There is also not much difference between the cumulative distribution of Landlords and the dollar amounts of their profits or losses (see figures 8 and 9). In dollar value terms 83% of all profits are earned by Landlords with a taxable income of less than $150,000 and 82.6% of all losses are incurred by Landlords with a taxable income of less than $150,000.
This sort of analysis suggests that property investment is a mechanism to generate income and wealth for low and middle income earners. Yet this analysis is often criticised as being incomplete. The argument being that taxable income is a poor indicator of income given — it is argued — that negative gearing is employed to manipulate and lower taxable income in order to reduce tax payable.
It is possible to test whether or not the ATO taxable income data are biased. The ATO also reports data for Total Income. Unfortunately due to a quirk of how the data are reported and captured the ATO Total Income data includes net rental income and not gross rental income. Consequently it is not possible to simply reproduce the figures above with Total Income instead of Taxable Income and so demonstrate that negative gearing benefits low and middle income earners. What I do with the Total Income data is search for any anomalies in the data. For example, in figure 10 I plot the average gross rent reported in each total income category and the average interest deduction for each total income category. If some Landlords are using interest deductions to distort their total (and taxable) income downwards then lower levels of total income should reveal unusually high levels of interest deductions or unusually high levels of gross rent. Figure 10, however, reveals no such anomalies.

Unsurprisingly high total income individuals report high levels of average gross rent and have high levels of average interest deductions. Low and middle total income earners have remarkably stable average levels of gross rent and interest deductions. These do increase somewhat at the $0 and less than $0 levels of Total Income. It is unclear, however, whether those particular Landlords are engaged in tax avoidance activities or are financially distressed.

There are no obvious distortions in the data; this suggests that negative gearing does not distort the overall ordering of individuals in the taxable income scale or total income scale for that matter.

Figure 10: Average Gross Rent and Average Interest Deductions by Total Income

Source: ATO Taxation Statistics, Author calculations

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4 See also Appendix 1.
5 The ATO definition of Total Income includes net rental income and not gross rental income.
Finally I show the cumulative distributions of gross rental income in dollar terms and net rental income in dollar terms by total income (figure 11).

**Figure 11: Cumulative Distributions for Gross Rent and Net Rent**

The difference between gross rent and net rent is the cost of doing business as a Landlord, including interest deductions. After $150,000 there is no difference between the two data series.

The ATO data shows that low and middle income earners benefit most from negative gearing. To the extent that the ATO data are net of negative gearing and are biased that result may be weakened. It is possible to test if the ATO data are biased and the test reveals that in an overall sense it is not biased. It may be the case that some individuals would be in the top marginal tax bracket and fall into a lower tax bracket due to negative gearing – or indeed, any other business expense – but there is no evidence to support large scale tax avoidance as a consequence of negative gearing.
4. Consequences of Restricting Negative Gearing

It seems that there is bipartisan agreement that negative gearing is in need of “reform”. There is no agreement on how negative gearing should be reformed. The Australian Labor Party have suggested that negative gearing be restricted to new properties only, while the Liberal Party have argued they want to limit the “excesses” of negative gearing.

The Labor proposal is superficially simple. Australian government policy already intervenes in the property market in similar ways. Non-residents, for example, can only buy newly constructed properties and subsidies are targeted towards first-home buyers. Their proposal is conceptually similar to existing policy. Yet it is not clear what constitutes a new property for taxation policy purposes. Would a new property be new so long as it had had only one owner? Or would it be a new property until the entire initial capital cost had been paid off? The first definition would result in illiquidity in the primary housing market, while the second would add to the taxation compliance burden. This proposal would also result in barriers to entry for new Landlords who would be forced to buy new expensive housing stock to begin their business as opposed to potentially cheaper existing housing stock. Market illiquidity would also adversely impact the supply of rental accommodation and would very likely result in price volatility in the rental market.

The Liberal Party policy is not clear as to the meaning of the word “excess”. The early indications are that the government views some rental property as being a “good thing” but many rental properties as being “excessive”. The way to examine this proposal is to view being a Landlord as being in any other small business. A micro business may own one property and rent it out. A successful Landlord may acquire other properties and expand the business. It is a very strange that a Liberal government might view an expanding small business as being “excessive”. In the early days of any business profits are likely to be low – this is especially the case for those businesses that have high initial capital investments financed by debt. Any limitation on the amount of debt these businesses can take on places a limit on the growth of that business – public policy does not normally seek to deliberately limit business growth or stymie entrepreneurship.
5. Conclusion

Politicians should leave well enough alone. There is no doubt that someone, somewhere is using negative gearing as a tax planning tool rather than a business strategy to grow their wealth or retirement savings. Those individuals, however, are not distorting the tax system or contributing much to reduced taxation revenue. If the ATO is confident that it can identify those individuals then the General Anti-Avoidance Rules of the Tax Act empowers the ATO to take action against them. There is no good reason to deviate from long established taxation principles and practices because politicians have a desire for short-term revenue gains.

The ability to pay principle, the deductibility of interest expenses, tax-loss carry forwards, and tax neutrality are all standard and uncontroversial features of any good tax system. It is these principles that underpin negative gearing.

Being a Landlord is a risky business – there are high initial capital costs, high on-going costs, high levels of debt and so high levels on financial risk. Then there is the business risk. Being a Landlord offers an opportunity for low and middle income earners to develop their own business and so build up a nest egg for retirement. At the same time they provide valuable housing stock and residential space to the population. As they are unincorporated businesses they bear the full business risk and financial risk of their business activities. This is something that should be applauded not penalised through the tax system. Attempts to restrict unincorporated businesses from enjoying the same tax treatment as would any other business would itself constitute a distortion in the economy.

The tax system should encourage entrepreneurship and risk-taking, it should not discriminate between different business structures and should adhere to common-sense principles that include paying careful attention to the ability to pay principle. Those politicians who see tax planning as an explanation for all economic activity need to realise that lower tax rates reduce the incentives to engage in tax planning.
6. APPENDIX 1: Robustness test of the ATO data

There is no pleasing everyone; some observers are not going to be convinced that the results I reported above are robust to potential biases in the reported ATO taxable income statistics or the total income statistics. In this appendix I report the results of another test I have undertaken. The ATO makes available a file of de-identified individual tax data that is broadly representative of the taxpaying public. I have downloaded that file and re-created a total income figure that includes gross rent and not net rent. I also included all other gross income as opposed to net income that the file made available. Table 1 shows summary statistics.

<table>
<thead>
<tr>
<th>Total Income</th>
<th>ATO Total Income</th>
<th>ATO Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>45,664</td>
<td>41,862</td>
</tr>
<tr>
<td>Landlord</td>
<td>78,618</td>
<td>55,319</td>
</tr>
<tr>
<td>Landlord (with negative gearing)</td>
<td>88,751</td>
<td>60,487</td>
</tr>
</tbody>
</table>

Source: ATO The 2012–13 individuals sample file, Author calculations

My estimate of (median) total income is $45,664 compared to what the ATO reports at $41,862. What is interesting to note is that the median total income for all Landlords is less than $80,000, while for those engaged in negative gearing it is $88,751.

I then used my estimated total income data to examine the income distribution of Landlords (figure A.1) and those Landlords using negative gearing (i.e. with a higher interest expense deduction than gross rental income) (figure A.2).

In each case 80% of Landlords (either in total or those who negatively gear) have a total income of less than $150,000. This result is broadly consistent with what I reported in the main body of the paper.

Figure A.1: Estimated Total Income Distribution of Landlords

Source: ATO The 2012–13 individuals sample file, Author calculations
Figure A.2: Estimated Total Income Distribution of Negatively Geared Landlords

Source: ATO The 2012–13 individuals sample file, Author calculations