Parliamentary Budget Office

Policy costing

Negative gearing and capital gains tax (CGT) reform	
Party:	Australian Labor Party

Summary of proposal:

The proposal has two components.

- Component 1 – Remove negative gearing
  - This component would remove negative gearing arrangements (which allow deductions for investment losses to be made against non-investment income) for all non-business investment assets held by individuals, superannuation funds, partnerships, trusts and companies, but allow these taxpayers to negatively gear non-business-related investments in the construction and purchase of new dwellings.
    - In removing negative gearing any investment losses could still be used to offset any investment gains in the same financial year, regardless of asset class.
    - Within-year non-business investment losses could be accumulated and used to offset any future capital gain made on these assets.
- Component 2 – Halve the capital gains tax discount
  - This component would change the capital gains tax discount for individuals, partnerships and trusts from 50 per cent after a 12-month holding period to 25 per cent after a 12-month holding period.
    - There would be no changes to the existing capital gains tax discount that applies to superannuation funds, or to the 50 per cent active asset reduction concession that applies to small business.

The proposal would have effect from 1 January 2020. The proposal would only apply to assets purchased or investments made on or after the date of implementation.

Costing overview

Policy background

Negative gearing

Under current policy settings, income from investments, such as rent, dividends or interest, form a part of taxable income. Investment-related expenses, such as interest, council rates, depreciation and maintenance costs, are mostly deductible from taxable income. Where these deductions exceed the value of investment income, they can be used to offset non-investment income, such as salary and wages. For the purpose of this costing, 'negative gearing' refers to a situation where investment-related deductions exceed the total value of investment-related income (a 'net investment loss').

With the exception of net investment losses attributable to investment in the construction and purchase of new dwellings, the proposal would end the tax deductibility of negative gearing by limiting investment-related deductions (including, but not limited to, interest, council rates, depreciation and maintenance costs) to the total value of investment-related income. The taxable income of some negatively-geared investors would increase as a result of the proposal, meaning there would be an increase in tax receipts. Investors would be able to use these denied deductions to offset any future capital gains, which would reduce future capital gains tax receipts.

Capital gains tax discount

The capital gain from an investment is the difference between the proceeds from the sale of the investment and the cost base of the investment (which is generally the purchase price plus any transaction costs associated with the purchase). Through the capital gains tax, capital gains adjusted for the capital gains tax discount are added to taxable income and taxed at the investor's marginal tax rate. Under current policy settings, the capital gains tax discount for individuals, partnerships and trusts applies at a rate of 50 per cent of the capital gain where investments are held by the individual for at least 12 months.

The proposal would reduce the capital gains tax discount to 25 per cent. This means that the taxable value of a capital gain on an asset held for more than 12 months would be increased to 75 per cent (rather than 50 per cent) of the value of the capital gain. This would result in an increase in taxable income for individuals eligible for the capital gains tax discount, and therefore an increase in tax receipts.

Financial implications

The proposal would be expected to increase the fiscal and underlying cash balances by $2,783 million over the 2019-20 Budget forward estimates period. This impact reflects an increase in revenue of $2,800 million, partially offset by an increase in departmental expenses of $17 million over this period.

The proposal would have an ongoing impact that extends beyond the 2019-20 Budget forward estimates period. Revenue would be expected to grow significantly as the proposal matures and the proportion of assets covered by the grandfathering provisions (that is, purchased prior to 1 January 2020) eventually declines to zero. The detailed financial implications of the proposal over the period to 2029-30 are included at Attachment A.

Table 1: Financial implications ($m)(a)(b)

	2019–20	2020–21	2021–22	2022–23	**Total to 2022–23**
Fiscal balance	-5	292	897	1,599	**2,783**
Underlying cash balance	-5	292	897	1,599	**2,783**

(a) A positive number represents an increase in the relevant budget balance; a negative number represents a decrease.
(b) Figures may not sum to totals due to rounding.

The increase in departmental expenses associated with the proposal would allow the Australian Taxation Office (ATO) to make systems changes, conduct information campaigns, and undertake compliance activities.

Uncertainties

The costing is subject to significant uncertainties, outlined as follows.[1]

- The costing is highly sensitive to key parameters used as inputs. These include, but are not limited to, the level of investment in, the net investment income derived from, and the holding times for negatively-geared dwellings. These inputs have been based on historical information and budget parameters, and can change significantly from year to year due to changes in economic conditions.
- There is uncertainty in the growth of the components of net investment income and capital gains. Periods of lower house price growth and lower turnover would reduce the financial implications of the costing.
- There is uncertainty surrounding the behavioural responses to the proposal, such as individuals investing more in new, rather than existing, dwellings, holding grandfathered properties for longer, or reducing their overall level of investment in housing. Such responses could have a significant impact on the financial implications of the proposal.
- There may be behavioural impacts in the transition to the new arrangements, such as investors bringing forward purchases of assets to take advantage of grandfathering provisions. The magnitude of such behavioural responses is highly uncertain but could have a material impact on the revenue raised from the proposal in the years around its proposed implementation.
- The proposal may have broader macroeconomic implications, including changes to the levels and growth rates of asset prices and rents. As the timing and magnitude of these impacts are highly uncertain, they have not been taken into account.

Key assumptions

The Parliamentary Budget Office (PBO) has made the following assumptions in costing this proposal.

Growth rates

- Capital gains tax assets and net rental incomes grow, on average, in line with growth in nominal gross domestic product.

Asset holding times

- The average holding time for negatively-geared investment properties is around seven years.
- The average holding time for assets affected by the capital gains tax discount component, which includes other asset classes, is just under nine years.
- Assets affected by the negative gearing and capital gains tax policy proposal are disposed over a maximum period of 20 years.[2]

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[1] There are inherent uncertainties in all policy costings, regardless of who produces them. For a more detailed discussion of the nature and sources of these uncertainties, see PBO information paper no. 01/2017, *Factors influencing the reliability of policy proposal costings.*

[2] The asset holding time profile assumptions have been based on an examination of ATO rental income schedules, the Australian Bureau of Statistics (ABS) *Survey of Income and Housing*, and the 2012 *Australian Share Ownership Study*, conducted by the Australian Securities Exchange.

Behavioural responses

- Bring-forward of asset purchases: some taxpayers would bring forward the purchase of assets affected by the negative gearing and capital gains tax policy proposals to before the implementation date to take advantage of the grandfathering provisions that would apply to assets purchased before this date.
  - 20 per cent of affected asset purchases in the first year following the implementation date would be brought forward to prior to the implementation date, and 10 per cent of affected asset purchases in the second year following the implementation date would be brought forward to prior to the implementation date.
  - In absence of these behavioural responses, the financial implications of the proposal would be around 3 per cent higher over the period to 2029-30.
- Investment in new dwellings: the proportion of negatively-geared investment by individuals in new dwellings would increase from 22 per cent in the first year following the implementation date to around 30 per cent in 2029-30.
  - The above assumption is based on owner-occupier housing finance data (ABS 5609.0 – *Housing Finance*) over the past decade, unpublished Reserve Bank of Australia estimates and information from Mortgage Choice's annual *Investor Survey*.
  - The increase in the share of investments in new dwellings takes into account the incentive under the proposal for individuals who would otherwise invest in existing dwellings to invest in the construction or purchase of new dwellings. The extent to which this would occur would depend on, among other things, the number of new dwellings compared with established dwellings.
    - The PBO has examined projections of dwelling completions from the *National Housing Supply Council: Housing Supply and Affordability – Key indicators 2012*, which suggest that this increase in demand for new dwellings could be met by the projected supply.
  - In the absence of this behavioural response, the financial implications of the negative gearing component would be around 8 per cent higher over the period to 2029-30.
  - If this behavioural response was stronger, with the proportion of negatively-geared investment in new dwellings by individuals increasing to 40 per cent by 2029-30, the financial implications of the negative gearing component would be around 12 per cent lower over the period to 2029-30.
- Alternative investments: individuals would increase the use of alternative mechanisms, such as other tax concessions or deductions, to reduce their tax liabilities, noting that such responses do not completely offset the revenue gain in all cases. Income elasticities have been used to incorporate this range of potential behavioural responses.
  - Individuals affected by the negative gearing component are expected to have a taxable income elasticity of 0.2.[3] In the absence of this behavioural response, the financial implications of the negative gearing component would be around 13 per cent higher over the period to 2029-30.

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[3] A taxable income elasticity is a measure of the responsiveness of taxable income to changes in tax rates. It measures the proportionate change in declared taxable income resulting from a proportional change in the net-of-tax rate (one minus the marginal tax rate). An elasticity of 0.2 means that if an increase in a marginal tax rate leads to a 1 per cent decrease in the net-of-tax rate, there will be a 0.2 per cent decrease in taxable income.

- Individuals affected by the capital gains tax discount component are expected to have a capital income elasticity of 0.3.[4] In the absence of this behavioural response, the financial implications of the capital gains tax discount component would be around 14 per cent higher over the period to 2029-30.

- Total impact of behavioural responses: in the absence of all behavioural responses incorporated into the costing, the financial implications of the proposal would be around 25 per cent higher over the period to 2029-30.

Methodology

Component 1 – Remove negative gearing

- The costing of this component was based on a 16 per cent sample of de-identified personal income tax and superannuation returns for 2016-17, as well as tax schedules for partnerships, trusts and superannuation funds (including self-managed superannuation funds).
- These data were used to estimate the baseline amount by which negative gearing would be expected to decrease taxable income for individuals and funds, including through distributions from partnerships and trusts, over the period to 2029-30.
  - The baseline amount of negative gearing was adjusted in each year over the period to 2029-30 to take into account the grandfathering provisions, the proportion of negative gearing relating to the construction and purchase of new dwellings, and the behavioural responses identified above. The change in tax revenue from the proposal was then calculated using this adjusted amount.
- Where the proposal would result in negative gearing deductions being denied, capital gains tax estimates were adjusted to take account of the carry forward of negative gearing losses offsetting capital gains.
  - This reduces the revenue from the negative gearing component, particularly towards the end of the period to 2029-30, when most of the properties purchased after the implementation date begin to be sold.

Component 2 – Halve the capital gains tax discount

- The expected revenue collections were calculated with the current discount (the base scenario) and with the proposed discount.
  - The amount of assessable income from capital gains was estimated for each year from 2019-20 to 2029-30, based on current revenue estimates and projections of capital gains tax.
  - This amount was adjusted in each year to take into account the grandfathering of the proposal and the behavioural responses identified above. It was adjusted further to reflect the proportion of income from capital gains claimed by small businesses in 2016-17 to account for the maintenance of the small business active asset reduction concession.
  - An average marginal tax rate for individuals reporting net capital gains was estimated based on historical tax data, expected future income growth and announced future changes to tax rates.

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[4] The values are consistent with the wider empirical literature across advanced economies, where the average estimate of taxable income elasticities is close to 0.2, with higher elasticities estimated for capital income; see, for instance, Klemm, A., Liu, L., Mylonas, V. and Wingender, P., 2018, *Are Elasticities of Taxable Income Rising?*, International Monetary Fund.

Interactions

- To estimate the interaction between the negative gearing component and the capital gains tax component, the impact of removing negative gearing was calculated against two different baselines: a capital gains tax discount of 50 per cent, and a capital gains tax discount of 25 per cent. The interaction was estimated as the difference between these two impacts.
  - The decrease in the capital gains tax discount means that negative gearing deductions denied and carried forward are able to offset more capital gains tax. Thus, there is a negative interaction between the components, as shown in Attachment A.

General methodology

- This costing has taken into account the timing of tax collections.
- Departmental expenses were estimated based on an analysis of previous policies with similar administrative complexity.
- Estimates of revenue have been rounded to the nearest $100 million.
- Departmental expense estimates have been rounded to the nearest $1 million.

Data sources

The ATO provided:

- 2016-17 de-identified personal income tax and superannuation data
- 2016-17 de-identified partnership, trust, fund and self-managed superannuation fund unit record files
- 2016-17 capital gains tax schedule data
- rental income schedules (1999-2000 to 2010-11).

The Treasury provided the economic and policy parameters, and capital gains tax and net rental income forecasts as at the 2019-20 Pre-election Economic and Fiscal Outlook.

ABS, *5609.0 – Housing Finance*, Australia.

ABS, *Survey of Income and Housing 2009-10,* confidentialised unit record files.

Australian Government, The Treasury, 2019. *2018 Tax Benchmarks and Variations Statement*, The Treasury, Canberra.

Australian Securities Exchange, 2012. *Australian Share Ownership Study*.

ATO, *Taxation Statistics 2016-17*.

Emrath, P., 2009. *How Long Buyers Remain in their Homes*, National Association of Home Builders.

HM Revenue and Customs, 2012. *The Exchequer effect of the 50 per cent additional rate of income tax*, London: HM Revenue and Customs.

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Investors favouring old properties over new. [Online] *Available at:* https://www.mortgagechoice.com.au/about-us/media-centre/media-releases/investors-favouring-old-properties-over-new/ [accessed 24 May 2019].

The National Housing Supply Council, 2012. *Housing Supply and Affordability – Key Indicators, 2012*.

Reserve Bank of Australia (RBA), unpublished estimates regarding lending to households for residential property investment.

Attachment A – Negative gearing and capital gains tax reform – financial implications

Table A1: Negative gearing and capital gains tax reform – Fiscal and underlying cash balances ($m)[(a)(b)]

	2019–20	2020–21	2021–22	2022–23	2023–24	2024–25	2025–26	2026–27	2027–28	2028–29	2029–30	**Total to 2022–23**	**Total to 2029–30**
Revenue													
Component 1 – Remove negative gearing	..	*300*	*800*	*1,400*	*2,000*	*2,500*	*2,700*	*3,000*	*3,200*	*3,400*	*3,500*	***2,500***	***22,600***
Component 2 – Halve the capital gains tax discount	-	-	*100*	*200*	*500*	*800*	*1,200*	*1,600*	*2,100*	*2,600*	*3,100*	***300***	***12,100***
Interactions	-	-	..	..	*-100*	*-100*	*-200*	*-300*	*-400*	*-500*	*-700*	**..**	***-2,200***
Total – revenue	**-**	**300**	**900**	**1,600**	**2,400**	**3,200**	**3,700**	**4,300**	**4,900**	**5,500**	**5,900**	**2,800**	**32,500**
Expenses													
Departmental													
Component 1 – Remove negative gearing	*-3*	*-5*	*-3*	*-1*	*-1*	*-1*	*-1*	*-1*	*-1*	*-1*	*-1*	***-12***	***-19***
Component 2 – Halve the capital gains tax discount	*-2*	*-3*	-	-	-	-	-	-	-	-	-	***-5***	***-5***
Total – expenses	**-5**	**-8**	**-3**	**-1**	**-1**	**-1**	**-1**	**-1**	**-1**	**-1**	**-1**	**-17**	**-24**
Total	**-5**	**292**	**897**	**1,599**	**2,399**	**3,199**	**3,699**	**4,299**	**4,899**	**5,499**	**5,899**	**2,783**	**32,476**

(a) A positive number for the fiscal balance indicates an increase in revenue or a decrease in expenses or net capital investment in accrual terms.
A negative number for the fiscal balance indicates a decrease in revenue or an increase in expenses or net capital investment in accrual terms.
A positive number for the underlying cash balance indicates an increase in receipts or a decrease in payments or net capital investment in cash terms.
A negative number for the underlying cash balance indicates a decrease in receipts or an increase in payments or net capital investment in cash terms.

(b) Figures may not sum to totals due to rounding.

.. Not zero but rounded to zero.

\- Indicates nil.