NEGATIVE GEARING, EXPECTATIONS AND HOUSE PRICING

A Submission to the Productivity Commission Inquiry on First Home Ownership

by

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Australia is currently experiencing a housing boom that is causing buyers to borrow more. First home buyers in particular are disadvantaged in this market as they are competing against property investors who can take advantage of generous tax concessions. Accordingly, the Productivity Commission inquiry on first home ownership is a welcome step. Discussions in the media have blamed many factors such as migrants, land supply, stamp duty, introduction of the GST, uncertainty in financial markets, negative gearing, etc for pushing prices out of reach for the first home buyers. However, negative gearing appears to be a major factor whereby the first home buyers are relatively disadvantaged. It is surprising to note that inquiry does not find mention to the impact of negative gearing.

The Reserve Bank in their submission to the Productivity Commission Inquiry on First Home Ownership, suggests that the surge in house prices has been fuelled by investors who enjoy various tax incentives. This submission attempts to quantify the value of the annual tax benefit (ATB) to the property investor compared to the owner occupier, particularly in regard to the first home buyer. In the RBA's submission an example of out-of-pocket costs of holding a rental property is described on page 48. The example

reveals a tax benefit of $250 per week for an individual taxpayer who is on the top marginal tax rate of 48.5%. Using this RBA example, we have estimated the expected value of tax benefits from negative gearing under different scenarios considering a compounded 10 per cent per annum reduction in the tax benefit to allow for smaller depreciation claims and higher rent over time. As is evident from the accompanying Table 1, the potential tax benefits from negative gearing to such property investors are considerable. These values are likely to be reflected in investor expectations, and hence in house prices. These benefits, combined with the advent of property investment seminars and coaching from quick-rich gurus, appears to be the driving force behind the popularity of building wealth through investment in residential property.

Subject to limitations of the underlying assumptions from the RBA example and our 10 per cent per annum compounded decrease in taxation benefits over time, we are of the opinion that:

First, many property investors are ordinary people who may not be aware of issues like diversification, time value of money and risks of high leverage etc. They may just add up the value of tax savings over their holding period. As such, they may see the value of tax benefits even in excess of $100,000 based on a median priced house as detailed under 'ordinary investors' in the accompanying Table 1. These values sooner or later, are likely to be reflected in higher house prices as property investors enter the market aware of the significant tax savings that are available to them.

Second, there is a direct relationship between the investors' required rate of return and the value of the taxation benefits for 'sophisticated' investors. Considering the low interest rate environment, investors required rate of return should be low. As such, the expected present value of taxation benefits has increased significantly under the current environment. This is also explained in the accompanying Table 1, by calculating the cumulative values (CV) of tax benefits (after allowing for the 10% per annum reduction discussed above) discounted at various rates over the corresponding number of years. For example, where an investor requires a 15 per cent return, then the present value of the taxation benefits will be $51,756 for a twenty year period. This compares to the situation where an investor who may only require a 3 per cent return derives a present value of the taxation benefits of $93,525 for the same twenty year period. Accordingly, if we compare the values in the corresponding columns of Table 1, then the magnitude of the difference at varying required rates of return is obvious. It is anticipated that a property investor's required rate of return on the taxation benefits would be low as the risk in generating these tax benefits under the current government taxation policy is minimal and the interest rates are low. However, even with higher required rate of return, the CV amounts are significant.

Consequently, first home buyers, even with the $7000 first home buyers grant, are no match with property investors' access to taxation benefits. Our estimate under various scenarios reveals that wealthy property investors are significantly better off in the long run. These favourable tax breaks have resulted in investors entering the housing market and distorting house prices resulting in first home buyers deferring the purchase of the

great Australian dream of home ownership. This questions the appropriateness of government policy to allow property investors to negatively gear their properties whilst future generations are kept out of the housing market resulting in them only being able to rent property. As such, the policy of negative gearing of rental properties needs a full governmental review.

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Table 1
Estimation of tax benefits of negative gearing
Property worth $400,000

		Ordinary investors*	***Sophisticated investors***			
Year	ATB**	CV (0%)***	CV (3%)	CV (7%)	CV (11%)	CV (15%)
1	$13,036	$13,036	$12,656	$12,183	$11,744	$11,335
2	$11,732	$24,768	$23,715	$22,430	$21,266	$20,207
3	$10,559	$35,327	$33,378	$31,049	$28,987	$27,149
4	$9,503	$44,830	$41,821	$38,299	$35,246	$32,583
5	$8,553	$53,383	$49,199	$44,397	$40,322	$36,835
6	$7,697	$61,080	$55,645	$49,526	$44,437	$40,163
7	$6,928	$68,008	$61,278	$53,841	$47,774	$42,767
8	$6,235	$74,243	$66,200	$57,469	$50,480	$44,805
9	$5,611	$79,854	$70,501	$60,522	$52,673	$46,400
10	$5,050	$84,904	$74,258	$63,089	$54,452	$47,649
11	$4,545	$89,450	$77,542	$65,248	$55,894	$48,626
12	$4,091	$93,540	$80,411	$67,065	$57,064	$49,390
13	$3,682	$97,222	$82,918	$68,592	$58,012	$49,989
14	$3,314	$100,536	$85,109	$69,878	$58,780	$50,457
15	$2,982	$103,518	$87,023	$70,958	$59,404	$50,823
16	$2,684	$106,202	$88,696	$71,868	$59,909	$51,110
17	$2,416	$108,617	$90,157	$72,632	$60,319	$51,335
18	$2,174	$110,791	$91,434	$73,275	$60,651	$51,510
19	$1,957	$112,748	$92,550	$73,816	$60,920	$51,648
20	$1,761	$114,509	$93,525	$74,272	$61,139	$51,756
21	$1,585	$116,094	$94,377	$74,654	$61,316	$51,840
22	$1,426	$117,520	$95,121	$74,976	$61,459	$51,906
23	$1,284	$118,804	$95,772	$75,247	$61,576	$51,957
24	$1,155	$119,959	$96,340	$75,475	$61,670	$51,998
25	$1,040	$120,999	$96,837	$75,666	$61,747	$52,029
26	$936	$121,935	$97,270	$75,828	$61,809	$52,054
27	$842	$122,777	$97,650	$75,963	$61,859	$52,073
28	$758	$123,535	$97,981	$76,077	$61,900	$52,088
29	$682	$124,217	$98,270	$76,173	$61,933	$52,100
30	$614	$124,831	$98,523	$76,254	$61,960	$52,109

**Ordinary investors:* Represents investors those may be unable to consider the time value of money in their calculations (or expectations).

**ATB = Annual Tax Benefit; first ATB value ($13036= $250 x 365 / 7) is based on an example of property worth $400000 used in RBA's submission; other values assume that the ATB would decrease at the rate of10 percent per annum (not based on rules; but we think may be a conservative approximation of reality, given that rent will increase and depreciation claims will decrease over time).

***CV (r%) = Cumulative Value of tax benefits discounted at the rate of r% per annum.