A Reply to The Productivity Commission Discussion Draft:

FIRST HOME OWNERSHIP

released in 2003.

The abovementioned Draft side steps the issue of negative gearing and states that there should be separate review in regard to taxation issues. This sidestepping very significantly reduces the value of the Commission's FIRST HOME OWNERSHIP report as the most significant controllable factor boosting house prices is apparently negative gearing. The issue of stamp duty and other costs are important and collectively not insignificant, but in general negative gearing alone apparently causes greater home price increases than all of the other factors combined. It is the psychology of negative gearing property purchasers that boosts property prices to the extent witnessed over recent years in Australia. When property prices begin to rise negative gearing fuels a propertymania psychology not unlike the well-known Dutch tulipomania. Due to their ability and propensity to purchase homes at higher prices negative gearers bid up home prices in a self-fulfilling prophecy that eventually sees prices rise beyond first homebuyer budgets. The fictional auction description below uses real life experiences to illustrate this point.

PROPERTYMANIA AND NEGATIVE GEARING

The auctioneer began to read the property description aloud. The group of potential buyers tightened into a crescent moon around him. Some were lookers who lived in the same street. Some were interested in learning local prices before buying themselves. A few were serious bidders each with his or her own maximum price to which they were prepared to bid. Three potential buyers were particularly interesting, as they were all keen to buy the property, but each had different motives. There was the first homebuyer couple, the full time property investor and the negative gearing investor.

The first homebuyer couple listened to every word as the auctioneer spoke. "I really want this home," she said to him. He nodded in agreement and recalled how they'd been to the bank before they started looking. They had worked out their budget with the bank officer and they now knew how much they could afford to pay for this home that they so dearly wanted to own.

"It is a good solid brick home with a cute cottage appearance," The auctioneer spruiked. Just right for a small family and very suitable for raising children, the couple had discussed. It had a great climbing tree out the back where they decided to fit some ropes and make a swing for their children to be. The kitchen was in good order and, overall, there was very little work to do over the early years while they met their potentially steep mortgage payments. One gutter and a downpipe needed replacing, but one room was already set up as a nursery…so that would save them some expense they reasoned.

"Two hundred thousand dollars," the bank loan approval letter had stated. In addition they had the first homeowner's grant of $ 7,000 to add to their savings of $10,000 (that $10,000 had taken a year to save and it was only possible because they stayed with his parents. Previously they had been paying $180 per week rent). Two hundred thousand dollars: That was as much as they could spend on a home because the bank wouldn't lend them any more on her income of $800 gross per week. He hadn't been able to get a job since he was retrenched; but now that they are close to buying a home he wants to work as a full time parent. They both believe children should have at least one full time parent at home. "But we would have to repay $309 per week on a $200,000 loan. That's too much," she had said to him. "We don't want to go broke and lose the house." They had decided to limit their mortgage payments to $250 per week.

That meant they could borrow about $162,000. Then they would use their savings and grant money to pay the stamp duty, legal costs and other expenses and they would have about $10,000 left over. Adding the two together they could afford to pay up to $172,000.

They had been looking for over 12 months now and prices had kept going up. They could have bought a better home in Woodridge for $73,000 just over a year ago but now that same home would cost them at least twice as much. If they can't buy this one at the auction today they might have to give up because on one income they can't keep chasing the prices up. They shouldn't have waited to save a deposit they now thought, but the bank had insisted they have a savings record. What a painful process it is to have to save a deposit while prices rise so quickly they now thought.

The investor considered his current financial position as the crowd gathered around the auctioneer.

"I've worked out the figures," he thought. "The most I should spend on this property is $78,000. With some luck I might get it for $70,000. The investor had bought 5 houses in the past 12 months and had paid a maximum of $77,250 for one. He had spent about $2500 to paint and do some minor repairs himself on that home and was now getting a weekly rent of $185. That meant that after all expenses, including $500 he budgeted for maintenance, he was now making $991.50 each year from the property. That's $19.07 per week he had calculated. He only paid interest on the loan, not principal, and had fixed the loan at 6.7% for five years so he could be sure he wouldn't be caught out by an interest rate rise at least until then. Four years left on that loan now, he thought, and the rent was up by $30 per week since he had bought that house. His best buy in the last year was probably the solid brick house with the double garage that he bought for $65,000 and it now rents for $175 per week. It had taken him six weeks of hard work for twelve to sixteen hours per day for six days per week to get the standard up from a smelly mess to the lovely and fresh condition it was in now. Real estate agents were now telling him that they could sell it for over $135,000 within a matter of days. The investor would not sell, as he had told the agents, because buying and selling was not his business, he kept the properties and rented them. His goal was to find good tenants over time (sometimes it took years) and to provide the best accommodation he could at the cheapest possible price. Eventually he usually found tenants who would stay for many years and who took good care of the property. When he found good tenants he would keep the rents lower than the market rate and that made the arrangement work well for both him and the tenants. Sometimes, though, the investor did have problems with tenants before finding good ones; like the people who had done thousands of dollars worth of damage and disappeared. And others who had done thousands of dollars worth of damage but had only lodged $440 bond. Those tenants lived mainly on social security and he would never be able to recover the money from them. "And to think they made the agent and I waste our time and more money by going to the Rental Tribunal and then how they had dishonestly claimed their innocence right to the end." The tenants had nothing to lose. They don't get punished or fined for lying.

The negative gearer was confident. He had watched prices rise dramatically over the past 12 months and he now believed he was on the path to wealth.

The auction began. The auctioneer took the first bid from the young couple. "$70,000," the young woman bid. The investor thought, "That's a high starting price, but I've been getting used to that lately. I might soon be priced out of the market the way prices have been going."

The negative gearer was holding back from making a bid. His strategy was to feign disinterest at first, to see who was bidding, and to come into the bidding a little later. "Try and make the auction look slow to discourage other bidders." he thought as he discreetly looked around the crowd.

The investor called out, "$72,000." The auctioneer replied, "$5,000 bids only." "$75,000" the investor called.

Bids moved steadily up to $110,000 although they faltered for a while at $85,000 when the auctioneer almost brought the hammer down for the third time. The negative gearer had been holding back and now made his first bid. "$115,000," he offered.

There were now 4 bidders left in the auction; the young couple, two others and the negative gearer. The investor had dropped out after his first bid when the price went to $80,000. There was too much risk and not enough return for him at that price. He needed positive cashflow, not negative.

But the negative gearer thought differently, and so did the young couple. The couple were prepared to go to the maximum they could reasonably afford so they could settle into their own home and become homemakers. The possible repayment struggle would be worth it, even though they wanted as little struggle as possible.

The negative gearer thought prices in this area would eventually go to about $200,000 or more over the next six or twelve months. He had checked the prices in surrounding suburbs like Daisy Hill, Slacks Creek, Underwood and Springwood. A house of the same type would sell for about $220,000 at least in those suburbs, and the way real estate prices keep going up there was no way he could lose, he thought. He remembered what his accountant had said, "If you don't get enough rent to pay for the interest and other expenses the government will effectively pay almost half of the loss because you are in the top tax bracket. And," His accountant had paused and smiled broadly at this point, "If your income goes below the threshold into the next lower tax bracket then when you sell the property you will be able to pay the 50% capital gains tax at the lower tax bracket rate of 42%. That will earn you another substantial tax reduction." He had a little difficulty understanding exactly what his accountant meant but the fundamentals sounded good. "Reduced tax, making big profits from buying and selling real estate, and it won't even cost me $50 per week. That is a great investment strategy," he thought. He could clearly understand that he would pay less tax while he owned the property and, when he sold it, he would keep the thousands of dollars of profits from the sale less the 50% capital gains tax (after one year). For about one year, while he owned the property, he would only have to pay about half of the difference between the rent and expenses. He would also have to pay stamp duty, conveyancing costs and some other minor expenses; but even those expenses would be almost half paid for by tax refund. "This is a great way to make money he thought." "If I buy for $140,000 and sell for $190,000 I'll make $50,000 minus about $15,000 (that is, about $6,000 in buying costs and $9,000 in selling costs). A total gain of $35,000. And all it will cost me is about $35 each week for about one year (that is, costs of about $160 per week interest, $1300 annual rates and $500 annual maintenance. And the tenant will pay about $150 weekly rent). And that $35 is tax deductible so I'll get nearly half of it back from the tax office! About $17.50 a week it will cost me, and I'll make $35,000 for attending a few auctions and getting my conveyancer, accountant and agent to do all the work I can't do."

"Say, I could go higher than $140,000," he thought, " It would only cost me about half of $600 (that is, 6% interest less about 50% tax refund) if I went up $10,000. That's less than $6 extra each week. I can easily afford to pay $100 each week to make money this easily. And the government pays for half of any loss if I ever lose. But real estate doesn't lose value (Like many people he was definitely wrong on this point). It always goes up in price or sometimes stays about level before it goes up again. Look at what my parents place is worth now. What a great way to make money."

The negative gearer then thought some more about how he could make even more money. "If I invest $100 per week in this property I could borrow a total of about $282,000," he roughly calculated. The sky's the limit he thought. "I'm going to get really wealthy out of all this. I can't lose unless property prices go down, and there is Buckley's chance of that happening." Or if interest rates go up he suddenly realised. "But even if rates go up the government will pay nearly half of the extra cost by tax refund," he thought. "That means if they go up by 4% (he chuckled quietly as he told himself that such a high rate hike would never happen) I would have to pay an extra $800 on say $200,000. That would be another $15.40 per week and I'd get half of it back as a tax refund. I'd be laughing, only $7.90 per week extra. But I'll do this really safely, the negative gearer assured himself, I won't go a penny over $200,000 then I can easily afford more than a 4% interest rate rise and I'll only have to pay less than $58 per week ($12,000 interest minus $7,800 annual rent plus annual expenses of $1,800 less about 50% tax refund equals $3,000 loss each year. That is $57.70 per week.) Yes, he thought, Daisy Hill and the other suburbs are going up too, and this house will surely go over $200,000. Look at what my parents place is worth now. It would cost over $100,000 to build a solid brick house like this today. Plus there is the land. Where can you get a decent block of land for less than $90,000 around here? Just to be really extra safe I'll only go to $180,000," he decided. "Excellent! That will cost me next to nothing each week to buy it, and I can just hold on to it for longer if the price rises more slowly." He had now firmly decided on his top price.

The other two bidders dropped out at $130,000 and only the first homebuyer couple and the negative gearer continued bidding. The young couple were in with a chance they thought. If it wasn't for their competitor they could have bought at $130,000, a splendid price for them. But the price kept on rising; through $140,000, then $150,000, then $160,000, then $172,000. The negative gearer believed he was close to making a purchase. Only the young couple stood in his way. "Let's go to $175,000," the first homebuyer whispered to his partner, "At least then we'll have a home." They both quietly agreed. At $175,000 the young couple made their last bid, and the negative gearer bid $176,000.

As the hammer began to fall for the third and final call at $176,000 a voice in the crowd said, "One hundred and seventy seven." The auctioneer responded. "$177,000, do I have one hundred and seventy eight."

"Who is that?" The first homebuyer asked her partner.

"I don't know, he hasn't bid before," her partner replied.

Another negative gearer had been quietly waiting in the crowd and he now saw his opportunity to buy. The two negative gearers bid the price up to $180,000. The more recent entrant dropped out at $181,000 and the property was sold at $182,000.

"That's only $2,000 more than I intended to pay at a very safe price," the negative gearer proudly thought to himself. "Great!

"To recover my $15,000 buying and selling costs I'll have to sell for over $197,000 to make a profit now, but I can easily wait a little longer if I have to before I sell so that I can get a better price and make say ten or twenty thousand."

“God, this just keeps getting better,” he thought as he suddenly remembered what he’d been told about depreciation. “I’m not even going to have to pay the $57.70 that it would have cost me each week to buy for the house for $200,000. I can depreciate the building and its contents and get nearly half of the depreciation back as a tax refund. If the building was built after 1985 then I can depreciate it for at least 2.5% each year. That’s about $2,500 depreciation each year if the building is worth $100,000. That’s around $1200 in additional tax refunds that I’ll get. $57.70 per week is $3000 per year. That means it will only cost me less than $35 per week (that is $3,000 minus $1,200 divided by 52 weeks). Even better, my accountant said I could depreciate some of the items in the house at a faster rate than 2.5%, even 20% and I might not even have to pay the $35 per week. I might not have to pay anything at all. I might even make a profit. But,” he paused in thought, “I better not depreciate too much though; or I might have to pay some more tax.”

The negative gearer smiled contentedly and thought about how he had just bought a home for next to nothing because the government was going to pay all his expenses.

“I’ll have to extend the mortgage on my home so I can draw more money out of my equity mortgage account to buy the next house I negatively gear,” he thought.

The negative gearer gave his details to the auctioneer, wrote a cheque for the deposit and signed the contract.

The auctioneer returned to his office and informed his associates of the new price level that had been achieved.

Summary:

Had it not been for the competition from the other bidders the top bid from the investor would have been $78,000 and he would have provided at least reasonable cost accommodation for future tenants.

Had it not been for the negative gearers the first homebuyers would have bought their home for $130,000.

The neighbours in the crowd now decided that their homes were valued at about $180,000 plus and, if they decided to sell, they would price their homes accordingly.

If the negative gearers had not been bidding and the first home buyers had been the successful bidders the neighbours would have decided that their homes were now valued at about $130,000 and would have priced their houses accordingly if they had decided to sell.

The auctioneer went back to his office and told his staff of the new price level that had been reached. When potential buyers came into the office and when new listings were being sought the staff would now advise buyers and sellers that homes in the area were now selling for around $180,000.

Conclusion:

Negative gearing is no less than a government provided subsidy for a privileged group of purchasers. Negative gearing tends to increase real estate prices to the disadvantage of first homebuyers, renters, investors and others who do not negatively gear. As a subsidy negative gearing is far more advantageous to negative gearers in terms of how high they can bid than is the first homeowners grant favourable to first homebuyers. In the above example, which is based on actual events and figures, the price of homes in the area increased by about $50,000 because of the demand generated by negative gearers.

Negative gearing results in negative gearers paying less income tax, therefore government collects less tax from negative gearers for no economic benefit to the Australian economy. If negative gearing were not permitted then income tax that is otherwise lost to negative gearing would be collected and could be used to reduce stamp duty and other government taxes and charges. This would assist all homebuyers or expenditure could be targeted to, for example, assist first homebuyers.

All other things being equal a negative gearer can always outbid those who do not negative gear.

It is clear that negative gearing can, and does, easily increase the price of houses by $50,000 or more.

Negative gearing of property should not be permitted and should be phased out over a period of about 5 years to allow for a smooth transition to a more level playing field.

To minimise disruption when eliminating negative gearing I suggest that only property purchased prior to a specified date be allowed as a deduction for negative gearing purposes. This is the same method that was used to introduce Capital Gains Tax in 1984. Alternatively, negative gearing could be phased out by reducing the allowable percentage deduction each year. To further ease controversy and to correct the high proportion of capital taxation in Australia Capital Gains Tax could be reduced by a revenue neutral proportion vis a vis negative gearing.

Yours faithfully,

Peter Rowan.