

Negative gearing is responsible for high property prices?

Tim Farrelly | farrelly's | 10 March 2017

A lot of people seem to believe – passionately – that negative gearing is responsible for high property prices. And, while negative gearing may place some upward pressure on house prices, the concept that this is a key driver requires us to regard our fellow humans as completely stupid (so it's not the worst theory of all time, but not a great one, either!).

Consider Dr Feelgood. She earns \$500,000 per annum and is looking for a suitable tax shelter for the \$200,000 not needed to support her more than comfortable lifestyle. She is able to borrow at 5.0% per annum and invests in apartments yielding 3.5% per annum. To achieve a loss of \$200,000 and a consequent tax saving of \$100,000 per annum, she will need to borrow \$13 million to buy \$16 million worth of property, assuming a 20% deposit. Along the way, she will pay stamp duty – a tax – of \$730,000 or more. So, on this basis, Dr. Feelgood will take seven and a half years to break even just on tax. Along the way she has taken on a liability of \$13 million. These apartments had better go up in price!

It is difficult to believe that tax is driving this investment decision.

A better explanation probably goes like this... Dr Feelgood's friends have all made good money out of investing in property. If she buys a \$1 million apartment which appreciates at the 8% per annum that she expects, the apartment will double in value in nine years (the rule of 72 again). After repaying the \$800,000 loan, she will have turned her \$200,000 deposit into \$1.2 million. Along the way, she will have earned rent of \$35,000 per annum and paid interest of \$40,000 per annum. Her \$5,000 annual shortfall will be halved, thanks to negative gearing. The end result is a gain of \$1 million and tax refunds of \$22,500. Nice! If it works once, she does it again and again.

If negative gearing was abolished, would she buy another property? Absolutely. This deal has got to be more about the \$1 million gain rather than the \$22,500 tax refunds, particularly if the good doctor recalled the \$55,000 she paid in stamp duty on day one. But if prices stopped appreciating, or if she didn't expect them to appreciate, it's hard to see her purchasing another property in a hurry.

In this more realistic view of the world, price appreciation drives negative gearing – it's not the other way around. Abolish negative gearing and nothing much happens.

Ironically, if governments of various stripes actually believed that negative gearing drives property investment, they should be all for it. Given the substantial transfers between the Federal and state governments, we should look at the total tax take – on a \$1 million

purchase, the combined government take is around \$45,000 to \$55,000, repaid in \$2,500 annual instalments.

As for the notion that removing negative gearing will help housing affordability? It's nuts and you can clearly see it's nuts.



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