
ALP housing incentive plan not enough to beat capital growth

By **STUART WEMYSS**

11:00PM FEBRUARY 8, 2019 •  5 COMMENTS

In case you missed it, in December Bill Shorten announced that the ALP, if elected, would introduce a subsidy of \$8500 a year for investors who construct new homes and offer them to low and middle-income earners for 20 per cent below the market rent. The incentive will last 15 years and be indexed to CPI. The ALP hopes this policy will drive the construction of 250,000 affordable rental properties.

Similar schemes such as the National Rental Affordability Scheme implemented by the Rudd government in 2008 have failed to reach their intended target of 50,000 houses (the scheme is only responsible for the construction of 37,000 houses). The ALP's latest target seems somewhat optimistic.

According to the ALP's tax policy, investors in existing properties will not be able to negatively gear, but owners of new properties will continue to receive the gearing benefits. Therefore, if the ALP is elected and implements these policies, a property investor is faced with two different opportunities. They can build a new dwelling and rent it below market, receive the subsidy and enjoy negative-gearing benefit. Or they can invest in an established property in a blue-chip suburb, probably receive a lower amount of rental income and not receive any negative-gearing benefits.

A property investment's total return is made up of two components: net rental income and capital growth. Capital growth will have a more substantial impact in the long run due to the nature of compounding returns. The absence of capital growth will render a property investment financially ineffective. Typically, the net income generated by residential property after paying all expenses and funding costs is a small amount and will not fund an investor's retirement. An investor would need several properties and, especially in today's credit environment, that is difficult to achieve. So a reasonable level of capital growth (above the inflation rate) is necessary.

The problem with new-build properties is that they tend to be where land supply is not scarce. They might be in new estates where land supply is increasing, as new stages of the development are released to the public. What tends to happen is that these locations do benefit from a small amount of capital growth in the first one to two years, as a new area gets built out and attracts amenities. However, capital growth then tends to evaporate, and prices tend to move in line with inflation. The law of supply and demand dictates that demand must be greater than supply for there to be price growth.

This is the problem facing investors that are attracted to new-build properties. They must assess whether the location and type of property will generate reasonable capital growth. Will demand for these properties outstrip supply? If not, the investment will not work.

Compare two scenarios. An investor who buys a new build for \$500,000, rents it for \$366 per week (being 20 per cent below market rent of \$420 per week) and receives the ALP subsidy and negative gearing benefit. I assumed the annual capital growth rate to be 3.5 per cent (1.6 per cent above the current inflation rate), a relatively low rate due to the lack of imbalance between supply and demand.

I compared this to an investor who buys an established property in a blue-chip suburb that is proven to generate strong capital growth for the same amount (\$500,000). The rental income is \$350 per week, no subsidy or negative gearing, and the annual capital growth rate is 7 per cent. All other assumptions were held constant between the two scenarios (such as expenses, interest rates).

I assumed the two investors held these properties for 20 years and then sold them and repaid the mortgage, capital gains tax and holding costs. The first investor (new build with subsidy) walks away with a cash profit of \$137,000. The second investor's (no subsidy or negative gearing) cash profit is \$459,000.

This analysis reveals that the higher income as a result of the subsidy and negative-gearing benefits do not offset the financial impact of investing in a property that has little capital growth prospects. In time, compounding capital growth will always be substantially more valuable than a higher rental income.

In addition, investors must consider the longevity of such a program. If the ALP retains government for one term, it is unlikely that the Coalition will continue to support the scheme. Property is a long-term investment. Laws, governments and incentives can change. However, it is the fundamentals of an asset that persist and will ultimately influence investment returns.

Not only is this ALP policy unlikely to solve the housing affordability/supply challenge, but it is likely to promote Australians to invest in sub-optimal properties, which are unlikely to generate adequate investment returns.

Stuart Wemyss is an independent financial adviser and author of Investopoly: The 8 Rules for Mastering the Game of Building Wealth.