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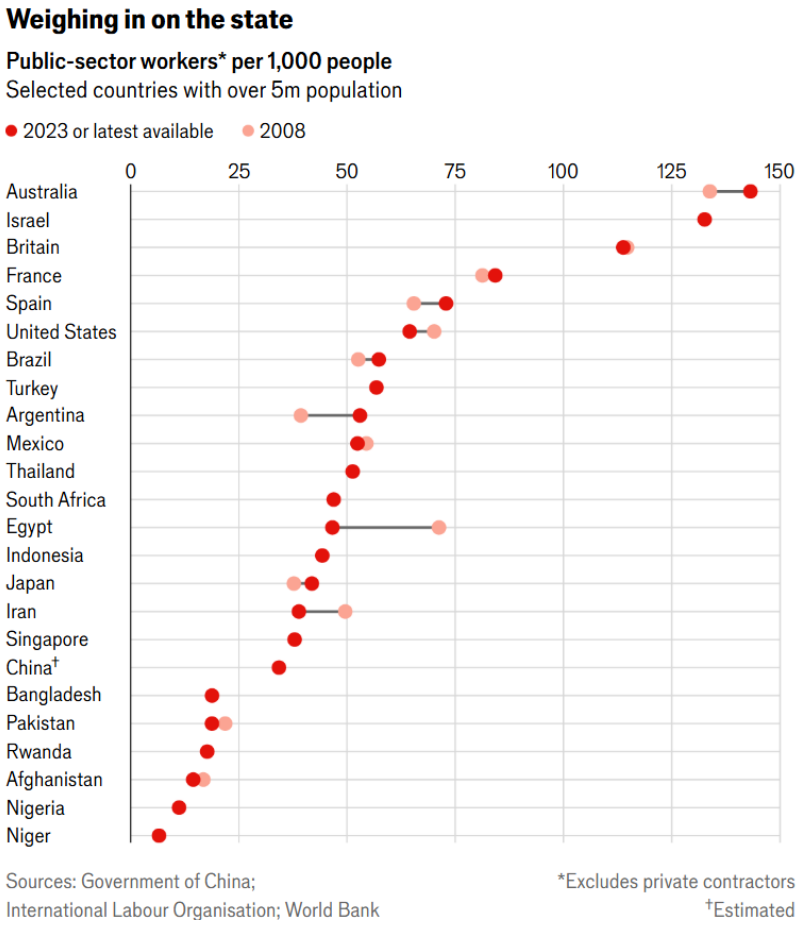
Contents

Editorial

Recently, *The Economist* magazine wrote an article proclaiming that Australia had the most bloated government in the world. It produced this chart, with data from the International Labor Organisation, showing that adjusted for population, Australia has the largest public sector workforce, with 143 employees per 1,000 people – roughly 29% of the country's workers.



The only problem? The numbers are almost certainly wrong.

Though comparing like-for-like public services is tricky, ABS figures show that Australia isn't as big an outlier at *The Economist* claims.

At June 2024, Australia had 2.51 million public sector employees out of a total population of 26.66 million - about 9% of the total population and 17% of the total workforce.

Though not as big an outlier, these figures suggest that Australia's public service would still rank third on the above list of 178 countries.

Yet, that may not tell the full story. Some think the numbers should adjust for things outsourced by governments such as healthcare. Here is how the figures versus four other countries look with that adjustment.

Cost of Government Comparisons

	Employed Persons	Government Employees	Private Healthcare	Combined	Govt + Health Share
	(m)	(m)	(m)	(m)	(%)
Germany	46.1	11.4	0.05	11.5	24.8%
Canada	20.9	4.2	0.05	4.3	20.3%
USA	161.3	22.0	10.5	32.5	20.1%
UK	34.0	6.1	0.06	6.2	18.2%
Australia	14.5	2.5	0.07	2.6	17.7%

Source: Ivor Ries

I am not totally convinced this is a like-for-like comparison either, though it's food for thought.

Labor loves Canberra

What's clearer is that the Albanese Government has significantly boosted Commonwealth public service numbers since it came to power. For the two years to June 2024, federal public service figures, ex-defence, increased from 195,800 to 308,200, or by 57.4%. Total numbers including defence rose 44%. And Commonwealth public service wages lifted by $13 billion during that period.

Federal public servants

Year	Numbers (000)	% change	Cash wages/salaries ($bn)	% change
2020	246.0	1.6	22.4	1.2
2021	247.6	0.7	23.1	3.2
2022	254.0	2.6	24.5	5.8
2023	350.3	37.9	33.9	38.6
2024	365.4	4.3	37.3	10.0

Source: ABS, Peter Warnes

Of the 101 departments and agencies within the Australian Public Service, just seven accounted for 63% of the new jobs added in the first two years of the Albanese government.

Defence led the way, with an extra 2,916 joining the department. Intriguingly, the number of uniformed ADF personnel fell over the two years, so all the jobs added were bureaucrats/administration.

NDIS and health were the other departments to have large increases in headcount.

Top 20 departments and agencies by staff increase				
	Department/agency	2022	2024	Change (n)
1	Defence	16,887	19,803	2,916
2	National Disability Insurance Agency	5,066	7,842	2,776
3	Health	5,689	7,155	1,466
4	Australian Taxation Office	20,242	21,601	1,359
5	Home Affairs	13,858	15,215	1,357
6	Veterans' Affairs	2,346	3,653	1,307
7	Services Australia	32,296	33,556	1,260
8	Aged Care Quality and Safety Commission	834	1,466	632
9	Social Services	2,776	3,366	590
10	NDIS Quality and Safeguards Commission	364	938	574
11	Finance	1,704	2,254	550
12	Australian Digital Health Agency	222	626	404
13	Australian Competition and Consumer Commission	1,396	1,767	371
14	Industry, Science, Energy and Resources	5,302	5,601	299
15	National Film and Sound Archive of Australia	185	441	256
16	Foreign Affairs and Trade	4,551	4,805	254
17	Attorney-General's	2,167	2,413	246
18	National Emergency Management Agency	192	415	223
19	Australian Institute of Health and Welfare	404	626	222
20	Federal Court of Australia	1,382	1,603	221
Source: Australian Public Service Commission				

How much of the increase can be justified?

The Albanese government came into office claiming the previous Morrison government outsourced an exorbitant amount of public sector work to external consultants, costing taxpayers' tens of billions a year. It intended to cut that waste and bring the work back to the Australian Public Service.

Labor had a point. In its final year in office, the Morrison government spent almost $21 billion on outsourcing public service functions. An audit commissioned by the new government found that external labour accounted for 53,911 full-time equivalent jobs in 2021-22. That 'shadow' workforce added 37% to the official public service.

Expenditure on external labour, 2021-22			
Agency	Expenditure ($m)	% of total incl. Defence	% of total excl. Defence
Dept. of Defence	15,713	76%	
Services Australia	981	5%	19%
Australian Taxation Office	648	3%	13%
Agriculture, Water, Environment	441	2%	9%
Dept. of Home Affairs	403	2%	8%
All other agencies	2,585	12%	51%
TOTAL	20,771		
Source: Audit of Employment			

I am sympathetic towards Labor's suggestion that the Morrison government gutted the public service and outsourced the work to consultants who filled their pockets.

However, the truth is that the Commonwealth public service has been decimated of talent for decades. It started under Hawke and accelerated under John Howard when he appointed Max Moore Wilton, aka Max the Axe, as Secretary of the Prime Minister's Department. Power shifted from the public service to ministerial offices. That meant politicians no longer relied on independent advice and data from public service departments and agencies, but on the advice of their own staffers.

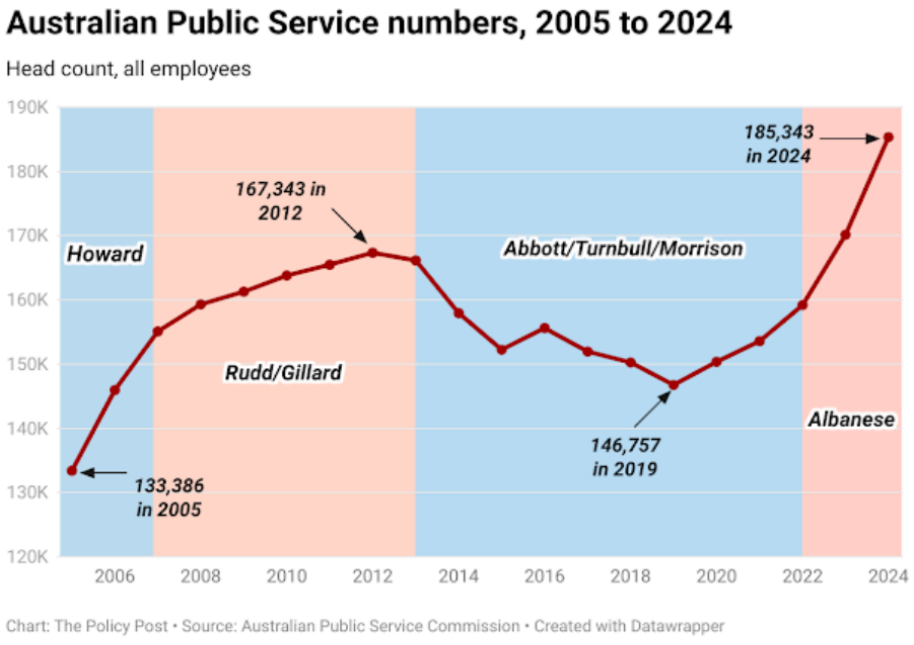
The problem with the Albanese Government is that it's added public servants at a significantly faster rate than it's cut outside consultants.

In recent budget papers, Labor said it had delivered on its commitment to reduce the public service's reliance on consultants, with $3 billion in cost savings in the 2022-23 budget. And it would reduce consultant fees by a further $1 billion in 2024-2025.

That total of $4 billion in savings compares to total consultant fees of $20.7 billion in the last year of the Morrison government. An almost 20% cut in consultant fees is decent work.

However, Labor has also hired new public servants to the tune of almost $13 billion during the same period. In other words, we've saved $4 billion in consultant fees by adding $13 billion in public sector wages.

The following chart shows that Labor isn't just restoring the public sector workforce but adding to it.



Larger government bloat may be elsewhere

Context is important when considering public sector wages. They are relatively small fry when compared to total government spending. Australia spends $37 billion on Commonwealth government wages out of total budget spending of $762 billion, amounting to less than 5%.

If you want to deal with government waste at the federal level, then there are bigger issues to tackle.

And there may be a larger problem at the state government and council levels.

When plowing through the numbers, I was surprised by the employee and wage figures at these two tiers of government.

State Governments employ 1.94 million people at a cost of $178 billion, almost 5x the total wages of Commonwealth public servants. And local councils spend $16 billion on their employees.

Public sector employees and cash wages and salaries

	Employees June 2024 ('000)	Cash wages and salaries 2023-24 ($m)
Commonwealth Government	365	37,319
State Government	1,939	178,372
Local Government	214	16,446
Total Public Sector	2,518	232,137

Source: Australian Bureau of Statistics, Public sector employment and earnings 2023-24 financial year

About 1 in every 11 Queenslanders is a state government employee, and it's 1 in 12 in New South Wales.

Public sector employees, level of government, states and territories ('000)

	Jun-23				Jun-24			
	C'wealth	State	Local	Total	C'wealth	State	Local	Total
NSW	84	540	61	685	87	557	63	708
Vic.	60	471	57	587	63	486	57	606
Qld	48	393	47	489	50	409	48	507
SA	20	140	11	171	21	143	12	176
WA	18	211	25	253	19	220	26	264
Tas.	6	53	4	63	6	55	5	65
NT	9	30	3	43	10	32	3	44
ACT	105	34	na	139	110	38	na	147
Australia	350	1,872	208	2,430	365	1,939	214	2,518

Source: Australian Bureau of Statistics, Public sector employment and earnings 2023-24 financial year

Public sector cash wages and salaries, level of government, states and territories ($m)

	2022-23				2023-24			
	C'wealth	State	Local	Total	C'wealth	State	Local	Total
NSW	8,171	48,447	4,627	61,244	8,938	52,356	5,053	66,346
Vic.	5,808	40,703	3,807	50,317	6,363	42,989	4,028	53,380
Qld	4,631	36,183	3,899	44,714	5,005	39,758	4,114	48,877
SA	1,925	11,293	874	14,092	2,151	11,952	959	15,062
WA	1,730	18,483	1,646	21,859	1,911	19,545	1,776	23,232
Tas.	542	4,315	293	5,150	566	4,741	323	5,631
NT	841	3,061	180	4,083	902	3,290	193	4,385
ACT	10,288	3,241	na	13,529	11,482	3,742	na	15,224
Australia	33,936	165,726	15,326	214,988	37,319	178,372	16,446	232,137

Source: Australian Bureau of Statistics, Public sector employment and earnings 2023-24 financial year

Breaking employee numbers (of Commonwealth, state and council) down by industry, about 1 in 3 public servants in Australia work in public administration and safety. Most of the rest are in education and healthcare.

I'm not sure we need 849,000 people working in public administration, costing $83 billion per year!

Public sector employees and cash wages and salaries, industry

	Employees ('000)		Cash wages and salaries ($m)	
	23-Jun	24-Jun	2022-23	2023-24
Electricity, gas, water and waste services	58	62	6,861	7,772
Construction	8	9	820	892
Transport, postal and warehousing	77	78	7,987	8,479
Information media and telecommunications	17	17	1,866	1,937
Financial and insurance services	20	21	2,328	2,594
Rental, hiring and real estate services	7	8	632	665
Professional, scientific and technical Services	36	39	3,507	3,803
Public administration and safety	818	849	76,889	83,444
Education and training	738	754	53,803	57,905
Health care and social assistance	615	642	57,574	61,685
Arts and recreation services	21	23	1,409	1,569
Other industries a.	16	16	1,312	1,394
All industries	2,430	2,518	214,988	232,137

a. Includes Agriculture, forestry and fishing, Mining, Manufacturing, Wholesale trade, Retail trade, Accommodation a

Source: Australian Bureau of Statistics, Public sector employment and earnings 2023-24 financial year

This data would suggest that state government and local councils may have a lot more fat to cut than the Commonwealth government.

James Gruber

Also in this week's edition...

Australian investors have been stumped by what's driven the extraordinary rise in CBA's share price over the past 18 months. **Clime's John Abernethy** says it's becoming clear that US fund managers are buying CBA to hedge against further falls in the US dollar and the potential for quantitative easing as America grapples with its huge budget deficit. He suggests the likelihood of QE and financial repression in the US has significant ramifications for Australia, beyond just CBA.

As markets reach record highs, exorbitant valuations and increasing concentration risk are leaving many investors with a quandary about what to do with their portfolios. **Jamie Wickham** advises on how to avoid knee jerk reactions and the best ways to position your portfolio for the future.

Soaring house prices are deepening Australia's cost of living crisis - and possibly distorting marriage decisions. New research by **Stephen Whelan** and **Luke Hartigan** links unexpected price changes to whether couples separate, stay, or silently struggle together.

Google has been one of the internet's poster children for disruption. Yet, AI is now threatening to diminish Google's lucrative search business - a case perhaps of the disruptor becoming the disrupted. **Alex Pollack** and **Harry Morrow** look into what Google is doing about it and whether it can reinvent itself to ward off competitors.

A new study has uncovered what many have long suspected about passive investing - that market ETFs and indexing don't just mirror the market but shape it, often amplifying the rise of the largest firms. **Larry Swedroe** outlines the study and its implications for investors.

There's long been a debate about swapping property stamp duties for land taxes. **Cameron Murray** looks at the pros and cons of such a move, and whether it should be a priority to deal with the housing crisis.

Joe Wiggins says many of the behaviours that have made humans such a successful species also make it difficult for us to be good, long-term investors. He thinks the key to better decision making is to understand what makes us human and adapt.

Lastly, in this week's whitepaper, **Fidelity** provides its mid-year outlook on the opportunities and risks in markets.

Trump's US dollar assault is fuelling CBA's rise

John Abernethy

The recent $1 billion investment in the Commonwealth Bank (CBA) by the Texas based fund manager - Fisher Investments (Fisher) – suggests that US-based capital is beginning to move in anticipation of a substantial Trump directed quantitative easing (QE) program.

In my view, Fisher's investment is not a strong vote of confidence in either the quality or value of CBA. Fisher manages over US$500 billion, so this is not necessarily a major position for the group. Rather, it is an investment that expresses concern for the outlook of the USD by large active US based investors. It is part of a significant hedging strategy, and it will be interesting to see how it plays out.

Speculating on the full range of reasons behind the investment by Fisher, the Australian Financial Review reported that: "Sources said Fisher was buying on behalf of clients who wanted to increase the exposure of their share portfolios beyond volatile markets in the United States".

I would suggest that active US-based asset managers, their consultants, and advisors, are urgently reviewing their investment portfolios. With Trump unleashing a continuous tirade at the Chair (Jerome Powell) of the Federal Reserve (Fed), they have concluded that a QE policy will occur at some point.

Further, whilst a general rise in tariffs will lead to an elevated inflation rate, a direction to the Fed to decrease interest rates will result in "negative real rates" - where cash rates and bond yields are driven below inflation by the Fed. This can only occur if QE is undertaken as part of a coordinated monetary program that includes an aggressive reduction in US cash rates.

The confusing outlook – higher inflation but with lower interest rates – flows directly from a strategy of monetary policy interference by the Trump Administration.

Based on statements of both President Trump and Treasury Secretary Bessent, they have a probable target of 2.5% (cash rate), about 3% for ten-year Treasury bonds and 4% for 30-year Treasuries. At those levels, the Trump Administration may hold the US government's interest bill to about 15% of US budget outlays. An uncomfortable level that is the upper limit of what is manageable.

Considering all factors in the US fiscal outlook following the passing of Trump's Big Beautiful Bill, the need to stabilise the US budget and debt is clear - especially with the US debt ceiling to be breached again in August. Both US government debt (110% of GDP) and its interest bill (rising above 3% of GDP) will be confronting for the bond market. Without central bank intervention, the bond market could falter, driving yields higher and bond prices lower.

Active managers must respond and a growing allocation to liquid non-USD assets comes into focus, particularly for US domiciled funds. Therefore, a tactical allocation towards AUD assets (inside an expanded non-USD allocation) is justified.

When targeting Australia, the choices are liquid AUS government bonds, corporate debt, and equities.

CBA, with no USD currency exposure, fits the bill perfectly. It is a pure AUD play and has a massive market capitalisation (about $300 billion). It is also the largest and best-performing bank in Australia, and one of its most valuable brands. Of note, unlike our major resource companies, neither its operations nor revenues will be affected by USD gyrations.

Obviously, this investment will unwind at some point in the future. But on the day, it created a rare liquidity event for Australian funds to sell down CBA shares at an extraordinary valuation. I will cover the CBA valuation below.

But first I will consider QE in a little more detail.

Will QE drive economic growth in the US?

To answer this question, we need not look too far into the past. QE has been a feature of monetary policy and economic management by major central banks since the GFC. It has been labelled as part of 'Modern Monetary Theory'.

Over recent macro-economic history, we have seen from Japanese (since 2000), European and US QE programs (post GFC), that an excessive use of QE does not necessarily lead to either a lift or recovery in economic activity.

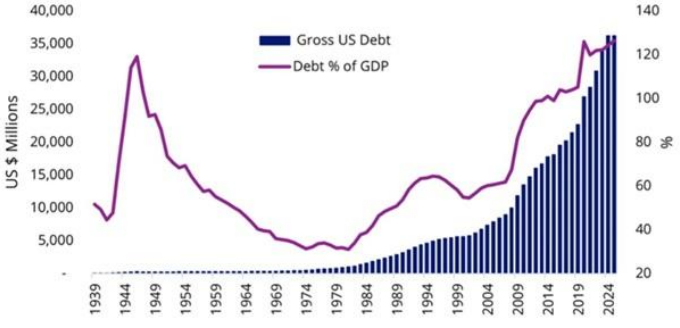
Indeed, zero or negative real yields can inhibit economic activity, whilst allowing highly indebted governments to manage a potential debt servicing crisis.

There is abundant evidence (Japanese and European 'negative' bond yields) that excessively low interest rates stall the flow of both risk and investment capital. Banks reduce their lending as interest margins decline and the confidence of companies to borrow is challenged by a low-rate environment. Business sentiment is not uplifted by excessively low interest rates because such rates normally suggest an outlook for weak economic activity.

QE and negative real yields in the US

The US government bureaucracy, the Trump Administration, the US Congress and the US Senate are staring at a government debt servicing crisis. The exponential growth in US government debt is well captured in the chart below.

Chart 1: Accumulation of US debt



Source: VanEck. FRED. Bloomberg. Data in USD.

Similarly, large US investment funds are facing an uncertain and potentially volatile USD outlook that may include:

1. The premature replacement of the Fed Chair by a Trump appointee. This process may well be chaotic if Trump pushes aggressively and Powell refuses to resign. What will Congress do if this happens? How will the US bond market react?
2. A Trump Fed appointee will likely move the Fed monetary policy guidance towards lower US bond yields - across the yield curve. The Fed, with Trump friendly appointees, will then be coerced to undertake QE.
3. Cash rates would be aggressively cut followed by a QE program designed to lower the US government interest bill. To achieve this, both cash rates and bond yields would need to fall (as noted above) to between 2.5% and 3%.
4. As rates fall, equity PER expansion is possible. However, with high PERs already in place (the S&P 500 index companies are trading at around 22x forecast earnings versus a 10 year average of 18x), an equity market rerating would still be dependent on 'real' earnings growth that will be confronted by rising tariffs, higher costs of doing business and fiscal policy adjustment – Bessent target of rebalancing the deficit from 6% to 3% of GDP; and
5. Domestic focused US companies (importers) are disadvantaged compared to multinationals. The US equity index (measured by high weightings to 7 or 8 mega tech companies) will need those companies to continue to perform, whilst many others face pressure. The high PERs of some stocks may be supported by their international earnings that are magnified by a weakening USD: around 30-35% of the revenues of S&P 500 companies are obtained from outside the US.

Given the above, the reduction of exposure to the issues confronting US based assets seems a logical response. Indeed, after a sustained period of US exceptionalism, US asset managers will need to think carefully and hedge against the risk of USD depreciation. The USD has fallen 10% over the last 6 months against a basket of other currencies. However, initially they may ride a US bond market rally and stay exposed to potential PER expansion when (or if) QE rolls.

A Trump induced QE, with aggressive cash rate adjustment, will take markets into a period of heightened volatility, featuring more asset price inflation, that will be likely followed by a period lower investment returns, as the US debt bubble is navigated.

CBA – buy, sell or hold

Fisher Investments has made their buy call and it seems that they picked up $1 billion of CBA shares around $180 per share.

As I suggested above, two of the connected reasons for them buying CBA may be to gain an exposure to a rising AUD, via utilising a highly liquid and yielding equity.

The call on the AUD is very much a call on the value of the USD. Is the USD likely to depreciate with a QE policy and interest rate manipulation?

The AUD has been weak against the USD since 2014 when it peaked at USD$1.10. Over FY25 it finished the year at 1.35% lower than where it started. However, since Trump's inauguration in January, it has appreciated by 5%, punctured short term by the April tariff declarations.

I have long believed that the AUD has persistently traded below its fair value. A consistent trade surplus, a couple of fiscal surpluses, relatively low government debt and massive superannuation savings have failed to support the AUD – when basic economic theory suggested they should.

One explanation is the connection between our large superannuation savings and their growing flow towards offshore investments. Our super pool of $4.25 trillion is about 50% larger than both our economy and the capitalisation of the ASX. As funds have been increasingly allocated outside Australia, the AUD is sold to acquire foreign currency (mainly USD).

Our relatively small Commonwealth government bond market, 25% of superannuation assets, also acts to push our savings offshore and towards larger companies – both in and outside Australia.

That results in an increasing flow into 'default index investing'. It may also explain why the Australian ASX 200 index has behaved similarly to the US indices – an excessive weighting of market performance explained by just a few stocks – and in the case of the ASX, by CBA.

From the following table we note:

1. CBA represents about 12% of the ASX 200
2. The ASX 200 lifted by about 8% (price) in FY25 against earnings revisions of minus $6.9 billion from initial forecasts over 12 months ago
3. Just 7 companies accounted for 82% of the index increase
4. CBA alone accounted for 38% of the increase in the index
5. CBA's earnings revision of $1 billion for FY25 (from FY24 forecasts) resulted in a revaluation of 90 times that incremental profit performance.

A year of concentration – the seven stocks shown below represented over 80% of increase in market cap of ASX 200 market in FY25. Within this, note the contribution of CBA ($96bn). What is going on?

Stock	Market Cap at 30.6.25	Increase on 12m ago		NPAT revision on 12m ago	
ASX 200	$3,049,333	$252,607		($6,916)	
CBA	$308,902	$95,914		$1,045	
Newmont	$97,787	$24,733	It took these 6 stocks in total to match the increase in value of CBA	$2,910	The profit increase of these stocks was 3.7x that of CBA
Wesfarmers	$96,192	$22,227		$75	
Westpac	$115,747	$21,286		$83	
Resmed	$57,792	$15,044		$441	
Pro Medicus	$29,791	$14,831		$56	
Telstra	$55,923	$14,096		$313	

Contribution of above stocks to total ASX 200 increase	82%

To suggest that the CBA share price is confronting is obvious. Compare the forward price earnings ratio (fPE) of CBA at 29 or 30x with some of the largest US banks like JP Morgan Chase (fPE of 14x), Bank of America (fPE of 15x) or Wells Fargo (fPE of 15x). European banks are priced similarly, with HSBC on fPE of 15x, UBS on fPE of 17x and BNP Paribas at about fPE of 9x. Smaller European banks are far cheaper, and most of them trade at fPEs in the single digits. Of course, we acknowledge that forward price earnings ratios are just one simple metric for assessing a bank's valuation.

We know that the share price on any day gives little indication of where its price will go in the next week, month or indeed year. Ultimately, market theory suggests that a company's share will eventually trade at or around fair value. However, fair value is opinion based and is naturally biased by qualitative assessments and observations of market price behaviour.

This second point emphasises why CBA shares are highly sought by international investors. Its price has performed and that suggests it is more likely to continue to perform (i.e. momentum) as QE floods the US and world capital markets with liquidity.

In other words, the weight of money and default investing will support the CBA. But could a headwind appear to push against the relentless inflows towards CBA? Of course they could – financial history is full of such tales.

My final table, created by Clime analysts and drawn from bank analysts across the market paints a difficult outlook for banks generally and CBA specifically as (and if) the RBA cuts cash rates.

A projected reduction of cash rates by 1% over an operating year is tracked in the following table.

CBA		Consensus	Rates cut 100bps	
	Unit	FY25	FY26	Change
Interest earning assets	A$bn	950	998	5.0%
- rate	%	6.1%	5.1%	
Interest bearing deposits	A$bn	800	840	5.0%
- rate	%	4.0%	3.1%	
NIM	%	2.08%	2.01%	-0.07%
Net interest income	**A$m**	**25,760**	**24,885**	
Non-interest income	A$m	3,500	3,500	
Total income	**A$m**	**29,260**	**28,385**	
Operating expense	A$m	13,000	13,260	2.0%
- cost to income	%	44%	47%	
Pre Provision Profit	A$m	16,260	15,125	
BDD expense	A$m	(1,000)	(1,050)	
PBT	A$m	15,260	14,075	
Less tax @ 30%	A$m	4,578	4,223	
NPAT	**A$m**	**10,682**	**9,853**	**-8%**
Shares	m	1673	1673	
EPS	A$	$6.38	$5.89	
P/E @ $170	X	26	29	
Provision as % RWA	%	-0.22%	-0.22%	
Risk Weighted Assets		464	487	

A reduction in cash rates, given a highly competitive mortgage market with regulatory and political oversight, will lead to a reduction net interest margins and profits.

CBA, more than its competitors, has done well to deal directly with its borrowers (with less reliance on brokers and intermediaries) and has a traditionally strong direct connection with retail deposit providers. That holds it in good stead, but it won't stop an earnings decline, or a flat profit outlook that will challenge the 30x PER rating (at $180).

Also, alarming is that the market capitalisation is 12 times its 'net interest revenue'. That multiple is more suitable for earnings, not for revenue.

Good luck to Fisher Investments. It will be interesting to see if they make money on their trade – and whether their hoped-for profit comes from currency movements or from the CBA's share price – or both or neither.

John Abernethy is Founder and Chairman of Clime Investment Management Limited, a sponsor of Firstlinks. The information contained in this article is of a general nature only. The author has not taken into account the goals, objectives, or personal circumstances of any person (and is current as at the date of publishing).

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With markets near record highs, here's what you should do with your portfolio

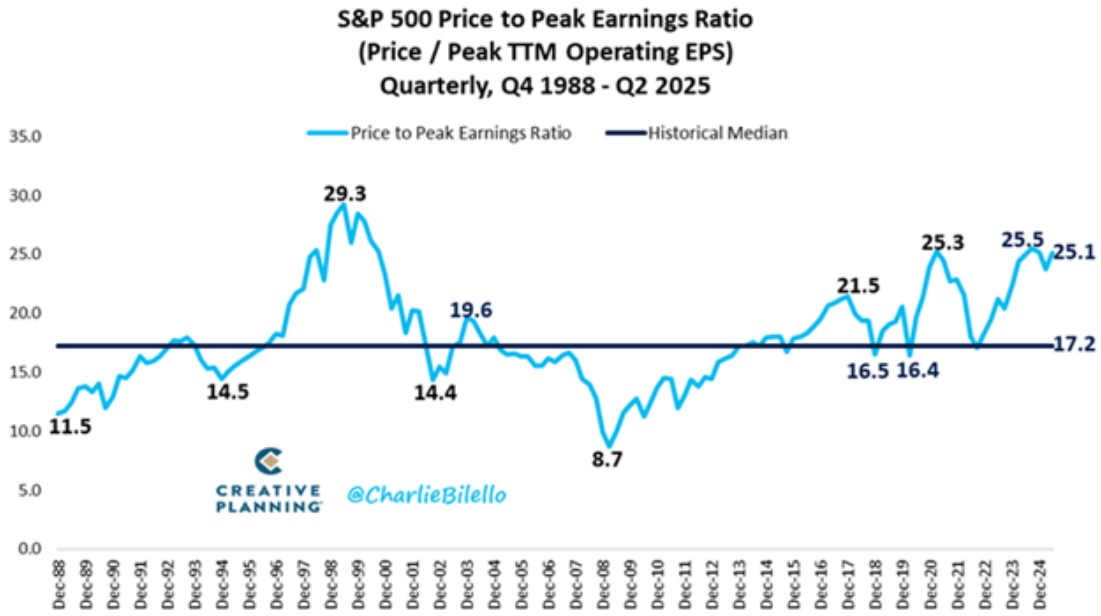
Jamie Wickham

Equity markets have emerged unscathed from a financial year marked by geopolitical turmoil and uncertainties over US trade policy, with many global indices finishing at or near record highs. But now come the tough decisions.

With the Australian market's total return in 2024/25 at 14% and unhedged global equities returning 19%, some valuations are looking stretched, and uncertainties are increasing. The S&P 500, for instance is trading at historically high multiples.

Compounding investor angst locally has been the concentration in the Aussie market. CBA alone accounted for one-third of the S&P/ASX 200 index total return with a return of 50% in the financial year and a 12% index weight.

So it's natural for investors to reflect on their portfolios at this time and ask whether they are appropriately positioned for whatever might come next.



Source: Charlie Bilello

For investors paying heed to market commentary, the kneejerk responses to these issues can be confusing. “Should I be repositioning my global equity exposure away from the US? Should I be rotating out of the banks and into the miners?”

While these are legitimate questions, they are more tactical than strategic, and speak to the need for a reflex, emotion-driven response rather than one that is more considered.

The truth is whatever the state of the market cycle, the most important element of portfolio management isn’t picking stocks or tactically shifting your exposures. Instead, it is the discipline and focus brought by a systematic approach.

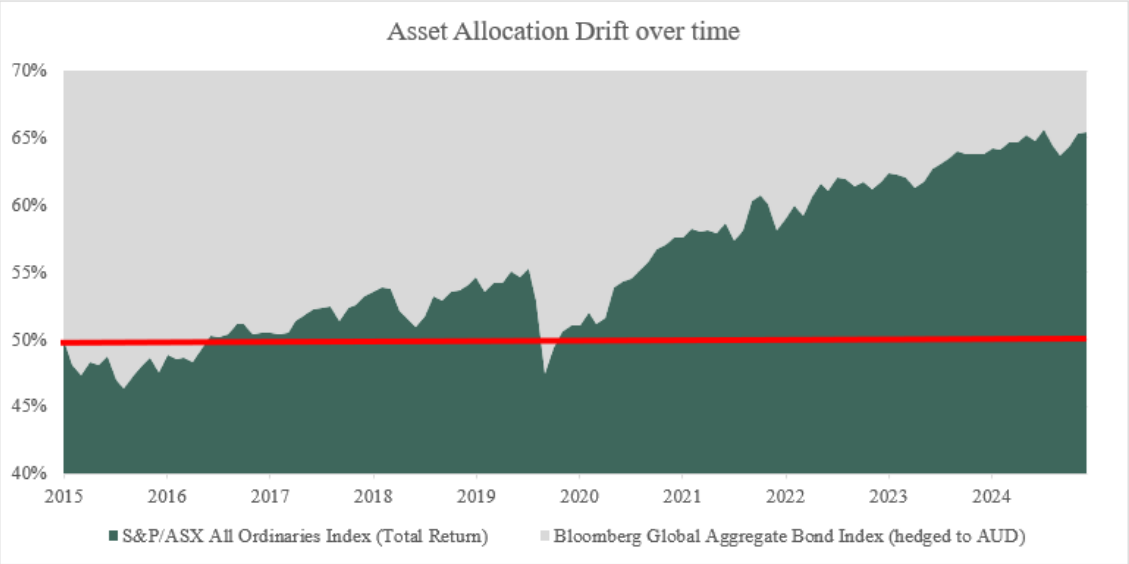
A risk control mechanism

While the temptation may be to make tactical moves and attempt to second-guess markets, it makes more sense at this time to revisit your portfolio make-up and rebalance it back to its strategic weights.

Rebalancing is first and foremost about risk control, particularly the risk of being overweight equities in rising markets, and the risk of a mismatch between your original portfolio design and its construction today.

The chart below shows you what can happen *without* rebalancing. Left untouched, the asset allocation of a simple 50/50 growth/defensive, Australian equities/bond portfolio would have drifted over the past decade to closer to 65/35. Using global equities, which have outperformed over this period, the drift would have been even more dramatic, to 75/25.

As my previous article showed, even slight changes in growth/defensive allocations can generate dramatically different outcomes. A 65/35 portfolio, for instance, will show much greater variability of returns than a 50/50 portfolio, post negative annual returns more frequently and have a higher probability of negative returns over extended three-to-five-year periods.



Source: Minchin Moore Private Wealth

Now, while that might be OK for you, such changes should result from an intentional decision on your part, not a head-in-the-sand, "I-never-look-at-my portfolio" situation.

Ultimately, your portfolio needs to be one you can live with. When you established it, you had an objective, investment parameters and risk tolerance in mind. If those factors still hold true, make sure your portfolio still reflects your intention.

A self-management tool

If investing is as much about managing yourself as managing money, then a compelling reason to rebalance your portfolio is behavioural.

Instead of trying to time markets or tactically allocate at different points in the cycle, systematic rebalancing takes the emotion out of it and realigns your portfolio to its strategic weights.

This doesn't require any decision-making on your part. You simply follow the rules as stipulated in your investment policy. All you need is the discipline and focus to implement those rules and not be tempted to time markets.

Looked at another way, disciplined and strategic rebalancing forces you to sell high and buy low – without a market-timing decision. You trim the asset classes that have outperformed and invest in those that have underperformed.

Such a framework not only controls for risk but can at times enhance returns, as we'll see below.

Rebalancing mechanics

One of the arguments *against* rebalancing is the impact of transaction costs and capital gains tax from the sale of securities. But there are ways to manage this.

Accumulators can use cash or additional contributions to buy underweight portfolio exposures, which will mitigate all or some of those costs (this is one reason to hold some cash - to enable efficient rebalancing).

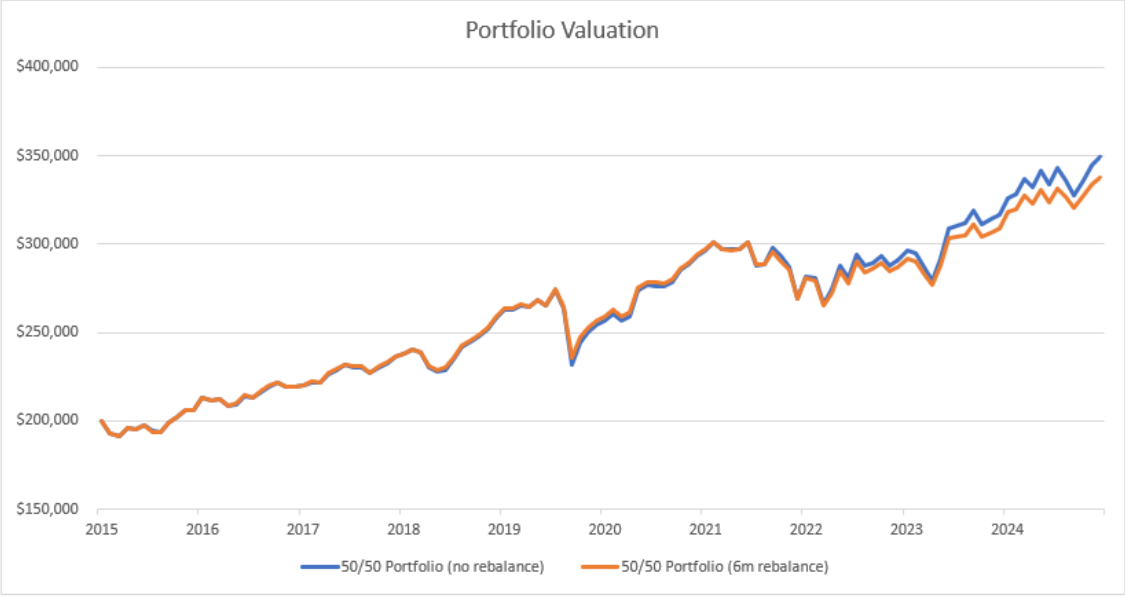
Those in drawdown often need to sell securities to supplement income harvested from the portfolio, which provides an opportunity to bring the portfolio back into alignment.

As to timing, a common approach is to rebalance twice per year on a set schedule, ideally to align with periods of significant cashflow. Rebalancing when the portfolio drifts outside of tolerance ranges can have merit, but this also introduces a discretionary element and can mean you are rebalancing too often or at time when you don't have cash to support it.

Rebalancing and performance

Rebalancing not only controls for risk but can deliver excess returns at times, although this can be dependent on idiosyncratic factors and is tough to control.

The chart below takes the same 50/50 portfolio in the exhibit above and tracks the performance of a version with no rebalancing versus a version that rebalances twice a year, in January and July.



Source: Minchin Moore Private Wealth

The rebalanced version was marginally ahead for the first six years through 2021, and further ahead on a risk-adjusted basis. This was driven by weakness in equity markets in 2015/2016, and the 2020 COVID shock, and the ability to rebalance into that weakness and top up equity exposure.

Calendar 2022 was an anomaly, with both bonds and equities down in the face of the post-COVID inflation breakout and subsequent central bank interest rate increases. This meant, rebalancing offered little benefit, and both portfolios suffered.

From October 2023, the ASX has powered ahead, albeit with a few blips, which has left the unbalanced version outperforming, as you would expect. More recently, we have seen not only strong upward momentum, but also periods of short, sharp volatility, such as February to June this year amid the tariff mayhem. In this instance, the dip didn't align with a rebalance date, and you didn't reap the rebalance benefit of this market weakness.

Summary – the friend you need to ride out whatever happens

After the financial year we've seen and the magnitude of ongoing uncertainties, it can be tempting to respond to the urge to make tactical shifts in your portfolio.

But your best approach remains using systematic, disciplined rebalancing as an integral part of your investment policy and program design.

Systematic rebalancing realigns your portfolio back to your original plan on a rules-based schedule, removes emotion from the process, and prompts you to sell high and buy low in a strategic way. What's more the costs can be managed successfully.

So if your portfolio has been drifting and withstanding the intermittent storms to date, don't be lulled into a false sense of security. Check your asset allocation and ensure you are comfortable with the settings.

With equity markets looking stretched, geopolitical and policy uncertainty mounting, and returns concentrated in a few stocks, there is bound to be a bigger storm brewing somewhere on the horizon.

Systematic rebalancing is the friend you need to you ride out whatever happens.

Jamie Wickham, CFA is a Partner at Minchin Moore Private Wealth and former managing director, Morningstar Australia.

Soaring house prices may be locking people into marriages

Stephen Whelan, Luke Hartigan

House prices continued to rise across Australia in June, recent data shows. Nationally, prices have risen about 38% in the past five years.

Higher housing prices are simply one contributor, albeit a very important one, to the cost of living crisis that Australian households face. Energy prices are another.

Those higher costs of living and the financial stress associated with them are linked to a range of negative outcomes for households, including poor health and wellbeing, greater housing insecurity, and some families having to go without some essential items.

One consequence of house prices that has largely been ignored is their relationship to marriage and divorce.

Divorce rates are at historic lows

The rate of divorce in Australia is at the lowest level since the introduction of no-fault divorce in 1976.

The 1990s recession was also a period of significant financial hardship for households, and divorces rose over that time. Why isn't this happening now?

Couples may prefer to divorce but can't for financial reasons.

Why? Put simply, divorce is a decision that brings with it significant costs. The financial implications of divorce could mean couples stay together longer than they'd like to.

Why do people choose to marry or separate?

To understand patterns of divorce, a good place to start is to think about *why* couples choose to marry, or separate, in the first place.

Economists argue that individuals marry if the expected benefits from marriage exceed the benefits from remaining single.

As new information arises or unexpected outcomes occur, individuals may reassess their beliefs about the expected benefits from being married versus being single.

In turn, we might expect that separation occurs if either partner believes they will be better off outside the marriage than within it, taking into account all costs and constraints.

How housing prices can affect the likelihood of divorce

Research shows that housing prices are closely linked to a range of household behaviours and outcomes, including consumer spending, labour supply and fertility intentions.

Rising housing prices might encourage couples to remain married (or not separate) due to the higher housing costs they would face if they separated.

It is generally cheaper to run a single household where many resources are shared rather than two separate households. This may be thought of as a *cost* that accompanies higher house prices.

Of course, higher house prices also offer some benefit in the event of separation. For homeowners, the asset held by the couple is more valuable and the wealth each partner may be entitled to is greater. This *benefit* from separation might encourage couples to separate and divorce.

Our research, presented at the Australian Conference of Economists last week and not yet peer reviewed, addresses this issue. We looked at whether *unanticipated changes* in the growth of housing prices are related to the likelihood of divorce.

It is important to focus on unanticipated changes in housing prices. Unanticipated changes, or "shocks", will lead individuals to reassess their decision to stay married, or separate and divorce.

Which factors explain divorce in Australia?

Our research sought to understand the key factors associated with divorce in Australia using the Household, Income and Labour Dynamics in Australia (HILDA) survey.

Not unexpectedly we found couples who share similar traits such as the same religion, education level or place of birth are more likely to remain married. A longer time being married is also linked to couples being less likely to separate. In contrast, partners whose parents had divorced are more likely to separate.

Importantly, the inclusion of housing price shocks into our analysis indicates they have a significant effect on the likelihood of divorce. But the effect differs depending on whether the housing price shock is positive or negative.

For homeowners, lower-than-anticipated housing price growth significantly increases the likelihood of separation. In this case the *cost* of lower house prices is more important than the *benefit* of lower house prices. When house prices don't grow as quickly as anticipated, couples can separate knowing they will not face as large a penalty running separate households.

So what lesson may be drawn from this research and why is a link between housing prices and divorce important?

Our findings indicate higher-than-expected house price growth may be keeping some people in marriages they'd otherwise leave, but don't, for financial concerns. This is more likely to include women with low education levels, low-income households and older couples.

In some instances, this will have negative consequences. Often those harmful consequences are disproportionately experienced by women and policy settings have a role to play in reducing those effects.

One only needs to look at initiatives such as the Leaving Violence Program. By providing financial support to assist people leaving potentially dangerous relationships, it will alleviate barriers associated with high housing costs that come after separation.

The Conversation

Stephen Whelan, Associate Professor of Economics, University of Sydney and Luke Hartigan, Lecturer in Economics, University of Sydney. This article is republished from The Conversation under a Creative Commons license. Read the original article.

Google is facing 'the innovator's dilemma'

Alex Pollak, Harry Morrow

A question that we have often been asked over the years is: can the disruptors be disrupted?

There is a ready answer. The largest, most valuable and closest disruptor on the horizon is artificial intelligence (AI) and one of the targets is the ten blue links in Google's search. Further, the threat is so serious that Google has been forced to disrupt itself with its own AI engine, Gemini. At stake is Google's US$200 billion annual search revenue stream – which explains why the funding of new AI disruptors continues to rise and 'big tech' companies (including Google) invest to position themselves in the AI era (big tech capex is expected to be US$300 billion + in 2025). Here is a non-exhaustive summary of capital raisings to date:

OpenAI

- **Amount:** US$40 billion (closed March 2025)
- **Valuation:** US$300 billion post-money
- **Lead Investor:** SoftBank (US$30 billion), with Microsoft, Thrive Capital, Coatue, and others
- **Purpose:** Funding next-gen AI models and the massive Stargate infrastructure project
- **Additional Plans:** Targeting another US$17 billion by 2027.

Anthropic

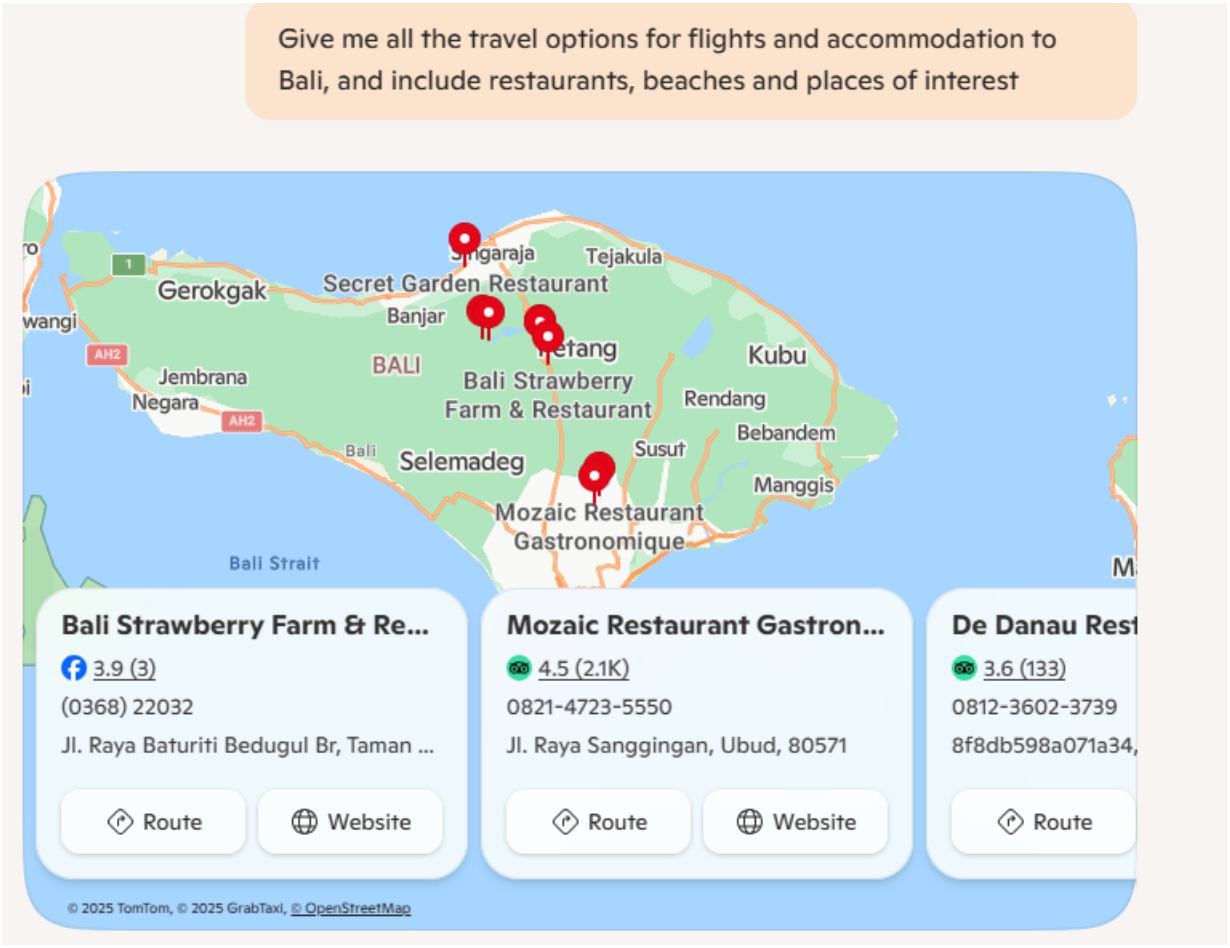
- **Amount:** US$7 billion in 2025 alone (mix of US$4.5 billion equity + US$2.5 billion debt)
- **Valuation:** US$62 billion post-money (as at March 2025 equity raising)
- **Lead Investor(s):** Amazon, Google, Lightspeed Venture Partners and others
- **Purpose:** Funding next-gen AI models, expand compute capacity, deepen research and accelerate international expansion.
- **Additional Plans:** Targeting another US$17 billion by 2027.

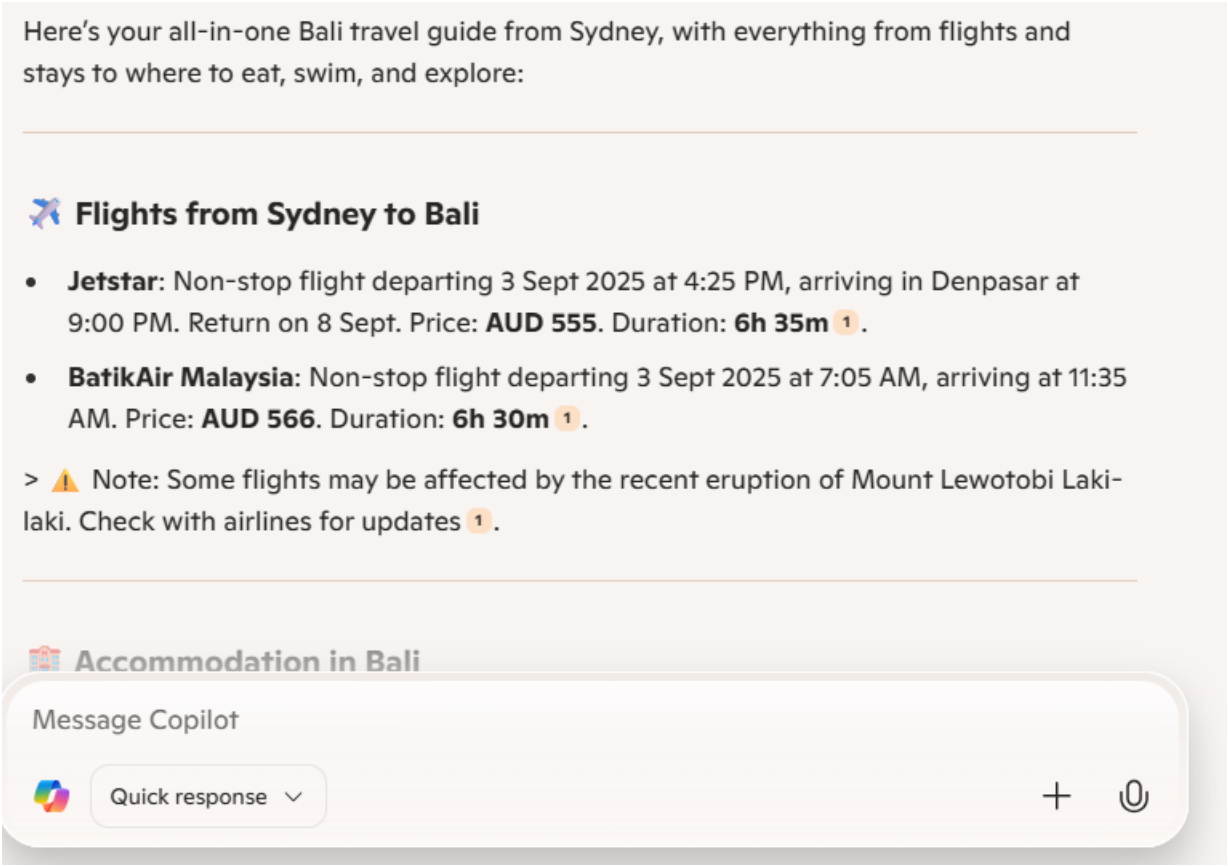
Grok / xAI (Elon Musk)

- **Capital Raising in Progress:** US$9.3 billion (mix of US$4.3 billion equity + US$5 billion debt)
- **Valuation:** US$80 billion (Q1 2025)
- **Investors:** Andreessen Horowitz, Sequoia, VY Capital
- **Use of Funds:** Infrastructure (e.g., 'Colossus' supercomputer), Grok model development, enterprise AI expansion

These capital raisings are coming for Google's search. Because for larger questions requiring finished documents (where the document may also be a programming routine) Microsoft's Copilot, ChatGPT – and Google's Gemini itself – do a much better job than Google search on its own. For example:

- Show the options for travel to Bali, including hotels and places of interest (shown below)
- Or "provide a timetable and the links to help me get conversational in Spanish in 1 year." Et cetera.





Source: Microsoft Copilot

Satya Nadella, the head of Microsoft, when announcing the company's entry into AI in November 2022, famously laid out the investment case, saying that just a 1% shift in search revenue from Google would be worth US$2bn to the company. His aim was to make Google come out from behind its search wall and be forced to compete on a battlefield where Microsoft was setting the terms. Nadella even taunted Google and its CEO Sundar Pichai by saying "I hope with our innovation they will definitely want to come out and show that they can dance. I want people to know that we made them dance".

Gemini: Google disrupting itself

Unfortunately for Microsoft, they did not make Google dance – but ChatGPT, the AI product from Microsoft-affiliated Open AI, certainly did.

Ever since the chatbot's launch in late 2022, it seems Google has been playing a game of catch-up. The threat was so great that reports suggested a 'Code Red' had been issued within the company. Would the company be able to pivot from being a *search* engine to an *answer* engine?

At least anecdotally, it seems more and more of those answers are being provided by ChatGPT (and not Google). Even if this is simply users performing non-commercial searches (often informational searches that can't be monetised), those users might end up shifting more of their commercial searches over time. That would be bad news for Google.

While yet to show up in the headline Google Search revenue (which is still growing at a healthy 10% Y/Y), under the surface there appear to be warning signs. In the company's latest quarterly SEC filing, the company disclosed the lowest paid click growth ever (2% Y/Y, lowest by ~2 percentage points). Meanwhile, Apple is reportedly looking at AI search as an alternative to Google in Safari and has had

discussions with Perplexity (another ChatGPT-like offering). To make matters worse an Apple senior executive in testimony suggested that in April 2025 Google searches in Safari declined for the first time ever.

But is it all doom and gloom for Google?

Over the past 12 months Google has aggressively rolled out various AI-powered solutions to its existing products, including Search. Readers will have noted that AI overviews are now appearing in more and more searches – reaching approximately 1.5bn users per month according to management. The company also plans to roll out "AI mode" to users in the US which incorporates even more features.

Google also disclosed that AI overviews monetise at the same rate and are driving higher usage as well as satisfaction. Queries were also 2x longer vs traditional search – it's because of these factors that monetisation might actually increase as a result of AI.

AI usage across Google's surfaces is still accelerating

Source: Google (Alphabet)

Just look at the travel example referenced previously – the searcher is disclosing significant, specific intent around flights, hotels and restaurants. The provision of this data may be extremely valuable to those who may benefit, owing to the higher likelihood of patronage relative to a traditional search.

And on the technology side, Google is unrivalled. The company has its own AI research lab (Google DeepMind), which helps produce its own Large Language Models (Gemini) on specialised hardware (Tensor Processing Units) that it has designed over the course of a decade for its cloud. It also has numerous applications that provide it immediate and significant distribution for these capabilities (billions of people interact with Google's suite of services every day).

But even with all these advantages, the company has to tread carefully so as to not upend the largest and most profitable part of its business (Google Search). This is the innovator's dilemma and why technological change and disruption are such potent forces. Microsoft successfully navigated its own disruption – the shift from a Windows-centric business to a Cloud-centric business – but wasn't unscathed during the process (it famously missed the shift to mobile) with a long period of underperformance from a share price perspective.

So for now, Google no longer appears in the portfolios we manage. We believe there are better exposures on a risk-adjusted basis to the big changes impacting advertising. And while we won't know for many years the final shape of the AI search market from an investment perspective, we do know (and are observing) that there is exploding growth in revenue for those supplying the tools for this AI. **Nvidia's** revenue has catapulted from US$35 billion in 2022 to an expected US$200 billion this year. And that is the reason we continue to hold it, and others in the area (including **Broadcom** and **Arista**).

Which other companies and industries are disrupting themselves?

Slightly further along is the disruption impacting the automotive industry. It was initially held that the electric car, which is a significant disruption to the car and transport industry, would be incorporated into the range of existing car companies like Volkswagen and Ford. But the speed, quality and number of the models coming from China are decimating the car industry, even the German car brands like Mercedes, as well as Toyota and US marques. It is even disrupting Tesla, which has not been able to respond adequately given the emerging scale of the Chinese car industry.

A handful of these automotive companies were disruptive in their own right – but that was over a century ago.

Disruption is dynamic – the winners of today are not necessarily the winners of tomorrow. Business models are constantly changing and new opportunities emerging, often fuelled by new technologies, and this change seems to be accelerating. An active investment strategy that recognises and takes advantage of these realities is essential.

Harry Morrow is a Senior Investment Analyst, and Alex Pollak is Chief Investment Officer and Co-Founder of Loftus Peak. This article is for general information only and does not consider the circumstances of any individual. Loftus Peak Global Disruption Fund (ASX:LPGD) is available to investors on the ASX as an active Exchange Traded Managed Fund.

Study supports what many suspected about passive investing

Larry Swedroe

The growth of passive investing has stimulated academic and policy interest in how it affects asset prices and the real economy.

Hao Jiang, Dimitri Vayanos, and Lu Zheng, authors of the March 2025 paper "Passive Investing and the Rise of Mega-Firms," set out to understand how the increasing shift from active to passive investing influences asset prices, particularly the prices of the largest firms in the market.

They developed a theoretical model showing how the rise of passive investing should affect prices in market equilibrium. They also tested some of the predictions of the model in the data, by analyzing the effects of capital flows into passive funds—such as index funds and exchange-traded funds—on the stock prices and volatility of large-cap companies. Their data sample took the S&P 500 and flows into index mutual funds and index ETFs tracking it. It covered the period from 1996 to 2020.

Before digging into their findings, we need to discuss two key points. First, research (see here and here) has found that active institutional investors (such as mutual funds), in aggregate, underweight large stocks. Second, the investors who then overweight these large stocks are active retail "noise traders"—investors who make decisions to buy or sell based on factors they believe to be helpful but in reality will give them no better returns than random choices. The idea of a noise trader comes from the belief that price action has "noise" that is unrelated to the signal of fundamental analysis about a security's value.

Their key findings:

- **Disproportionate Price Increases for Large Firms**: Their theoretical model shows that inflows into passive funds disproportionately raise the stock prices of the largest companies in the economy (reducing their financing costs), especially those that are already overvalued by the market in the sense of experiencing high demand by noise traders.
- **Wide Market Impact**: These price effects are significant enough to lift the overall market, even if the inflows are simply due to investors reallocating from active to passive strategies, rather than new money entering the market.
- **Increased Idiosyncratic Volatility**: The authors observed that passive flows create additional idiosyncratic (firm-specific) volatility for large firms. This increased volatility discourages active institutional investors from correcting mispricing caused by passive flows, allowing price distortions to persist.
- **Empirical Evidence From the S&P 500:** Consistent with their theoretical model, the largest firms in the S&P 500 experienced the highest returns and the greatest increases in volatility after passive fund inflows into the index. Moreover, consistent with households investing at the beginning of each month a fraction of their monthly paychecks in passive funds through their retirement plans, the largest stocks outperform the index in the first week of each month.

The authors explain the intuition for their results through a feedback loop mechanism. They use a stylized example of a large firm that is in such high demand by noise traders that active funds short-sell it in equilibrium:

> *"A switch by some investors from active to passive generates additional demand for the firm because passive funds hold the firm with its weight in the market index while active funds hold it with negative weight. Active investors can accommodate the additional demand by scaling up their short position. This renders them, however, more exposed to the firm's idiosyncratic risk, which is non-negligible because the firm is large. The firm's stock price must then rise to induce active funds to take on the additional risk. Crucially, because the stock price rises, the stock's idiosyncratic price movements become larger in absolute terms. This gives rise to an amplification loop: The short position of active funds becomes even riskier, causing the stock's price to rise even further, and the stock's idiosyncratic price movements to become even larger. The amplification loop explains why passive flows have their largest effects on large firms in high demand by noise traders."*

Their findings led the authors to conclude:

> *"Our theory implies that passive investing reduces primarily the financing costs of the largest firms in the economy and makes the size distribution of firms more skewed."*

Key takeaways for investors

- **Passive Flows Can Distort Prices:** Investors should be aware that the mechanics of passive investing can drive up the prices of the largest index constituents, sometimes beyond what fundamentals justify.
- **Volatility Risks**: The increased idiosyncratic volatility in mega-cap stocks may present both risks and opportunities for investors, particularly those employing active or contrarian strategies.
- **Market Concentration:** The rise of mega-firms, fueled by passive flows, can lead to greater market concentration, which may have implications for portfolio diversification and systemic risk.
- **Active vs. Passive Dynamics:** While passive investing offers low fees and broad market exposure, its growing dominance can create feedback loops that institutional investors may exploit.

Shaping the market

The paper highlights a crucial dynamic in today's markets: The surge in passive investing doesn't just mirror the market—it shapes it, often amplifying the rise of the largest firms and creating new risks and opportunities. For investors, understanding these effects is essential. While passive strategies remain a powerful tool for long-term wealth building, awareness of their broader market impact can help investors make more informed decisions about diversification and risk management.

Postscript

Jiang, Vayanos, and Zheng showed that flows to passive funds have led to a rise in the valuations of the largest stocks more than is justified by fundamentals and lowered their financing costs, raising the question: Could that lead to misallocation of capital?

Larry Swedroe is a freelance writer and author. The views expressed here are the author's. For informational and educational purposes only and should not be construed as specific investment, accounting, legal, or tax advice. The author does not own shares in any of the securities mentioned in this article.

Should we dump stamp duties for land taxes?

Cameron Murray

Should we tax the land value component of property, or the entire property value, including the value of buildings on the site?

On this question, Georgists, who find deep insight in the analysis of 19th-century political economist and philosopher Henry George, come down firmly on the side of taxing land values.

When you tax something, you get less of it.

Since land isn't going anywhere, taxing the *value* of land leads only to lower land *values*. But buildings can go somewhere if you tax the value of the property (land and buildings together); buildings can be

built in other jurisdictions, their construction can be delayed, or they can be built at a different density or size.

Because land value taxes don't change incentives, they are supported across the political spectrum. Right-wing economists like Milton Friedman and left-wing economists such as Joseph Stiglitz all support this tax base for fairness and efficiency reasons.

Wouldn't it be better to raise more revenue from land and less from people's work incomes?

I have also long advocated for boosting taxes on land and limiting carve-outs for owner-occupiers. I looked at the progress of the Australian Capital Territory's (ACT) decade-long transition towards more taxes on land and found the outcomes to be favourable.

But I have also been cautious about substituting one tax on property for another. Stamp duties are a tax levied on property value triggered when a property is sold. But their economic incidence is fully on land (as will be explained later).

Why swap two taxes on property for each other?

Another popular property-for-property tax swap is replacing a property tax (on the value of land and buildings) with a land value tax (on the value of land only).

Is this a good idea? And most importantly, do home and land values go up or down under this tax switch scenario?

Given the popularity of switching from property to land tax, there is a lot of confusion about the likely outcome. Too often, we hear that "land value tax will solve this" without any justification. There is a surprising gap in our collective knowledge, as this X thread from Mike Fellman illustrates.

Let's dig in and see what we can learn.

Taxes on assets reduce their value

Before we differentiate between taxing property or land, let's dispel the misleading notion that either tax increases the cost of buying housing.

Think about other assets in the economy, like company shares (stocks).

Let's be more specific and consider the example of two classes of shares in the same company. Class A shares have no ongoing holding costs. However, Class B shareholders must pay 10% of their market value to the company each year, like a tax.

Will Class A and Class B shares have the same market price, with Class B having an extra cost added on top due to the tax?

No.

The prices of these two shares will differ to account for the difference in expected tax payments.

Class B shares will be discounted relative to Class A shares by exactly the value of the future tax obligations (i.e. the present value of the expected flow of taxes).

This ensures there is no arbitrage in the market—at the prevailing price, the after-tax rate of return for a dollar invested in Class A or Class B shares must be the same.

Assume that both classes of shares earn a $1 dividend per year. Class A shares might trade at $10. With the 10% 'share tax' (like property tax) Class B shares would trade at $5.

The $1 per year dividend is a 10% after-tax net return on the value of Class A shares and is also a 10% net return on Class B shares after the 50c 'share tax' is paid (10% of the $5 share value). For each dollar spent on either class of share, you get the same rate of return for the same risk.

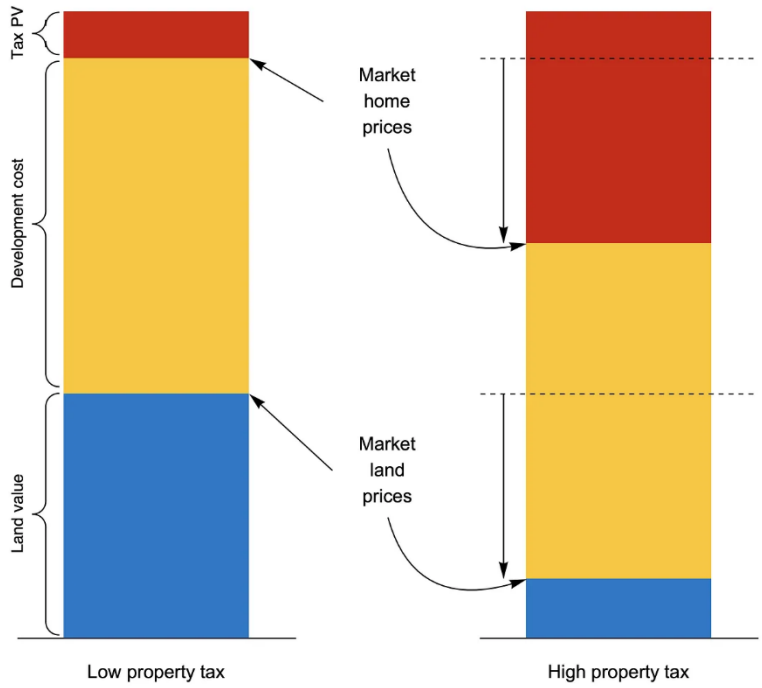
How property and land taxes reduce asset prices

Just like our two classes of shares, two identical adjacent homes with two different rates of property or land tax will have two different prices—buyers of the home with the higher tax will factor the cost of the tax into the upfront price paid.

The diagram below illustrates this.

The total height of the two columns is the total present value of the benefits of occupying the home. Buyers will be willing to pay a total cost equal to their total benefits because if there were a gap, another buyer could bid up the price to close it and still be better off from buying the home.

Illustration of the "capital stack" of home and land
Same benefit means the same cost, but more tax reduces asset prices



Source: FET illustration
freshEconomicThinking.com

The left column shows a property with a low property or land value tax. The buyers of this property subtract the present value of that tax (the red portion) to determine the net benefit to ownership and pay the seller this value.

The right column shows a property with a high property or land value tax. Here, the buyers also subtract the present value of this higher tax and pay the seller a lower market price for the home (house and land).

Notice that since the construction/development cost of these two identical homes is the same (yellow portion of the bar), the effect of the higher property or land tax is to reduce the land value only.

Both taxes reduce the asset price of land. So when vacant land trades in this market, a tax on land or property will reduce its value by the same *amount* as the completed home value, which is a much higher *proportion* of its counterfactual land value under a no-tax scenario.

An example

Let's put some numbers to the chart above using my home in Brisbane to represent the low-tax left column and see what would happen if a Texas-style 2% property tax were applied.

My home is worth about $1.5 million, with an assessed land value of about $800,000.

I pay $2,900 per year in council rates, which are a tax on land value. That's a 0.34% tax rate on the land value (i.e. $850,000 x 0.34% ~ $2,900), and an equivalent property tax to raise the same tax amount would be 0.19% (i.e. $1,500,000 x 0.19% ~ $2,900)

Applying a Texas-style 2% property tax will reduce the market price of the property down to $937,000 because of the massive $18,750 annual tax cost. This will push down the land value from about $850,000 to about $287,000, a whopping 66% decline.

The downloadable spreadsheet here allows you to tinker with the effect of land value tax and property taxes on market prices and land values.

The extra tax amount in the Texas scenario, although levied on the value of buildings and land, has the effect of reducing land value without changing the cost of construction.

To raise the same $18,750 annual tax amount from just the land value of my property would require a 6.5% land value tax rate (nearly a 20x higher tax rate than the 0.34% that currently applies).

No wonder often Texas *appears* cheap in terms of market prices for housing assets—these properties come with huge ongoing tax liabilities. Their relatively high property taxes are equivalent to enormous land value taxes.

Shifting from property to land value tax

Either a property tax or land value tax can be levied on already-constructed properties and the effect is to reduce property and land values.

One big difference between these taxes is what landowners pay prior to development.

Before building a home, a property tax will apply at the same *rate* to the land value only. After the home is built, the property tax will be paid at that rate on the value of the land *and* the new building.

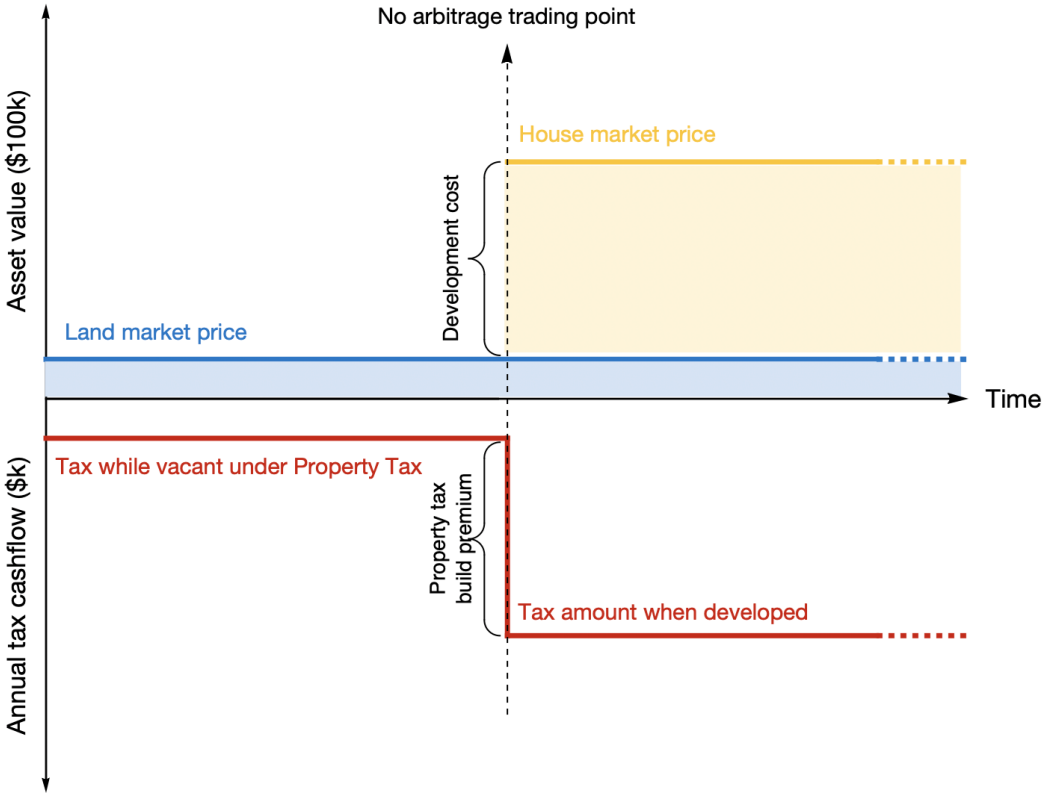
The diagram below shows how the tax amount changes over time before and after housing development.

The *no arbitrage trading point* in the diagram reflects the idea that a vacant piece of land *must* have a market value that ensures that when combined with the development cost of a home, there are no surplus returns above the expected risk (which is explained in detail in this FET article).

To put some rough numbers on it, consider an area with a 2% property tax where a typical home is worth $500,000 and home construction is $400,000. This means that the land is worth $100,000. However, before building a home the property tax is $2,000 per year, while after development, it is $8,000 per year, meaning there is a $6,000 annual tax premium for developing housing.

Property taxes before and after development

Taxes rise when development occurs but suppress land prices before



Source: FET illustration

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Under a land value tax of say, 6.5%, the amount paid before development would be $6,500, which doesn't change when a home is built. This lack of change is why most economists argue that land value taxes are *neutral* in terms of changing decisions about when and what to build.

Do land values rise or fall when shifting from property to land value taxation?

With all this background in mind, we can now get to the heart of the question we initially asked: what happens if we shift from a property tax to a land value tax that raises the same revenue?

Does shifting the tax base to land make the land value go down as our intuition might suggest (i.e. tax land value, get less land value)?

No. It doesn't.

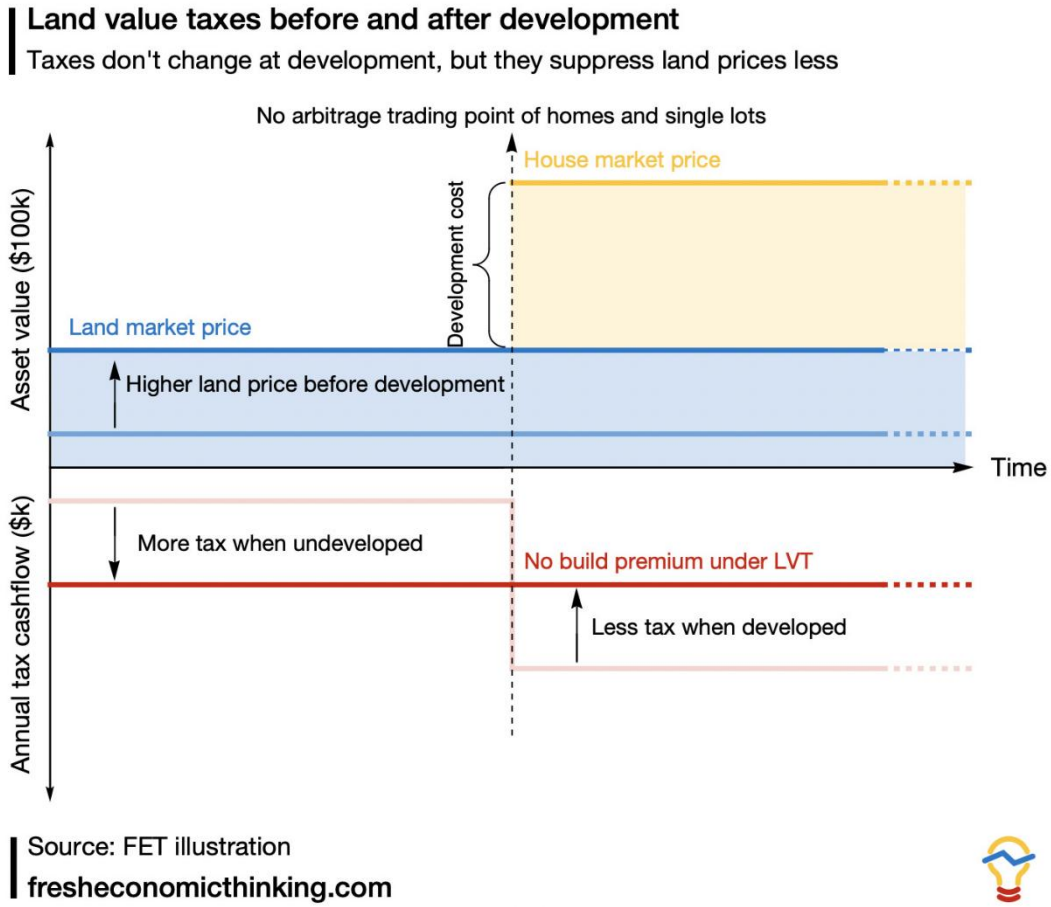
If the same total tax revenue is sustained, but the base is shifted from property value to land value, then land values will *rise*, not fall.

Raising the same amount of total tax revenue from a land tax as was raised from property tax will, on balance, involve *less* revenue from developed homes and *more* revenue from large vacant or underdeveloped sites.

Less tax revenue from developed homes will *increase* home values. An *increase* in home values, without any change to development/construction costs, means an *increase* in land values by the same *amount*, and hence by a greater *proportion* (as we saw earlier).

I have tried to visualise this effect in the diagram below. The lighter colours show the land value and taxes under property taxation. The stronger colours show the new scenario raising the same revenue from a land value tax base. The house price is higher due to lower taxes (yellow line) and the construction cost is the same (yellow area) hence the land value is higher under the land value tax.

However, the tax amount paid is the same for landowners before and after development, unlike under property tax.



Here's where things get a bit subtle about the distributional effects of this tax switch.

The value of undeveloped large subdividable lots is derived from the value of each single housing lot that the site can produce, so owners of large undeveloped parcels of land face both

1. rising market values for the lots able to be subdivided from their land, and
2. rising tax obligations.

The tax shift provides these owners with a benefit, in the form of higher land value, as well as cost, in the form of extra taxes before development. This opens up an interesting question.

Is it possible that owners of large undeveloped land parcels are equally well off, or even better off, financially when shifting from a property tax to a land value tax?

In other words, do the benefits of rising market values of land outweigh the costs of higher taxes?

Here's an example with some numbers attached to get a feel for the possible outcomes (I will dig deeper into this question in future articles).

Imagine a city or state has two properties—one is my house, and one is an adjacent vacant lot.

As we saw earlier, a Texas-style 2% property tax makes the market value of my home $937,000 and generates $18,750 of annual tax revenue. That same tax rate on the vacant lot next door with a $287,000 land value would raise $5,750.

That's a total tax revenue of $24,500 in our make-believe town with one house and one vacant lot.

When we shift to a land value tax, that means setting a tax rate that raises $12,250 (down from $18,750) from my house, and the same amount from the vacant lot next door (up from $5,750).

The land value tax rate that does this is 2.36%. At this tax rate under the scenario in the above downloadable spreadsheet, the adjustment to a lower tax rate involves increasing the market price of the home from $937,000 to $1,170,000 (about 25%) and in the process, increasing the market value of the land from $287,000 to $520,000 (about 80%). The 2.36% land value tax on the land which is now worth $520,000 gives the $12,250 of tax revenue.

In this example, the cost to the buyer is the same. They pay a higher price but get a lower tax, but the all-in annual cost to buy is the same.

What about my neighbour with a $287,000 vacant lot paying $5,750 in property tax? Now, they have a $520,000 vacant lot paying $12,250 per year in property tax.

They got about $230,000 of land value in exchange for $6,500 per year in tax. Given prevailing yields, this cost is exactly equal to the benefit in present value terms (in reality the relativity of costs and benefits to owners of undeveloped land depends on the proportion of developed and undeveloped land in the tax administration region).

		Before	After	Change	
Me	**Property value**	$937,500	$1,170,000	$232,500	Asset value
	Tax	$18,750	$12,250	$6,500	Annual tax saving
Vacant lot owner	**Property value**	$287,500	$520,000	$232,500	Asset value
	Tax	$5,750	$12,250	($6,500)	Annual tax cost

Shifting to taxing land values leads to higher land values, not lower values, as many might assume when they say, "land value tax will solve this".

A similar analysis by Jan Brueckner back in the 1980s, showed that taxing property less and land more will *increase* land values, noting that "the level of improvements per acre rises, as does the value of land". In other words, property taxes lead to lower density and lower land values, while land value taxes lead to higher density and higher land values.

The only way to switch from a property tax to a land value tax without raising the market price of homes and land is to levy a land tax at a rate that raises much the same revenue as the property tax for typical homes.

In our example case, the land value tax would need to be 6.5% per year, which would raise the same $18,750 from the existing home, but also $18,750 from the owner of the undeveloped housing lot next door. This would raise $13,000 *more* total tax revenue, all coming from the owners of un- or under-developed land who pay a lot more tax but get no benefits in the form of higher land values.

Of course, if more tax comes from land, this extra land tax revenue can be used to reduce other taxes in the economy, such as taxes on income. With higher after-tax household incomes, people will pay more to rent and buy homes, leading again to higher land values, which will be taxed. This feedback whereby taxing income less and land more allows the same revenue to be raised from the land tax is described by Georgists with the phrase *all taxes come out of rents* (ATCOR).

So what?

We often hear that taxing land values will solve just about everything. But like any rigorous economist, we must interrogate such claims, especially so when land value taxes are intended to replace other similar taxes on property.

Yes, land value is a fair thing to tax, and such taxes don't face many of the implementation and incentive problems involved in taxing things like personal income. But this is also mostly true of property taxes, which also come out of land values (since land values are *derived* from the returns from use when developed) and are levied at a lower rate on the broader base of the value of land and buildings combined.

Focussing on swapping two good taxes that are incident on land seems like a strange priority to me, especially when a likely result is higher market prices of homes and land with the same total purchase cost for homebuyers (higher price but lower tax).

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Being human means being a bad investor

Joe Wiggins

One of my favourite Daniel Kahneman quotes is: "Nothing in life is as important as you think it is while you are thinking about it". It beautifully encapsulates our tendency to significantly exaggerate the importance of whatever is on our minds at any given moment. This is an issue that is particularly troublesome for investors. There is just one problem – the quote gets it wrong.

I am asleep in my bedroom one night when I am awoken by the sound of an alarm going off. I then see smoke creeping underneath the door. I quickly realise that there is a fire in the house and need to work out what to do next. Sometimes, just sometimes, events might be as crucial as we think they are when we are thinking about them.

We have a tendency to overstate the significance of whatever has our attention because – on rare occasions – it will be profoundly consequential. From an evolutionary perspective this makes perfect sense. Worrying a lot about things that might be a threat to our survival is a highly effective adaption. We can't reproduce if we cannot survive.

Kahneman's quote might instead have been: "The vast majority of things in life are not as important as we think they are while we are thinking about them". Not as catchy, I grant you.

If nothing was ever as important, then we wouldn't act as if a lot of things were. This gets at a core issue of why investing is so difficult. Many of the behaviours that have made humans such a successful species, also make it difficult to be good, long-term investors.

Our overreaction to short-term, visible, in-the-moment risks, is just one of them. There are plenty of others – including herding, aversion to losses, and our susceptibility to stories.

Discussion around investor behaviour often seems focused on creating a long list of detrimental biases that humans suffer from as if we are just a poorly wired species, ill-equipped to make good decisions. This is not the case – it is simply that certain ingrained behaviours that are incredibly effective in some contexts, can be detrimental in others.

That investment issue that you are currently worrying about is very unlikely to be as vital as you believe it to be, but it is very human to act as if it is. The key to good investment decision making is to understand what makes us human, and then to adapt those elements which might also make us bad investors.

Joe Wiggins is Director of Research at UK wealth manager, St James's Place and publisher of investment insights through a behavioural science lens at www.behaviouralinvestment.com. His book The Intelligent Fund Investor explores the beliefs and behaviours that lead investors astray, and shows how we can make better decisions.

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