Submission to the Senate Enquiry into the effects of the so called "discount" of CGT on property sales.

Summary

I welcome this timely and valuable Senate enquiry into the effects of discounting capital gains tax (to correctly avoid unfairly taxing inflation) on property investment, because the issues raised need to be properly examined rather than be the focus of ill-informed commentary in the media and elsewhere.

Briefly, I am a Chartered Accountant who has owned one investment property and had a long career in the Financial Services sector until recent retirement, so am well qualified to speak to issues concerning economics and in particular housing investment and ownership. I wish to make the following submission and to examine the real causes of the present enormous house price bubble. I also hope to offer a couple of helpful suggestions on how to address those real causes and try to remedy this serious societal issue. I will also examine the unintended effects which altering the CGT regime would cause, which are in fact the opposite of what the author of this proposal might envisage. I am more than happy to appear before the Committee as a credible and skilled witness, with deep relevant experience in public advocacy.

Introduction

It has been incorrectly suggested that John Howard is responsible for the steep rise in property prices because he dropped capital gains tax to being applied to only 50% of capital gains. This is not in fact the cause of so called "housing inequality" at all. I also seek to correct the seriously erroneous assertion that the adoption of the 50% discount suddenly dropped capital gains tax by 50%. That did NOT happen, as I will prove below, and to say that capital gains tax is the main driver of the property price rise is simplistic and dramatically incorrect. Unfortunately, someone in the debate chose to call John Howard a "bastard" (I quote his vulgar and offensive remark) in the public domain, which is grossly offensive, and does not add anything valuable to the case.

History of CGT

What did in fact happen with capital gains tax is this. When the Hawke/Keating government introduced capital gains tax in the mid-1980s, it was recognised right from the start that it would be manifestly unfair to tax inflation, which is what happens if you use the historic cost of an asset held for a longer period of time (usually is the case with capital assets to which the tax would be applied). Thus, a formula was created whereby the original historical cost was inflated by the CPI across the time the asset was held until the time of sale. That inflated cost was then deducted from the sale price to determine the net real capital gain to be subject to tax. As you can readily imagine if you did not experience this (I did as a chartered accountant since 1975) the calculations even for a single purchase asset such as property, let alone multiple separate purchases like shares, became enormously complex for all parties, taxpayers, tax agents, and the ATO. All parties, including importantly the ATO who had to check and audit such calculations, wished there were a far simpler way of making (and checking) this calculation. Therefore, the government, led by John Howard at that time, commissioned a careful study to establish what this alternative might be. The study found that across the 15 years of operation of capital gains tax (*one could pause here to ask the question as to why there was not a massive housing price boom in the years before ANY capital gains tax was levied on such gains, if CGT relief was really the cause of such price booms!)*, the resultant average adjusted cost indexed by CPI compounded every year (as the formula required) turned out to be an average net taxable gain of around 50% of the nominal gain using only the historic cost. As a result, the government sensibly concluded that a far simpler formula would be to take the apparent capital gain derived by deducting the nominal cost from the sale proceeds and simply tax 50% of that. This was a huge relief to the ATO, as it made compliance checking very simple to do and achieved a <u>fair compromise result which everyone accepted as a fair solution</u>.

As can be seen, there was therefore NO REDUCTION in actual capital gains tax levied. Indeed, using the "Discount" method rather than the original Indexed method in fact INCREASES the amount of Capital Gains tax paid in many instances of longer held assets. Here is my proof. In 2002 I invested in an investment property. I sold that property earlier this year. Had I been able to apply the old Indexed Method, increasing the historic cost each year by the published CPI, I would in fact have incurred a <u>Capital LOSS,</u> rather than the capital gain I made under the present 50% discount method! That fact brings me to a rather interesting realisation regarding property prices and increases therein. I will return to that shortly.

The real causes of steep property price increases

Now let me address the simplistic, and incorrect, assertion that the capital gains tax applied to 50% (*even if that populist assertion that it was a reduction, rather than in fact a simplification of the existing CGT method of calculation, were true, which I have demonstrated it is not*), is solely responsible for such steep property prices over the years. It categorically was NOT. The situation was caused by two main factors: one difficult to avoid, and the other badly mishandled by the Reserve Bank of Australia. I even took the trouble to write to the RBA several times across the years to warn of the effect they would cause and have been proven right in this respect every time.

<u>The first factor</u> is the <u>massive imbalance between supply of property and demand.</u> Demand due to substantially increasing population in the main cities (*I will not address the increasingly politicised issue of immigration, but it is one of many contributing elements*) has massively outstripped supply. Inevitably, that has put sustained upward pressure on prices. Australia is not alone in experiencing

this, it is happening globally. Look no further than Hong Kong to show a relatively extreme example of land shortage and what then happens. The fact that main cities have practical limitations on available new land and space is a serious (and obvious) supply stress factor, and cost of building and availability (thus cost) of materials, exacerbated by restrictions during covid, has made this measurably worse. In the absence of a truly biblical government-led housing construction programme, something I doubt is even possible, this is a very hard challenge to overcome.

However, the second main contributing factor is not, and was not, hard to overcome and I hold the RBA responsible for very short term and ill-informed decisions here. Lowering interest rates to already historic and imbalanced low levels, hugely exacerbated during covid, provided a turbo charging effect. Buyers were able to source very cheap finance, which the banks were of course most willing to provide, and thus could bid far higher prices. And did. I warned the RBA several times of an impending house price bubble if they did this, and kept doing so, and that has indeed transpired. As a result, so-called "mortgage stress" is now a fact of life, as interest rates returned towards, but are still below, historic averages. What the RBA failed utterly to grasp (as does every media outlet talking about this issue), is you MUST have a balance in interest rates in order to attract lenders to place deposits with banks and fairly reward depositors. If deposit interest rates are too low, not only do you penalise mainly pensioners who rely on such deposit interest in their older age, but you deter people from making such deposits in the first place. This neutral interest rate (the "Cash Rate") is more technically correctly known as the "Zero risk base interest rate" and has been accepted by economists all throughout my professional career of 50 years as 5% PA. I highlight here that present Cash Rates in Australia are still well below this, so are what is called "stimulatory" in economic terms. Once deposit interest rates are too low, people seek alternative (higher risk) assets in which to invest. Over time, this presents a big problem as if banks cannot raise deposits, from where do they source the funds to on-lend to mortgage borrowers? Quite. The GFC of 2008 famously highlights one predictable outcome of riskier financing on both sides of the balance sheet. Interest rates should never have been dropped to such absurd levels. Borrowers became used to inappropriately cheap finance, were able to bid far too highly on housing, and are now stuck with that inappropriate debt level. An extreme example of such irresponsible lending (and borrowing) is so called "sub-prime" mortgages, which was the basic banking flaw which led to the GFC. Are we at risk of a repetition of the GFC? I believe so. Once raised, house prices rarely retreat substantially other than in a crash. I do not think we want that outcome, for so many reasons.

Other issues affecting property ownership and investment.

One suggestion raised is a draconian regime of freezing rents as a way of helping poor embattled renters. The property investor is not able to contain rising costs, so the resultant reduction in net rental income will have a hugely discouraging effect on potential investors, upon whom the rental market depends. Another disincentive (the subject of this particular enquiry) is imposing capital gains tax upon 100% of the nominal gain, thus taxing inflation. I will point out here that the returns on my investment from rental income after all the many costs involved in ownership such as rates, insurance, strata levies, maintenance and repairs (*and those were just usual repairs, not extra repairs caused by malicious tenants of whom there is an increasing number, with significant additional cost to a property owner*), and so on, were less than half of which I would have received from term deposits (for taking a measurably greater risk). All such policies will do is further deter investment in property. I have recently sold my one investment apartment, in no small measure because of the increasing political risk I see coming. I know of many other like-minded people departing the investment property space due to the shifting landscape towards ever increasingly "tenant-friendly" legislation, and the threat of further such. Where then will properties come from for renters to rent? I suppose the author of such policies has in mind some magical formula whereby government will step in and provide cheap rental accommodation. Even if there was the will to do so, I seriously doubt any government would be capable of constructing anywhere near the massive number of dwellings required.

Some positive suggestions to address the real causes

Rather than discourage property investment, we should actually be actively working on ways to promote further such investment in order to address the serious rental crisis. Simultaneously, there are in fact a number of genuinely affordable types of pre-fabricated and other houses which, whilst not luxurious, at least can provide homes for those without. This is a major societal issue requiring urgent attention to the real causes, not attacking genuine investors.

Another serious issue at present is the number of builders going broke and being unable to complete houses already started. I believe the importance of having a viable and healthy property construction industry is one key element of the supply issue. Towards this end I would propose a form of mandatory government-run industry insurance scheme (not unlike what exists to ensure depositors in major banks are protected, to a certain level) into which all building companies must contribute, so that in the event of a failure of a builder, the customers of building companies have assurance their projects will be taken over and properly completed. Thus, many more people would feel able to make the commitment to building, and would happily do so.

A further issue of real concern is the number of apartment blocks being completed which then we discover major construction quality issues. This aspect also requires significant tightening, so new owners are not faced with potential huge and ruinous costs. This concern is a major suppressant of investor enthusiasm as well as new owner occupiers.

The cost of building materials, which escalated sharply during the restrictions of availability during covid, also requires examination. I am not able to offer great solutions here, but do raise the issue as it is pertinent to the actual cost of construction of housing, and thus the prices thereof.

Are property prices in fact escalating as quickly as the media would have us believe? Undoubtedly yes in some areas. However, it was salutary to use my own case, of an apartment I bought in a desirable location in Sydney, back in 2002. Indexing that cost at CPI across the intervening 23 years (*which I did out of interest to see what CGT I would have paid under the original Hawke/Keating formula*) actually produces a higher figure than the price for which I sold it in September 2025. So, I would have made a loss, not a gain! That is interesting, the price did not keep pace with inflation, let alone exceed it. I believe a LOT more hard work is required analysing this issue with actual real cases, rather than trust the media hype! It is so important to have an informed debate on such an important issue.

In conclusion

I generally believe that the CGT based on 50% of the Nominal Gain over historic cost is a fair and appropriate taxing of a capital asset, and did NOT cause the present house price bubble, as demonstrated above. Altering that so as to make investment more risky and less rewarding would I believe would have quite the opposite effect of that intended, and further reduce supply of rental properties, to the detriment of the very people this original complaint sought to help.

In so saying, I recognise that “flipping” a property after a short time (just over 1 year, the minimum time required to qualify for CGT relief) and benefitting from the CGT discount, may well require some fine tuning to shift investment towards genuine longer term investment rather than short term speculation.

I wonder if the following might achieve a “sensible compromise”. If you sell in less than 5 years, say, the discount does not apply. CGT is applied to the full 100% nominal gain. That does tax inflation, but not so severely. Then, say, if you sell after 5 years but before, say, 10 years, the gain is discounted by 30%. This number would on present inflation levels largely take care of the unfairness of taxing inflation. Then apply the full 50% discount to all assets held over 10 years. I think this compromise could achieve the effect of encouraging longer term property investment rather than speculative, so giving renters some more stock and stability, whilst not discouraging investors completely. This retains the advantage for the ATO of simplicity of compliance and checking thereof, whilst still retaining fairness for the taxpayer risking investment in long term (socially important) assets.