Submission to the Select Committee on the operation of the CGT Discount

Key points and Executive Summary

- Lack of housing affordability in both the owner-occupied and rental markets is mainly due to the interaction of demographic and lifestyle trends on the demand side, and supply constraints and cost increases on the supply side.
- Reducing the CGT discount might cause a small one-off drop in house prices (a level shift), which should transmit through the market fairly quickly, as asset prices are typically expectations dependant. After that and absent other changes to demographic trends and supply constraints, house prices can be expected to continue to grow as they have in the past.
- The CGT discount as it applies to housing investment is not overly generous and is not responsible for the excessive, ongoing growth in house prices, nor is it contributing much to wealth inequality (accepting that rising house prices do contribute to wealth inequality between homeowners and non-homeowners).
- To the extent that a reduction in the generosity in the CGT discount causes house price levels to be lower than otherwise, it would also cause rents to rise. Modelling would be needed to estimate the extent of this effect.
- Contrary to what some may think, rising house prices relative to income do not make Australians better off overall. Like any other good, if houses cost less we would be able to afford better houses or have more money to spend on other things.

Housing price growth is largely driven by demographic factors and supply constraints

Lack of affordability in the housing market in Australia has mainly been driven by demographic factors such as high population growth and the trend to fewer people per household on the demand side, and supply constraints such as restrictions on land release and usage, rising construction costs and labour shortages on the supply side. For a detailed discussion of these issues see State of the Housing System, published by the National Housing Supply and Affordability Council.

Reducing the GCT discount could affect the level of house prices but not ongoing growth in prices

If the CGT discount was reduced, the effect on house prices is likely to be a once-off (a level change) rather than changing the ongoing growth rate.

By making rental housing less attractive for investors relative to other investments, the housing market can be expected to return to ‘equilibrium’ though a combination of a reduction in house prices as some investors leave and some tenants to become owner-occupiers, as but also a rise in rent for remaining tenants as remaining investors will now require a higher portion of investment returns to come from rent instead of capital gains. Econometric modelling would be needed to estimate the size of price and rent effects and the time it would take for the policy change to be fully transmitted through the market. However, tax changes would likely be transmitted through the market fairly quickly as asset prices are typically forward looking and depend on expectations of returns.

After the housing market returns to 'equilibrium' and absent other changes, the same factors that have led to general housing unaffordability will still apply and house prices can be expected to continue to grow at much the same pace as they have in the past.

It should be noted the CGT discount also applies to other investments for individuals, such as shares and it has not led to ongoing, excessive price growth in that asset class.

The rental market does not show signs of overinvestment due to the CGT discount. If it did, the market would be characterised by an excess of rental properties, high vacancy rates and low rental yields and, as investors accepted these in exchange for greater capital gains returns.

While home ownership rates have reduced over time, this is likely due to general lack of affordability, delays to earning income due to longer periods of education and well as people delaying forming families and having children.

No doubt, some 'mum and dad' investors choose to invest in rental properties as this is an asset class that they feel familiar with. As house prices have not fallen for a long time, they may also consider rising prices a sure bet. However, there are no signs that the discount distorts investment generally. Forced superannuation savings at 12 per cent of pre-tax income has meant that there is an abundance of capital available in Australia for other investments in the economy. Australian super funds are increasingly looking to invest overseas due to better investment opportunities available in other countries.

The CGT discount is not overly generous

The CGT discount as it applies to housing investment is not particularly generous, despite its headline rate which discounts 50 per cent of nominal gains. This is for two reasons. First it applies to nominal gains with no discount for inflation. Second, because CGT is realised in a lumpy form when properties are sold, Australia's progressive system of tax rates means the discounted capital gain is likely to be taxed at a higher marginal and average rate than would apply to the taxpayer's income earned in most years.

To provide an illustrative example, house prices have risen by around 69 per cent between 2015 and 2025. However, inflation over the same period has been 29 per cent. Using these figures, an investment property bought for $600,000 in 2015 might be worth just over $1,016,000 today, a nominal capital gain of $416,000[1]. Applying the 50 per cent CGT discount, means $208,000 would be declared for tax purposes if the property were sold. In contrast, discounting for inflation over the same period would mean $241,000, would need to be declared for tax purposes. As this capital gain puts the taxpayer well into the top marginal tax rate, the after-tax benefit of the CGT discount is around $15,500 compared to inflation

[1] These numbers likely significantly overstate the actual capital gain as they do not account for stamp duty, council rates and land tax that would feed into the CGT cost base.

indexing today, or $12,000 at 2015 prices on a $600,000 initial investment held over a 10-year investment horizon.

It should be noted most countries apply some discount to capital gains and the economic literature since the 1980s, including the 2010 Henry Review, has tended to favour the idea that investment income should face a lower tax rate than income earned from salary and wages. This is because greater investment supports higher growth rates which leads to higher salaries and wages over time. The Henry Review recommended that savings income generally be taxed with a 40 per cent discount but also in the context of a flatter income tax rate structure.

Rising house prices relative to income do not make Australians better off overall

Former Prime Minister, John Howard, once remarked that no one had ever complained to him because the value of their home had risen. Since then, it would seem many politicians have come to believe that if house prices fell or even just remained steady, they might suffer a political backlash.

However, rising house prices on their own do not make Australians better off. This is particularly so if house prices are being driven higher by supply constraints. The myth that rising house prices are generally beneficial for homeowners conflates cause and effect. House prices will typically rise during periods of economic prosperity, where job security and real wages increase. Conversely prices may fall during periods of rising unemployment or falling real wages. It is these underlying conditions, which are of benefit or detriment with changes in house prices being an effect. Like any other good, if houses were more affordable, we would be able to buy better houses or have more money to spend on other things. Unaffordable housing is increasing a major drag on the standard of living in Australia.

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