As the federal budget approaches, the government is grappling with ways to enhance housing affordability, including reforming the current 50% capital gains tax (CGT) deduction on property investment.

The Economics Society of Australia (ESA) Monash Forum polled economists on this proposition:

Capital gains tax deductions for housing investment should be removed because they overstimulate the housing market, contributing to rising house prices.

This is a deliberately more extreme measure than the proposal reportedly being considered by the federal government, which is to cut the current discount to 25%. But we wanted to assess more generally the effect of capital gains taxes on the housing market.

The poll found 44.4% of economists agreed with a statement that the tax deduction should be removed entirely (22.2% agreeing and 22.2% strongly agreeing). But 40.7% disagreed with the statement (22.2% disagreeing and 18.5% strongly disagreeing); while 14.8% of respondents were uncertain.

While some economists support the current role of the CGT discount to avoid taxing the capital gains that arise as a result of inflation increasing house prices, as opposed to the valuation in the land or property due to development (Saul Eslake, Rodney Maddock, Nigel Stapledon and Doug McTaggart), others believe the tax should also apply to the gains as a result of inflation (Kevin Davis and Margaret Nowak).

Many argued the principle of the CGT discount is not a bad policy, however the level of the discount is generous and is open for abuse.

They also pointed out that changes in one type of tax will distort the economy, especially if it is only targeted to one type of asset, in this case property. Instead some economists suggested the approach should be a holistic reform to fix tax inefficiencies, and tax treatment should be equal between all forms of investment and saving.

Most of the economists agreed housing affordability policies should be focused mainly on housing supply and housing market constraints (as well as transport and infrastructure) to solve the crisis. Other policies such as shared-ownership schemes and government-backed bonds are also being considered.

Capital gains tax

The capital gains tax (CGT) is calculated at the effective marginal tax rate of the investor, on the capital gains made at the time of sale of the asset. Investors who hold an asset for longer than 12 months receive a 50% discount on the CGT liability, at the time of sale. For superannuation funds, the discount rate is 33.3%.

Owner-occupiers are fully exempt from capital gains tax on the sale of their primary residence.

Some of the options reportedly being considered by the federal government include decreasing the CGT concession to 25%, decreasing it to 40% discount (as recommended in the Henry Tax Review) only for property investments, or some other reduction in the CGT discount for property investments.

Another option is completely removing the concession if the property is sold in the initial investment years; and phasing the discount in after the investment has been held for some specified number of years.

The economists’ arguments for and against

Economists who supported removing capital gains tax deductions for housing investment said the discount provides incentives to over-invest in property rather than other assets that provide income. So by eliminating or reducing the CGT discount, the cost of capital will increase and buyers will reduce their demand for property, resulting in lower, more affordable house prices.

Those who agreed with the statement argue any change in the CGT discount to address property speculation should also be accompanied by reforming negative gearing. They argue that eliminating the CGT discount for property only would push residential investors towards cheaper properties or towards investing in other assets that maintain the CGT discount.

Most studies find no evidence of capital gains advantages being a main incentive for investors holding residential property. However it appears to be a small factor in the intention of investing in residential property.

Those against the statement argue the timing may not be right as the housing cycle is currently at its peak, and the double digit house price appreciation rates are only seen in the inner-ring suburbs of metropolitan cities and only for houses and not apartments.

Economists would expect to see only a short-term drop in house prices if the CGT deductions are eliminated, as investors switch away from property and into other assets. So the remaining residential investors in the market would purchase cheaper properties, potentially still crowding out first-home buyers.

They would also hold the property for a longer period. In the medium to long-term, the reduction in residential investment would impact on the new and existing supply of housing, resulting in housing shortage and rising house prices.

You can read the economists' individual answers by clicking below.

The ESA Monash Forum is a joint initiative between Monash Business School and the Economic Society of Australia. Maria Yanotti was a guest writer for the Forum.

Maria Yanotti does not work for, consult, own shares in or receive funding from any company or organization that would benefit from this article, and has disclosed no relevant affiliations beyond the academic appointment above.

Read more http://theconversation.com/capital-gains-tax-concession-is-too-generous-economists-poll-75060