

MELBOURNE INSTITUTE
Applied Economic & Social Research

Policy Briefs Series

Reform Options for State Property Taxes

John Freebairn

Policy Brief No. 2/17
October 2017



THE UNIVERSITY OF
MELBOURNE



MELBOURNE
INSTITUTE

Reform Options for State Property Taxes*

John Freebairn

Department of Economics, The University of Melbourne

Melbourne Institute Policy Brief No. 2/17

October 2017

* Revised version of a presentation at the “Federal Relations and Tax Reform Workshop”, Adelaide, 28 and 29 August 2017. With the usual caveats, I am grateful for discussion with Brendan Coates, and comments of the Workshop participants and Roger Wilkins. For correspondence, email <j.freebairn@unimelb.edu.au>.

Melbourne Institute: Applied Economic & Social Research

The University of Melbourne

Victoria 3010 Australia

***Telephone* +61 3 8344 2100**

***Fax* +61 3 8344 2111**

***Email* melb-inst@unimelb.edu.au**

***WWW Address* melbourneinstitute.unimelb.edu.au**

Melbourne Institute Policy Briefs Series

The Policy Briefs Series is a collection of research publications that examines current policy issues and provides an independent platform to examine pertinent issues in public debate.

Log onto melbourneinstitute.com or follow @MelbInstUOM for more details on this and other series from Australia’s leading and longest standing research institute in the field of economics and social policy.

Abstract

Alternative design details for a revenue neutral tax reform package to replace conveyance duty, narrow base land tax and stamp duty on insurance with a broad base property tax are described. Optional design details include: the taxes to be replaced; for the replacement tax, land or property for the base and then disaggregate for different broad uses of property and by state, and a flat or progressive tax rate schedule; and, different transition strategies. Replacing the three taxes with a comprehensive property base tax would require an average annual tax rate of about 0.4 per cent, or a trebling of the current local government tax rate. The comparative implications for economic efficiency and distribution of the tax burden of the design alternatives are evaluated. A comprehensive land base and flat rate wins on efficiency gains, but it would have very different tax distribution effects compared with that of the current taxes to be replaced. By contrast, a property base and a progressive rate schedule reduces the magnitudes of the redistribution effects at a cost of a partial loss of the potential efficiency gains. Further disaggregation of the replacement tax with different rate schedules by category of property use reduces redistribution effects and efficiency gains, but still with a net efficiency benefit. A gradual transition to the reform package modifies some equity concerns, but delays realisation of the efficiency gains.

JEL classification: H21, H22, H71

Keywords: Taxation reform, land tax, property tax, conveyance duty

1. Introduction

Numerous official reports on taxation in Australia, including Henry Review (Henry, et al., 2010) and state reports, including Victoria (Harvey et al., 2001), SA (Government of South Australia, 2015), WA (Western Australia Department of Treasury and Finance, 2007) and ACT (ACT Treasury, 2012), academic papers and others, have recommended an approximate aggregate revenue neutral reform package to replace one or more of conveyance duty, the current narrow-based land tax, and perhaps stamp duty on insurance of property, with a broad based property tax. The reform package would result in significant reductions in distortions to decisions on the investment in, and the use of, property, a more stable and predictable revenue stream, and some gains in simplicity. On the other hand, the reform package will have redistribution effects which challenge political acceptance of reform. Explanation of the redistribution effects together with careful attention to the design details can cushion, but not eliminate, redistribution. This paper presents some options for the details of the reform package, and then assesses their comparative efficiency and redistribution effects. The many dimensions or details of an alternative approximate aggregate revenue neutral reform package to be considered include; the taxes to be replaced; the base and the tax rate schedule for the replacement tax; and transition path options.

The rest of the paper is organised as follows. Section 2 provides background details of the current taxes levied by the states (and territories) on property, including the tax bases or taxable sums and tax rates, revenue, and an overview of their distortions to decisions and efficiency costs, and of their economic incidence and redistribution effects. The efficiency, revenue stability and simplicity arguments for replacing the current property taxes with a broad base flat rate tax are discussed in Section 3. The next three sections describe some of the more detailed options, or the “devil in the details”, for the replacement of current property taxes, and then assesses their relative efficiency and redistribution properties. Section 4 covers options for the tax base, including land or land and improvements, and possible differentiation of property uses across owner occupied, other residential, commercial and primary production, and by state. The relative merits of a flat versus a progressive rate schedule is the topic of Section 5. Section 6 considers proposals for the transition path, including a cold turkey switch, grandfather recent purchases, the ACT phased rate changes, and provisions for the income-poor and asset-rich. Section 7 draws together a comparison of the efficiency and redistribution effects of the reform options relative to the current taxes.

2. Current State and Local Property Taxes

Table 1 details the tax base, tax rate schedule and 2015-16 revenue for conveyance duty, land tax and stamp duty on insurance premiums collected by the states (and territory) governments, and local government rates. Arguably municipal rates are a crude form of a user pays charge for services provided. The conveyance duty, land tax and insurance stamp duty are general revenue raisers. In aggregate, these revenue raising taxes on property collected \$32.3 billion in 2015-16, or 40 per cent of state own-source taxation revenue.

Table 1 Tax Bases, Rates and Revenue of Current Property Taxes

| | <i>Tax Base</i> | <i>Tax Rate Schedule</i> | <i>2015-16 Revenue \$million</i> |
|------------------------|---|---|----------------------------------|
| Conveyance duty | Unit property sale value | Progressive rate (up to 7%) | 20,607 |
| Land tax | Exempts owner occupied and primary production. Entity holding | Progressive rate (up to 3.75%) | 7,237 |
| Insurance stamp duty | Gross premium | Flat rate (9 to 11%) | 4,429 |
| Local government rates | Unimproved value for NSW, Qld, NT and ACT, improved value for WA, and mixed for Vic, SA and Tas | All a flat rate, and some plus a fixed charge | 16,037 |

Source: NSW Treasury (2016) and ABS (2017)

The three potential taxes to be replaced have quite different tax bases: property sale value for conveyance; land value for land tax; and, value of buildings insured for stamp duty on insurance. There are important differences in the tax rate schedules across the states, including: no land tax in the NT; different progressive rate schedules in terms of threshold values, and then marginal tax rates, for property transfers and on land; and different flat rates for stamp duty on insurance.

Important to understanding the effects of property taxes on market outcomes and on redistribution is the link between the (annual) flow of rent income and the stock or property asset value. In a well-behaved market, the property asset value at time t , A_t , equals the expected present value of the future stream of rent income (equal to rent received less

expenses other than interest) net of tax, $R_t (1 - Tr)$ where R_t is the pre-tax rent income earned on the asset and Tr is the tax rate on rent income, namely

$$A_t = \sum (1 + d)^{-t} R_t (1 - Tr) = R (1 - Tr) / d \quad (1)$$

where d is the discount rate. For simplicity, if rent is constant over time and $R = R_t$, the far right hand term of (1) is reached. The market equilibrium in (1) reflects an average outcome across many individual property transactions over time, and the tax rate Tr refers to an average across transactions and over time, for example so that the infrequent payment of conveyance duty by a small set of property transfers each year corresponds to an approximate aggregate revenue neutral annual land tax on a broad base.¹

From (1), an increase (decrease) in a rent or property tax becomes a decrease (increase) in the asset price. That is, investor arbitrage activities across a portfolio of assets, of which property is one option, results in a change in the effective property tax becoming a windfall asset price change to restore the after-tax return available on alternative wealth asset investment options.

An interesting observation drawing on (1) is a comparison of effects of a pure revenue collection tax, including conveyance duty and land tax, and taxes seen as a crude form of user pays, possibly municipal rates. The revenue taxes affect the Tr term but not the rent return term R . By comparison, a user pays tax by increasing the services provided to the asset owner also raises the willingness to pay or demand for property, and then increases the rent return R to balance the higher tax effect on the asset price.

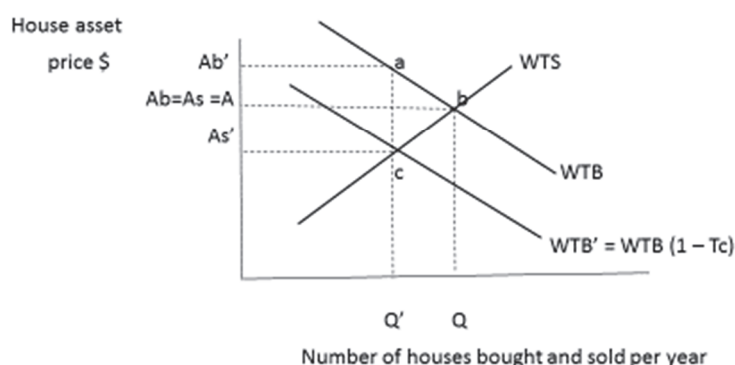
2.1 Conveyance duty

Key effects of conveyance duty on market outcomes, efficiency and tax distribution are shown in Figure 1 for the market to buy and sell houses, or to transfer ownership. The willingness to buy, WTB , is the demand for a new or second hand property, and the willingness to sell, WTS , is the supply of new and second hand properties. The functions include the usual market determined transaction costs. With many in the market being both a potential buyer and a potential seller, it is likely that the elasticities of both functions will be similar. In the absence of conveyance duty, the market determines a quantity of houses bought and sold at Q and a household market or

¹ Tax on the asset value, A of (1), can be linked to tax assessed on the annual rent income flow, R , following Henry et al. (2010, page 270), using $Tr = Tl / (Tl + d)$, where Tl is the tax rate on the asset, Tr is the tax rate on rent, and d is the annual discount rate.

asset price of A for both buyer and seller. Assuming no market failures, this market outcome also is an efficient one.

Figure 1 Effects of conveyance duty



Conveyance duty as a tax on property transfers at rate T_c initially paid by the buyer shifts down the WTB function of Figure 1 by the tax wedge. The tax wedge is given by $ac = T_c A = Ab' - As'$, Ab' is the new higher cost of property to the buyer, and As' is the new lower market housing price and return to the seller. The number of market sales or property transfers falls from Q to Q' . Available data indicates that Q' represents an average turnover of property of around 5.5 per cent per year (Leal, et al., 2017).

Note that the economic incidence of the conveyance duty is borne in part by the buyer and the seller. If, as argued above, the elasticities of the WTB and WTS functions are about the same, the economic incidence is roughly a half to each of the buyer and the seller; a contrast with the Davidoff and Leigh (2013) econometric estimate that all conveyance duty is borne by the buyer which requires the implausible assumptions of either an infinitely elastic WTS curve or a perfectly inelastic WTB curve in Figure 1.

Arguably, conveyance duty fails the horizontal equity criterion. Taking an average across the market and over time, for households of similar income and wealth, those who buy and sell relatively more frequently than the average pay a larger share of conveyance duty, while those who retain ownership for relatively longer periods pay a smaller share of conveyance duty.

The efficiency cost of the conveyance duty in reducing society Pareto improving transfers of property as people change employment location, family demographics evolve for smaller or larger homes, income changes and so forth is given by the triangle abc in Figure 1.² Estimates of the marginal excess burden by Henry et al. (2010), Cao et al. (2015) and Murphy (2016) place conveyance duty among the most distorting of Australian taxes and in excess of 80 cents per dollar of conveyance duty revenue.³

Figure 1 provides the story for a flat rate conveyance duty, or for a category of housing disaggregated by value class facing a common marginal conveyance duty tax rate. In reality the current stamp duty rate schedule is a progressive one. This means the effects on market outcomes, redistribution and efficiency of conveyance duty are greater for higher and higher value classes of property; although the vertical redistribution effects are reduced with lower average turnover rates for higher valued properties. Data on the vertical redistribution effects of the progressive conveyance duty compiled by NATSEM (and referenced in South Australia Government, 2014) by household income and wealth quintiles show a mildly progressive incidence. Clouding the progressive incidence picture includes: those with a larger wealth tend to have a smaller share of property in their portfolio; and, across generations and age many retirees are asset rich but income poor, and some of the young high income earners are yet to accumulate wealth, and in particular property.

2.2 Land tax

Compared with the efficiency of a comprehensive base and flat rate land tax, the current land tax with both a narrow base and a progressive rate schedule for each taxable entity's land asset creates market distortions and efficiency costs. The narrow land tax base exempts land allocated to owner occupied dwellings and primary production, while falling on land allocated to rental dwellings and commercial property.⁴ About a half of the potential land tax base is exempt (Daley and Coates, 2015). Further, the narrow base works to undermine vertical equity redistributive effects of the progressive rate schedule.

An illustration of the effects on market outcomes, efficiency and redistribution of the current narrow base land tax is given in Figure 2. For simplicity, a fixed supply of land for residential

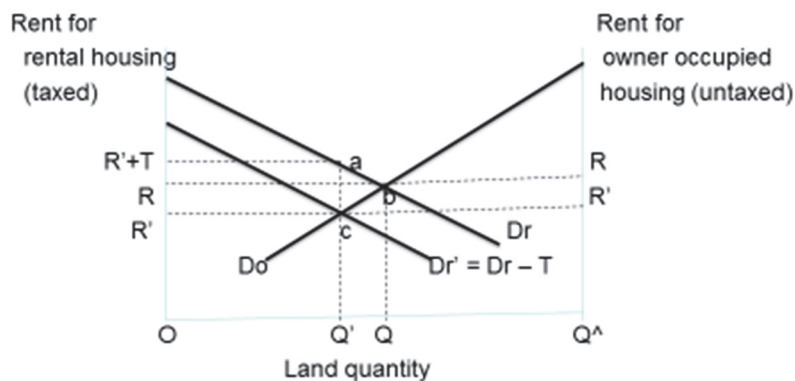
² In addition to the private costs represented by the triangle abc, there also may be additional external costs of extra pollution and traffic congestion associated with additional commuting travel.

³ The efficiency cost of conveyance duty estimated in these studies include the distortion to property transfers described in Figure 1 plus second round effects of the property ownership distortion causing a reduction in the perceived productivity of investment in property and then a reduction in the investment quantity.

⁴ Also exempt are commonwealth and state owned land, public hospitals, religious and charitable institutions.

purposes, Q^A , can be allocated to owner occupied housing or to rental housing. Demand for land for housing as a function of (actual or imputed) rental price is given by D_o for owner occupied housing and D_r for rental housing. In the absence of a land tax, market equilibrium is given at price R for both owners and renters, and with the land split between the alternative uses at Q . In the absence of market failures, the market outcome is efficient.⁵

Figure 2 Land tax exemptions



The narrow base land tax falls on rental property and exempts owner occupied property. The land tax shifts down the demand for rental property from D_r to D_r' . The shift results in a lower market rent rate of R' for both categories of land use, and via (1) a lower property asset price, and a reallocation of $Q'Q$ land from the taxed rental to the tax exempt owner occupied. Q' for owner occupied represents about 75 per cent of current residential land. The reallocation distortion involves an efficiency cost represented by the triangle abc . The more elastic one or both of the demand curves the greater the efficiency cost, and the efficiency cost rises with the square of the tax rate.

⁵ On the other hand, in a broader picture of commonwealth income tax and social security outlays, the playing field is far from level and favours land allocation to owner occupied property, so that the land tax on rental property exaggerates the distortion. Under the income tax system, the return on savings invested in owner occupied property is not subject to income tax on imputed rent or on capital gains, but there is no deduction for expenses of mortgage interest, repairs and maintenance, municipal rates, etc. By contrast, for income earned on savings invested in rental property, net cash flow income represented by rent receipts less expenses of interest, repairs and maintenance, etc are taxable, or if negative deductible against other sources of income, and a half of realised capital gains are subject to income tax. Owner occupied homes are not included in the means test for the Age Pension.

Redistributive effects of the current narrow based land tax are mixed. As illustrated in Figure 2, while landlords pay the land tax, once the market adjusts, some of the tax is passed forward to renters, with the market price rising to $R' + T > R$. Some of the tax also is passed on to owner occupiers as a lower rent return than otherwise and subsequently a lower house price via (1), but as a consumer of housing services they gain with a lower implicit rent price. With the progressive land tax rate schedule, these redistributive effects are magnified for higher and higher land value housing sites, including closer to the large city central business districts.

A further distortion of the current land tax stems from its use of a tax base per taxable unit, whether individual or business, in combination with the progressive rate schedule. Larger asset holding classes face a higher marginal tax rate and are discriminated against relative to small by value land asset holders. If economies of scale are important for some property investments, the progressive rate schedule places relatively higher tax burdens on the larger scale production methods, and then on relatively large scale intensive products, with associated distortions to decisions and loss of efficiency.⁶ To the extent that large asset holders are more likely to invest in larger scale housing suitable across a range of different categories of tenants, including those seeking low cost rental housing, this form of a progressive land tax rate schedule also is regressive in its redistribution effects.

2.3 Stamp duty on insurance

The flat rate stamp duty on insurance of from 8 to 11 per cent depending on the state is levied on the gross premium. Regarding the cost of insurance as the difference between the gross premium and the average pay-out, or the cost of providing the intermediation financial services and normal profit, the effective tax rate per net cost of insurance is about three times the statutory rate. Stamp duty on insurance is a product specific tax, with no rationale of internalising an external cost associated with insurance.

Distortions to decisions and efficiency costs of the stamp duty on insurance involve a direct effect and a set of indirect effects. The tax added cost to insurance reduces the insurance taken and it imposes additional costs of risk to those who either do not purchase insurance or choose to under-insure. There is anecdotal evidence⁷ that those on lower incomes, and those in more risk prone areas and hence face higher effective tax rates, are over represented among the non- or under-insured. Further, by raising the effective cost of investing in housing and in other

⁶ A related example of the efficiency costs is given in Dixon et al. (2004) for the effects of the small firm exemption from payroll tax.

⁷ Evidence of those uninsured from recent major bush fire and flood events.

buildings, the selective product tax has second round distortion effects on aggregate investment in, and consumption of, housing and other buildings relative to alternative expenditure options.

Higher insurance premiums increase the production costs of buildings for use in the business sector, and then distort business input mix decisions and raise the relative prices of building intensive goods and services.

Overall, the redistributive effects of the flat rate stamp duty on insurance are likely to be regressive. Those on low incomes are more likely to not- or to under-insure, and buildings and building intensive products have an income elasticity less than unity.

Movement of the fire services charge or emergency services levy from insurance premiums to a specific additional levy in municipal rates enacted by several states in recent years provides a workable reform template.

To summarise Section 2, there are compelling efficiency gains to replace each of the current conveyance duty, narrow base land tax and stamp duty on insurance. The municipal rates system provides a guide for a replacement broad based tax on property. As often is the case with tax reform, the devil lies in the details of the reform package. With this background, the rest of the paper considers some of the detail options, and then their implications for efficiency and distribution of the tax burden.

3. Replacement Broad Based Property Tax

By contrast with the current conveyance duty, narrow based land tax and stamp duty on insurance taxes discussed in the preceding section, a broad based tax on property involves minimal distortions to decisions and efficiency costs, and more so if property is measured as land rather than land plus buildings and other improvements. This section outlines the reduction of distortions to decisions and the efficiency gains of moving to a broad based property tax base, and it discusses redistribution effects of an approximate aggregate revenue neutral reform package.

In aggregate, land is perfectly inelastic in supply, and individual areas of land are geographically immobile. Land in different locations earn a scarcity rent which is used to allocate particular parcels of the land to its most profitable use. The rent is a residual return, and income to the land owner. A comprehensive land tax involves no changes in the allocation of land across different uses, and no change in the market determined rent return.⁸ Rather, a land tax

⁸ Using footnote 2 the tax base could be the land asset or the rent income.

redistributes a portion of the residual return from the land owner to the government, and via (1) it leads to a one-off reduction in the land asset value for current owners.

Further, both the land and property assets tax bases have been growing faster than GDP over the last 25 years (Coates and Daley, 2015), and this trend is likely to continue in the future with projected increases in population. A broad based property tax, and with Australian taxation of property currently below the OECD average, would be an efficient growth tax to help fund projected increases of state expenditures.⁹

A reform package that is approximately aggregate revenue neutral which replaces one or more of the current conveyance duty, land tax and stamp duty on insurance with a flat rate tax on a comprehensive land tax base would deliver significant gains in national efficiency. In the case of replacing conveyance duty, those deciding to hold property, or to sell or buy property, will face the same tax burden with the reform option. The reform package removes the high distortion costs to the transfer of property from lower value to higher value uses caused by conveyance duty described in Figure 1.

Removing exemptions of the current land tax for owner occupied homes and for primary production to achieve a comprehensive and larger land tax base would require a lower rate and it would reduce the distortions to the allocation of land between the taxed and exempt uses. Alternatively, local government municipal rate tax bases could be used, with the ACT 2012 reform package an example. Also, a flat rate would remove distortions to the choices on the scale of operation by land owners associated with the current combination of the tax paying unit's land holding tax base and the progressive rate.

Replacing stamp duty on insurance premiums with a broad based land or property tax would remove distortions and efficiency costs associated with decisions to insure and to under insure property.

Replacing the current conveyance duty levied on property sales and stamp duty on insurance levied on the value of buildings and improvements with a broad base property base rather than a land base would have a lower magnitude of efficiency gains than a broad based land tax. But, there still would be significant efficiency gains. Inclusion of buildings and improvements in the broad based property tax base means a much larger base, on average about double the size, and a lower required tax rate for aggregate revenue neutrality. Unlike land which is inelastic in

⁹ As an aside, to increase state own source revenue and minimise perceived adverse redistribution, some have suggested a sequence of small increases of the tax rate on property so that over time property prices still rise but at a lower rate.

supply and immobile, investment in buildings and improvements is responsive to price in general, and a property tax in particular. But note that replacement of the current conveyance duty and stamp duty on insurance taxes with a comprehensive base tax on property largely is swapping one form of property tax for another form. Importantly, the reform package removes efficiency costs caused by conveyance duty distortions to decisions on the transfer of property to more valuable uses, and removal of the additional special tax on insurance of property would reduce distortions to insurance choice decisions. Drawing on estimates of average excess burdens of different taxes by Cao et al. (2015) and Murphy (2016), a replacement tax reform package with a land base and a flat rate would generate efficiency gains of 50 to 80 cents per dollar of tax mix change,¹⁰ and smaller gains for a property base.

Indicative estimates of the magnitude of the average tax rate, or a flat rate tax, to replace the revenue now collected by conveyance duty, current land tax and stamp duty on insurance are shown in Table 2. The replacement average tax rates are expressed as a percentage of the asset value for a comprehensive land or property base, and as a multiple of the current local government tax revenue. The assumed broad base land and property tax asset bases are \$4 trillion and \$8.3 trillion from Daley and Coates (2015) drawing on ABS data. Revenue to be replaced and the current local government rates are ABS data shown in Table 1.

Table 2 Indicative Average tax Rates for Different Tax Bases to Replace Current Property Taxes

| <i>Tax replaced</i> | <i>Replacement average tax rate for base</i> | | |
|-------------------------|--|--------------------------|---|
| | <i>Land base (%)</i> | <i>Property base (%)</i> | <i>Multiple of local govt. rate tax</i> |
| Conveyance duty | 0.5 | 0.25 | 1.2 |
| Narrow land tax | 0.2 | 0.09 | 0.4 |
| Stamp duty on insurance | 0.1 | 0.05 | 0.3 |
| All of above | 0.8 | 0.39 | 1.9 |

Replacing conveyance duty with a broad base property tax each year would require a rate of about 0.5 percent of the land asset, or 0.25 percent for the larger property asset base, or a bit over a doubling of revenue collected via current local government rates. Replacing the three

¹⁰ Note that when replacing taxes, the average excess burden rather than the marginal excess burden is the appropriate measure.

current taxes in an approximate revenue neutral package would lift the tax rates to 0.8 per cent for a land base, 0.4 per cent for a property base, and about treble the current local government rate.

Two general observations about redistribution and equity effects of an aggregate revenue neutral reform package with a broad based property tax replacing current state property taxes are important to the reform debate. First, an aggregate revenue neutral reform package can be expected to have a minimal effect on property asset prices. Drawing on (1), the asset value of property, A, depends on the discounted value of the future stream of after tax rent income, with R being the market determined annual rent income and assumed constant over time for simplicity.

$$A = R (1 - T_{cu} - T_{re}) / d \tag{2}$$

T_{cu} is the average aggregate effective tax rate on rent income generated by the current taxes on property to be replaced, including one or more of conveyance duty, narrow base land tax and stamp duty on insurance. T_{re} is the effective tax rate on R of the replacement broad based property tax. The property market determined asset price A reflects an average across the decisions of all buyers and sellers in the market. This means that the tax rate terms T_{cu} and T_{re} in (2) reflect an average across all players and over time in the property market. Then, an aggregate revenue neutral reform package means $T_{cu} = T_{re}$, and no change in property asset prices. Experience with the ACT example increase of its local government rate tax to fund a reduction of the conveyance duty rate to date has had no discernible effect on property prices.¹¹

Second, while (2) tells an average market story, the reform package will have different distribution effects for individual market participants. For each individual $i = 1, 2, \dots, n$, an individual's tax $T_{cu,i} \neq T_{cu}$ while $T_{re,i} \approx T_{re}$. Conveyance duty is paid only on the transfer of property. Those who buy and sell relatively frequently, say less than every 15 years, pay more conveyance duty over time than the average, that is, $T_{cu,i} > T_{cu}$, with infrequent property transferees, say less often than every 20 years, paying less than the average over a lifetime, that is $T_{cu,i} < T_{cu}$. By contrast, a broad base property tax would have all property owners pay the same property tax each and every year, that is $T_{re,i} \approx T_{re} = T_{cu}$. In this way the reform package redistributes the property tax burden across different taxpayers. Starting from scratch, the

¹¹ But, sorting out the independent effects of other drivers of house prices from any tax change effects is a near impossible task.

reform package better meets an objective of horizontal equity in the sense that those with similar property assets pay a similar property tax.

Given the above general properties of a reform package, the following three sections discuss more specific design options and details for the replacement tax.

4. Tax Base Options

From an efficiency objective perspective, a comprehensive land tax base and a flat rate provides the benchmark for neutrality of taxation of decision choice options. But, other objectives, including equity, with a heavy weight on a comparison of the redistribution effects of the taxes to be replaced with the replacement tax, and simplicity cannot be ignored.

The reform package involves replacing current taxes with different tax bases and rate schedules, and the rate schedules vary across the states. Changes from the distribution pattern of the current taxes to be replaced can be reduced if: the replacement tax uses a property (land plus improvements) base rather than a land tax base; and, by applying different rates to different categories of properties, including owner occupied, rental property, commercial property and primary production, and across the different states. Simplicity has been suggested by some in favour of a land plus improvements base over a land base.

Consider first the option for a comprehensive base for either land or land plus improvements, including buildings. For revenue neutrality, the land plus buildings base means a halving of the tax rate. The larger property base corresponds with the property tax base of conveyance duty, and it would be a reasonable proxy for the value of buildings tax base for stamp duty on insurance. Given variations across regions, uses and values in the relative mix of land and buildings in property value, a property base will cause smaller vertical and horizontal redistribution effects than a land base. While including buildings in the tax base adds a degree of progressivity above the land only base, because property as a share of total wealth decreases with aggregate wealth a property base has important limits as a progressive tax on wealth as an aggregate (Daley and Coates, 2015).

Against the efficiency benchmark of a land only base, adding buildings and improvements to the property tax base involves additional distortions. While land is fixed in supply, over the long term investments in buildings and other improvements are price sensitive, and these decisions will change with changes in the effective tax burden of income generated by the investments. However, in the short run, most of the current building stock and broader property tax base is a sunk cost with a negligible supply elasticity so the efficiency costs are small initially.

The paucity of market transactions for unimproved or land only values, especially in large urban areas, means values for the land base have to be imputed. That is, information for a land base often is neither simple nor transparent, and these characteristics can result in uncertainty and in some cases expensive litigation (Mangioni and Warren, 2014). By contrast, market data on improved or property values on a regular time profile is readily available.

On efficiency grounds, a comprehensive property tax which imposes the same tax rate on land allocated to owner occupied residential, rental residential, commercial, primary production and to environment amenity uses is the ideal benchmark. A revenue neutral broad based land or property tax replacement for the current narrow base land tax would have large redistributive effects. At a cost of some loss of efficiency, but in exchange for smaller redistribution effects, and less political resistance to reform, a replacement broad based property tax with different tax rates, including a zero rate, between, say, commercial,¹² residential and primary production property, and for residential property between owner occupied and rent property would reduce changes to the tax distribution.

Starting from the current property taxes with different tax systems across the states, including no land tax in the NT and different progressive rate schedules in terms of thresholds and their marginal rates, together with different distributions of property values, approximate maintenance of the revenue and distribution effects could support different tax rate schedules for each state. Given the geographic immobility of land, the efficiency loss effects would be minimal for a land tax base, but of some impact with a property base as the different tax rates alter decisions on the state location of buildings and associated investment. Even so, rate differences across the states with a general reform package are unlikely to differ markedly from the different tax rate schedules and effective tax burdens of the current taxes to be replaced.

5. Tax Rate Schedule Options

There is a significant efficiency versus equity trade-off between a flat rate and a progressive rate schedule for the broad based property tax to replace one or more of the current state property taxes in an approximate revenue neutral reform package.

For either the land or the land plus buildings base, a progressive tax rate schedule introduces further distortions to land use and to investment in building decisions. As discussed in Section 2.2 for the current land tax, a combination of the progressive rate and a base for the value of the

¹² Also, unlike residential property, concerns about the asset-rich and income-poor is not an issue for commercial property owners.

asset held by each taxable unit means higher marginal and average tax rates the larger the scale of operation. This distorts decisions by scale of operation, with the efficiency cost larger the more important the cost savings by scale of operation and the more important the mix of products cost effectively produced by different scales of operation.

Alternatively, a progressive tax rate may apply to a property base assessed as value per unit of land or property, such as the Henry Review (Henry, et al., 2010) recommended progressive land tax assessed on dollars per square metre.¹³ This option does not distort decisions by scale of operation as happens with the current land tax. But, by placing lower marginal and average property tax rates on lower value assets relative to higher value assets, it favours investment in low value relative to high value property.¹⁴ While these distortions with a progressive rate structure and a comprehensive property base reduce the efficiency case for reform, these distortions are only a sub-set of the distortions to decisions discussed in Section 2 above for the current property taxes with their progressive rate schedules.

In terms of redistribution or the equity objective of tax reform, a progressive rate schedule would be required to achieve some degree of progressivity found with the current conveyance duty and land taxes; but not required for the part of a reform package replacing the flat rate stamp duty on property insurance. Replacing the current property taxes with their progressive rate schedules with a flat rate comprehensive base property tax would be highly regressive relative to the current redistribution. The ACT reform package has a progressive rate schedule on a property base in order to minimise redistribution effects.

Should a progressive rate schedule be included in the reform package, automatic indexation of the thresholds would be a desirable restraint on government expenditures.

6. Transition Options

A commonly expressed equity concern with a reform package involving a broad based property tax to replace conveyance duty is an unanticipated higher tax burden on recent property purchasers. Under a cold turkey transition, those who recently purchased property have paid conveyance duty and then have to pay the new property tax in what many describe as “double taxation”. Some long term property owners and those not intending to sell and who anticipate

¹³ An important desired outcome of the proposal was to continue to exempt agriculture land from the land tax.

¹⁴ These effects can be illustrated with a revised version of Figure 2. Replace the home owner property with low tax rate property such as property at city extremes, and in the extreme a zero rate, and replace rental property with high value property such as property in the CBD. The higher tax burden on high value property relative to low value property shifts investor decisions away from high value to low value property uses, and associated efficiency costs of the triangle abc.

not paying conveyance duty in the foreseeable future see the replacement property tax as a new and additional tax. While the analysis of Figure 1 shows that those who are both a seller and a buyer of property bear all of the conveyance duty partly as a buyer and partly as a seller, and they account for a large share of traders, new buyers of property bear about a half of the economic incidence of conveyance duty. Different transition options, including the cold turkey option, a grandfather option, credit for recent conveyance duty paid, and the ACT balanced increase in the broad base tax and reduction of the conveyance duty rate over an extended period (of 20 years), have different revenue, efficiency and equity outcomes.

A cold turkey jump from the current taxes to the replacement broad base property tax would be revenue neutral and it would quickly gain the efficiency benefits. Those who recently purchased will consider themselves losers, and more so if they are infrequent property transferees. Those with no plans to sell also may see themselves as losers.

By contrast, a grandfather transition strategy whereby those who maintain current ownership and remain exempt from the new broad based property tax has the opposite mix of effects. The revenue loss would be long and sustained, given that only around 5.5 per cent of properties change hands each year. It seems unlikely that the Commonwealth would bridge such a large revenue gap, or that the states and the financial sector would agree to borrow enough to maintain spending capacity during the extended transition period. Potential efficiency gains would be small and slow to realise. Further, the added incentive to avoid payment of the new property tax while maintaining current ownership will introduce a lock-in effect that further adds to the distortion of too few property transfers driven by the conveyance duty.

Potentially, a strategy between the above cold turkey and grandfather transition paths can be constructed to generate an in-between pattern of revenue, efficiency gains and redistribution.

An alternative transition strategy would provide recent transferees with a sliding scale of credit for payment of the new property tax. For example, a declining credit of 100 per cent if conveyance duty paid last year, 80 per cent for two years back and zero five years back, and then at a half of these credits if one accepts the analysis of Figure 1 that buyers bear only a half of stamp duty. While this strategy comes at a revenue cost, given that only around 5.5 per cent of properties change hands each year, the cost may be manageable and it is short term. At the revenue cost, such a strategy lessens the magnitude of the perceived “double tax.” Since the credit applies to past decisions, the full efficiency benefits of the reform arise from day one, and this is a significant advantage over the grandfather transition strategy and for the ACT one discussed next.

The ACT strategy initiated in 2012 involves an extended period (of about 20 years) to slowly increase the replacement broad base property tax using the local government unimproved land base and a progressive rate and simultaneously reduce the conveyance duty. By design the strategy is revenue neutral. The small annual increase of the replacement tax and reduction of conveyance duty cushions the magnitude of actual changes in distribution of the tax burden, and perhaps more importantly perceived changes in tax incidence. On the downside, the efficiency benefits of the reform initially are relatively small, with all the gains not realised before the end of the transition period.

Another transition design issue is special provisions for the so called asset-rich and income-poor. Here the stated advantage of conveyance duty is that when it is payable, a fluid cash position is in play, and further, the buyer is responsible for its payment even if the economic incidence is partly pushed back to the seller. By contrast, annual payment of the replacement property tax requires an annual cash transfer from property owner to government. A proportion of mature age people with a strong preference to live in a long-held family home, and often a high value property, have a relatively low annual cash income. As a consequence, they could face difficulty in funding the new property tax. Following existing arrangements for the payment of municipal rates in SA, WA and the ACT, to overcome the liquidity challenge the asset-rich and income-poor retirees, and perhaps others, would be given the option to carry forward payment of the new property tax, indexed by the government borrowing cost, to be paid from the estate or property sale, whichever comes first. A restriction might be placed on a minimum net equity share, although the restriction is unlikely to be binding unless a significant drop in house asset values eventuates.

7. Conclusions

Reform of taxation inevitably involves trade-offs between distortions to decisions and loss of potential national productivity, distribution of the tax burden and especially relative to the current tax system economic incidence, revenue and simplicity. In general, an approximate aggregate revenue neutral reform package to replace one or more of the current state property taxes, namely conveyance duty, a narrow base land tax, each with progressive rate schedules, and stamp duty on insurance of property with a flat rate, with a broad based property tax will generate significant efficiency gains but with important redistribution effects. Alternative design details of a reform package which involve some loss of the efficiency benefits, but still important net gains, to reduce the redistribution effects are explored.

Major sources of efficiency gains of a broad base property tax to replace some current state taxes are as follows. A costly tax distortion to decisions to buy and sell property when personal and business circumstances change is removed when conveyance duty is replaced with an annual property tax. The current narrow base land tax distorts the allocation of land between taxed and exempt uses, and requires a higher rate for revenue neutrality. There is no market failure argument to support the very high effective tax rate distortions to decisions to insure or to under-insure caused by stamp duty on property insurance.

The least distorting replacement broad base property tax would use land value as the tax base and then apply a flat rate. Consideration of redistribution, together with recognition that conveyance duty applies to property value to include improvements and buildings along with land, insurance duty applies to property, and with progressive rate schedules for both conveyance duty and land tax, provide a maintenance of the current equity argument for a property base and a progressive rate. A property base involves additional decision distortions on the quantity and form of investment in buildings and improvements compared with a land base. A progressive rate schedule incurs some distortions to the mix of investments by value and scale relative to a flat rate. On the other hand, compared with a flat rate tax on land, a combination of the broader property base and a progressive rate schedule can maintain overall progressivity of property tax incidence provided by the current taxes.

An aggregate revenue neutral reform package is shown to have a minimal effect on property asset prices.

Replacing conveyance duty with a broad based property tax will have significant horizontal equity effects. Under conveyance duty, households of similar income and wealth pay a relatively high sum of conveyance duty over time if they buy and sell property more frequently than average, while those who hold property for above average periods pay much less. A reform package to replace conveyance duty with a broad base tax on property will result in a similar tax payment for all households of similar property wealth, regardless of how frequently or infrequently they buy and sell.

Given the different effective property tax burdens levied by current taxes on property allocated to resident uses, and then for owner occupation or for rental property, commercial and primary production uses, the least distorting ideal of a common rate across all property use categories may have to give way to different rate schedules by property category for a closer approximation to the current tax system incidence. Similarly, differences in tax rate schedules

and the distribution of property values between the states may justify different reform packages across the states.

Concerns for inequity via “double taxation” of persons and businesses recently purchasing property and paying conveyance duty and then paying the replacement broad base property tax has given rise to proposals for a transition path rather than a cold turkey transition. The ACT model of an extended period of small reductions in the conveyance duty rate matched by small increases of the replacement property tax provides a constant and stable revenue stream, but at the cost of very small gains of efficiency in the early years, and with all gains delayed to the end of the transition period. A grandfather transition strategy with some appeal for equity incurs a large revenue cost, and it would aggravate distortions to buy and sell property decisions.

References

ABS (2017), Taxation Revenue 2014-15, Catalogue 5506.0.

ACT Treasury (2012), ACT Taxation Review, Canberra.

Australian Treasury (2015), Re:think, Tax Discussion Paper, Canberra.

Cao, L, Hosking, A, Kouparitsas, M, Mullaly, M, Rimmer, X, Shi, Q, Stark, W and Wende, S (2015), “Understanding the Economy-wide Incidence of Major Australian Taxes”, Treasury Working Paper 2015-01, Canberra.

Daley, J and Coates, B (2015), Property Taxes, Working Paper, Grattan Institute.

Davidoff, I and Leigh, A (2013), “How Do Stamp Duties Affect the Housing Market?”, Economic Record, 89(286), 396-410.

Dixon, P, Picton, R and Rimmer, M (2004), “Payroll Taxes: Thresholds, Firm Sizes, Deadweight Losses and Commonwealth Grants Commission Funding”, Economic Record, 80(250): 289-301.

Harvey, J, Feeley, N, Freebairn, J and Townsend, K (2001), Review of State Business Taxes, Department of Treasury and Finance, Melbourne.

Henry, K, Harmer, J, Piggott, J, Ridout, H and Smith, G (2009), Australia’s Future Tax System, Report to the Treasurer, Canberra.

Leal, H, Parsons, S, White, G and Zurawski, A (2017), “Housing Market Turnover”, RBA Bulletin, March, 21-30.

Mangioni, V and Warren, N (2014), "Re-defining the Land Tax Base in Highly Urbanised Locations", Australian Tax Forum, 29(2), 455-475.

Murphy, C (2016), "Efficiency of the Tax System: a marginal efficiency cost analysis", ANU Tax and Transfer Policy Institute Working Paper, 4/2016, ANU.

NSW Treasury (2016), Interstate Comparison of State Taxes, 2014-15, Sydney.

SA Government (2014), State Tax Review Discussion Paper, Adelaide.

WA Department of Treasury and Finance (2007), State Tax Review, Perth.

