

STAMP DUTIES, LAND TAX AND HOUSING AFFORDABILITY: THE CASE FOR REFORM

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1 Introduction

House prices and rents have increased ahead of average earnings over the last 25 years tipping more and more Australian households into housing affordability stress. The percentage of households in the bottom 40% of the income distribution whose housing costs exceed 30% of their income rose from 15% to 20% between 1982 and 2007¹. Population increases, deregulation of mortgage markets, buoyant labour markets and inflexible planning systems are all likely to have played a role. But underpinning an inflationary bias in residential property markets is a set of Federal and State tax arrangements that distort the use of land and buildings in ways that impair the efficient operation of housing markets.

Federal income tax arrangements exempt both net imputed rents² and capital gains on owner occupied housing thereby offering a preferential tax treatment as compared to other personal assets. This results in a powerful incentive to accumulate savings in owner occupied housing, a motive that is sharpened by asset tests determining eligibility for pensions (and allowances) that exempt owner occupied housing (Yates, 2009). These Federal tax expenditures tend to favour higher income households in later stages of the life cycle (Wood et al 2010b). While they have come to be regarded as an important pillar of retirement incomes policy (see Castles, 1998), their inequitable distribution is the source of much criticism (Bourassa and Hendershott, 1994; Freebairn, 1999; Yates and Flood, 1987; Yates, 1994).

The state governments’ taxation of residential land and buildings has not attracted the same scrutiny but is arguably as inefficient and inequitable as Federal taxation arrangements. There are two main

¹ The figures are population weighted estimates derived from the confidentialised unit record files of the Australian Bureau of Statistics 1982 and 2007 Surveys of Income and Housing.

² Net imputed rents are the gross rental value of owner occupied housing less costs of holding the property such as interest and operating costs.

tax instruments³. Stamp duties must be met by the purchasers of residential property and are levied on purchase price, with marginal rates of duty that rise across purchase price brackets. Most states provide some form of relief for first-homebuyers although the extent of, and eligibility for such relief varies depending on the jurisdiction. The duty schedules can also differ depending upon whether the housing has been purchased as a principal residence or rental investment. Duty schedules in the latter case impose a higher tax burden, giving a financial advantage to home owners relative to landlords.

State governments also levy land taxes on the unimproved capital value⁴ of residential land, but exempt land used for owner occupied housing and these arrangements also favour home owners relative to landlords. Typically state governments zero rate land below a value threshold, and then apply a progressive schedule with marginal rates that increase with assessed land values. An important feature of land tax arrangements is measurement of the tax base on a cumulative basis. Thus multiple property owners are taxed on the cumulative value of the land plots that their properties occupy, rather than on the value of each individual plot of land.

Tax receipts from stamp duties and land tax are an important source of revenue for state governments. For example, in Victoria in 2010 –'11 they amounted to \$5.3b or 35% of total tax revenue⁵. Understandably there is a reluctance to introduce reforms that threaten this revenue base. This reluctance has persisted despite considerable expressed dissatisfaction with stamp duties on residential property transactions. For example, at the recent Australian Government Tax Forum, the weight of opinion favoured the removal of such transaction taxes.

Indeed, the Henry Review believed the case for reform was strong enough to warrant the following key recommendations (51 to 54) (see Henry et al 2009):

- the abolition of stamp duties on all property transactions;
- the levying of land tax on all land;
- levying land tax using an increasing marginal rate schedule applied to unimproved capital values, with the lowest rate being zero and thresholds determined according to per m² value in order to tax more valuable land at higher rates;
- levying land tax on a per land holding basis, not on an entity's total holding, to promote investment in land development.

The introduction of such measures would radically alter state government taxation of land and buildings. This paper analyses the case for reform, and assesses what impact their introduction would have upon land prices based on modelling of the Melbourne housing market. In section two we outline the range of issues the Henry reforms raise for the efficient operation of housing and land markets, with an emphasis on their implications for housing affordability. Section three reports findings from a modelling exercise that designs a broad based land tax schedule to offset the revenue lost on removing stamp duties and replacing the existing land tax. The formal incidence of land taxes is computed, and capitalisation effects into land prices are estimated. As ever, tax reforms create winners and losers so in Section four we reflect upon the extent to which the Tax Forum created any momentum for reform and consider what transitional arrangements might address impediments to reform.

2 The Case for Reform

³ Local governments are responsible for rates but might more properly be regarded as a user charge.

⁴ Unimproved capital value is the assessed market value of land in the use that maximises value, but excluding the value of buildings that have been constructed on the land. Unimproved capital value can include the value of 'merged improvements such as drainage, mains water connection and so on.

⁵ Victorian Department of Treasury and Finance, 2011-'12 Budget Paper Number 5, Statement of Finances. These estimates are for revenue generated from both residential and non-residential property and land.

Stamp Duties

The discussions leading to the Henry Review recommendations would no doubt have aired a range of concerns about stamp duties relating to their rationale, and the potential detrimental impacts on residential mobility, housing affordability and efficient use of the housing stock. A rationale for transaction (excise) taxes such as stamp duty can be that a good or service is responsible for incidental side effects (externalities) that negatively impact community wellbeing. A transaction tax, it is argued, will raise the tax-inclusive price, reduce the quantity traded, and hence curb negative side effects. But there is no obvious reason why property should be thought to solely generate negative externalities; indeed housing is, if anything, linked to positive externalities such as health benefits (see Rohe, McCarthy, and Van Zandt, 2000; McCarthy, Van Zandt, and Rohe, 2001).

A second possible rationale is that a tax can play an important redistributive role; but while higher income households typically pay more for housing, demand tends to be income inelastic and so stamp duties can be regressive (see Wood, 1994). Stamp duties are also thought responsible for negative effects in housing and labour markets. They impede access to home ownership as it is a transaction cost that needs to be paid upfront upon purchase of a property (Bourassa and Yin 2006; Wood et al. 2006). Additionally they can have adverse impacts on housing affordability because they raise the price of housing⁶. Finally, there are efficiency concerns. Stamp duty is a tax on mobility and to the extent that it deters residential moves the duty is an added friction impairing the smooth functioning of labour markets (Henry et al 2009; Yates 2010). This is an issue of particular relevance to labour shortages in resource boom regions of Australia. Reduced mobility is also problematic in housing markets because it slows the transfer of property from lower value uses to higher value uses, and results in an inefficient allocation of resources in housing markets. This is most evident in terms of underutilisation of the housing stock, where households that may be consuming large amounts of housing (e.g. ‘empty nesters’) are deterred from trading down as a result of the stamp duty they would have to pay on their next purchase⁷.

Land Taxes

The Henry Review would undoubtedly have encountered similar efficiency concerns when considering land taxes, for current land tax arrangements also introduce inefficiency into housing markets by distorting the allocation of land between alternative uses. Land taxes also make housing less affordable in rental markets. Both these impacts arise because land used for owner occupied housing (as well as primary production, and certain other uses such as education) is exempt from land tax, while land used for private rental housing (and commercial or industrial uses) is subject to land tax.

When a tax is applied conditional on the use of a factor input (land, labour or capital) in production, the resource will flow out of the types of production that are taxed and into the untaxed uses. This is because the after-tax returns in the taxed use decline on introduction of the tax; the resource transfer continues until the after-tax returns are equalized. In a land market where land is only used for rental or owner occupied housing, the taxation of the former will then result in a contraction in

⁶ Economic theory demonstrates that the tax (duty) inclusive price of housing increases, but by less than the full amount of the tax. On the other hand, the after-tax price received by vendors will fall, though by less than the full amount of the tax, and so the effective incidence is shared between buyers and sellers (see Freebairn, 2010, figure 7.1).

⁷ It also has the incidental effect of eroding the welfare role of housing wealth as stamp duty eats into the equity released when home owners trade down. The stamp duty impacts on both residential mobility and the price (and hence affordability) of housing are formally analysed in Freebairn (2010, figure 7.2)

the supply of rental housing, as some rental investors seek higher returns elsewhere, and an increase in rents. Thus the current land tax arrangements harm the supply of affordable rental housing, and this is aggravated by its application to the cumulative unimproved value of land that impedes attraction of private finance (from superannuation funds, for instance) into the private rental housing market (Wood et al 2010a).

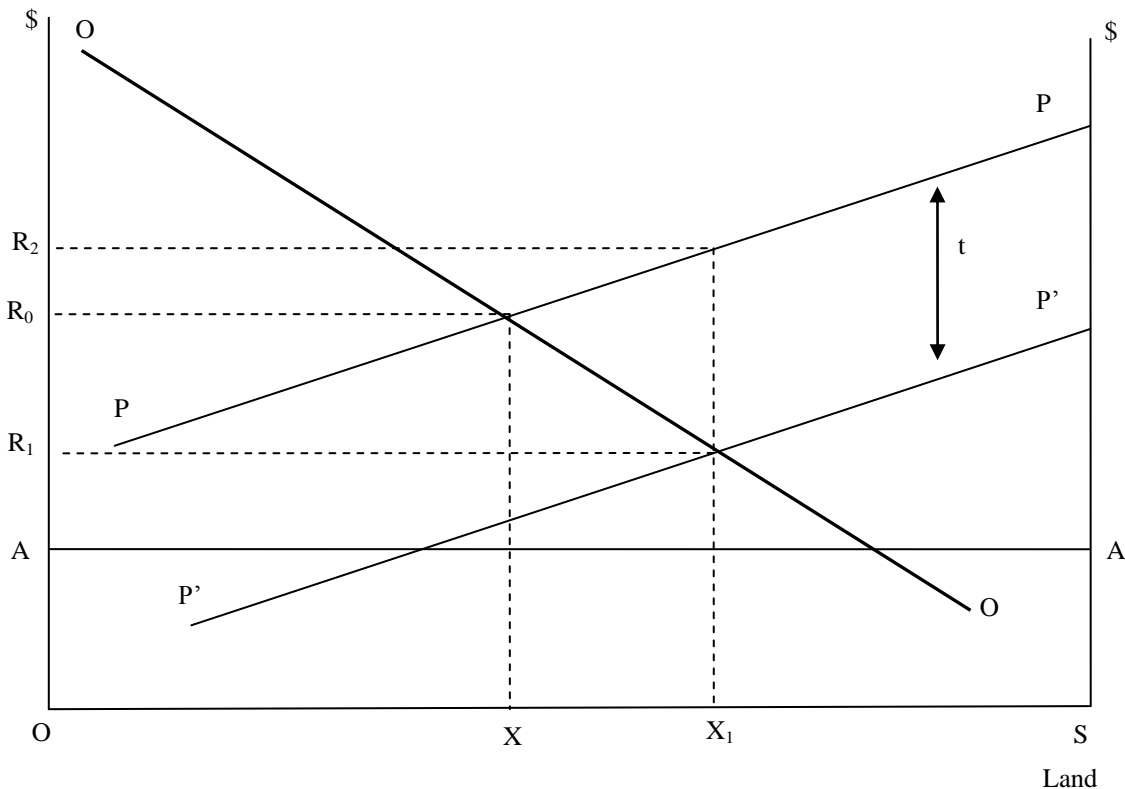
Figure 1 substantiates some of these propositions in a more formal setting where it is assumed that 'raw' land has only two uses – the production of housing for purchase by home buyers, or alternatively the production of housing that is purchased by landlords (and subsequently leased to tenants)⁸. There is a *fixed amount of land* measured on the horizontal axis from O to S; rents are measured on the vertical axis⁹. Land used by producers of housing for owner occupiers (rental housing) is measured along the horizontal from left to right (right to left), and beginning at O (S). Denote OO as the demand for land from producers (developers) of owner occupied housing; as the amount of land used increases the rent they are prepared to pay owners of land declines (since in order to attract more home buyers they must drop the price of new housing). PP is the demand for land from producers (developers) of rental housing; again the demand curve is downward sloping. Owners of land have a fixed reservation rent equal to A, which can be thought of as its value in agricultural use. In a market where land is not taxed producers will compete and outbid each other until the rents they are prepared to pay for the last unit of land used are equal at R_0 . This equilibrium rent occurs at X, with OX (SX) land used by producers of owner occupied (rental) housing.

Suppose a flat tax t per unit of land is imposed on land used for rental housing but a tax exemption is granted to land that has been purchased for the construction of housing purchased by home owners. This reduces the rent received by landowners (who formally pay the tax) from producers of rental housing by t , so they begin to lease more land to the developers of owner occupied housing until (after-tax) rents are equalized at X_1 . The pre-tax rents R_2 paid by developers of rental housing are higher, and the amount of land used for production of rental housing shrinks from X to X_1 . Externalities and other causes of market failure can justify departures from a 'level playing field'. But it is difficult to understand what market failure justifies preferential tax treatment for land used for owner occupied housing.

⁸ The analysis draws on Evans (2004, chapters 2 and 17).

⁹ In a perfectly informed market without frictions such as transaction cost, the capital value of land will equal the present value of rents. As Oates and Schwab (2009, p.55) point out a land tax can be applied to land rents or land values, and every tax rate on land rents can be expressed as an equivalent rate on land value that generates the same tax revenue. The analysis can then be conducted in terms of rents or land values.

Figure 1: Land tax and housing markets

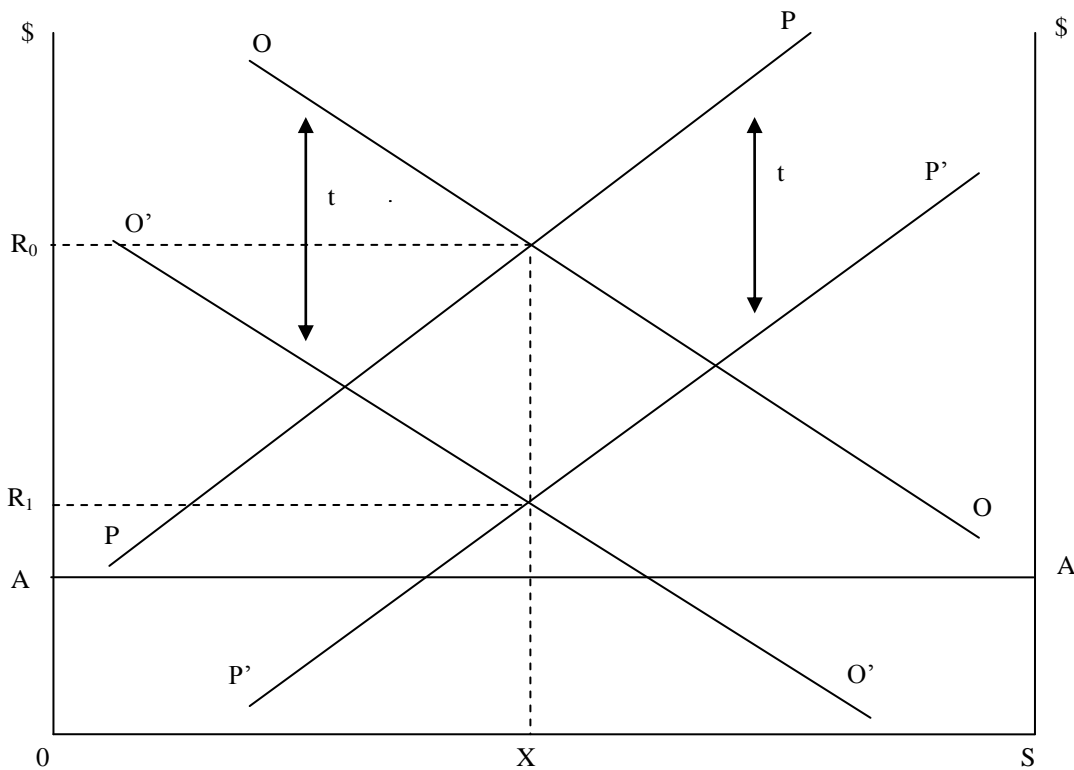


Current land tax arrangements will then harm the supply of affordable rental housing and inflate the rents tenants are obliged to pay for rental housing. But there will also be capitalisation impacts on land *prices*. In an efficient market with perfect foresight land prices will equal the net present value of the future stream of after-tax rents (see Henry Review, p248-250 and Oates and Schwab, 2009, p52 - 53). In the new equilibrium illustrated in Figure 1 the producers of owner occupied housing pay rents equal to R_1 ; the producers of rental housing pay higher pre-tax rents R_2 but the after-tax rents received by landowners are again R_1 . The post-tax equilibrium rents received by landowners are then lower than R_0 the pre-tax equilibrium rents. These lower rents will be capitalised into lower land prices.

A broad based land tax that is uniformly applied avoids the distortionary effects resulting from the current non-tenure neutral provisions, and leaves tenants unaffected according to the analysis taken up in figure 2. It assumes a flat per unit tax t applied uniformly to both land used for rental and owner occupied housing. The respective demand curves OO and PP shift downward by the amount t . As figure 2 demonstrates a parallel shift in both curves of distance t leaves the amount of land used by developers of rental and owner occupied housing unchanged, and the rents paid by developers are also unchanged. As both must pay the same tax, the rents they are willing to pay owners of land will stay the same *all else remaining constant*. A broad based tax is tenure neutral according to this static analysis. The tax burden is shifted to landowners who receive lower after-tax rents R_1 that will be capitalised into lower land prices. This is clearly an appealing outcome from the perspectives of all but landowners at the time the tax is introduced. Developers are unaffected because they continue to pay the same for land as before the tax, and if the industry is competitive, the entire tax will be shifted backward to landowners rather than forward to home buyers and tenants. As the after-tax rents received by landowners fall by t the price of land will fall by the discounted present value of the future stream of tax liabilities. There are potentially important implications for the affordability of rental housing. As compared to *present arrangements* (see

figure 1) the supply of private rental housing expands (from $S-X_1$ to $S-X$) and the fall in pre-tax land rents (R_2 to R_0) will (if markets are competitive) be shifted forwards, thereby lowering tenants' housing cost burdens.

Figure 2: A broad based land tax



The analysis presented in figures 1 and 2 allow us to draw the following conclusions regarding incidence and housing affordability. Removing stamp duties will lower the price of housing, and help relax home buyer borrowing constraints. Replacing current land tax arrangements by a broad based flat rate land tax will improve the supply of rental housing, and lower rent burdens thus easing housing affordability in a tenure that offers shelter services to many low income households. Home buyers will also find housing more affordable; though land tax liabilities offset the lower land and housing prices due to capitalisation effects, the removal of stamp duty will also reduce the price of housing, thereby providing a net affordability gain for home buyers. To these benefits we can add efficiency gains as stamp duties are an impediment to mobility and encourage an underutilisation of the housing stock. Furthermore, if land tax is applied uniformly at a flat rate, a more efficient pattern of land use will emerge, as compared to current arrangements which distort land use patterns in ways that have no compelling market failure rationale. Finally, a broad based land tax will speed development of vacant sites where developers' binding liquidity constraints prompt them to accelerate construction plans. To the extent that this effect is significant, a more compact urban form will be encouraged. However, owners of land (including home owners) at the time tax reforms are introduced will suffer capital losses, an issue that we return to when discussing transition arrangements below. Finally, a broad based land tax might prove to be the source of a more stable revenue stream than that currently generated by stamp duties.¹⁰

¹⁰ The current narrow land tax base appears to generate a revenue stream that is just as volatile as that yielded by stamp duties. For example, Victorian annual land tax revenue between 1996-97 and 2010-11 ranged from a maximum of \$1,398 million to a low of \$325 million, with a coefficient of variation equal to 0.44. Victorian annual stamp duty revenue ranged from a maximum of \$3,910 million to a low of \$981 million, with a coefficient of variation equal to 0.43 over the same period (authors' calculations from the State Government of Victoria Department of Treasury and Finance 2011).

3 A Broad Based Land Tax

The theoretical analysis in section 2 imagines a setting where the housing stock is auctioned under different tax arrangements that can be instantaneously substituted. The incidence under these alternative arrangements is then compared as if we could conduct such an experiment. But the reality is that reform must be enacted in housing markets where existing home owners have already paid stamp duty on their property purchases. A proposal to replace stamp duty with a broad based land tax will (in the absence of transitional arrangements) impose an additional tax on *existing* home owners, who will also suffer a decline in land (and hence house) values.

It is then important to estimate the typical land tax liabilities (and decline in land values) that existing home owners would be asked to pay if the Henry Review proposals are introduced. In this section, we describe these land tax burdens, as hypothetically levied in Melbourne, one of Australia's largest cities, and compare the new tax burdens with liabilities under existing tax arrangements. We design a revenue neutral broad based land tax that would broadly align with the principles outlined under recommendations 51 to 54 of the Henry Review (see page 2 above). Our analysis is based on two key data sources. The first estimates the revenue foregone in Melbourne municipalities if stamp duties and the existing land tax regime were abolished. Using Victorian Office of Valuer-General data on 68,400 residential property sales transactions conducted in metropolitan Melbourne in 2006, we estimate that \$1.29 billion of tax revenue would be lost if stamp duty were abolished. According to the Commonwealth Grants Commission (2007), state-wide non-principal residential land generated \$279 million in land taxes in 2006. 77.5% of private renter dwellings in Victoria are located in Melbourne (based on 2006 data from the nationally representative Household, Income and Labour Dynamics in Australia Survey), suggesting a revenue loss of \$216 million due to abolition of the current land tax regime. The total revenue foregone would therefore be \$1.5 billion.

The second component of our analysis involves utilising 1,136,000 records from the Victorian Office of Valuer - General's valuations data to estimate land tax assessments on residential properties under the Henry Review's proposed reforms. The new land tax schedule is revenue neutral, i.e. land value thresholds are set so as to raise enough revenue to compensate for the loss of stamp duty and current land tax revenue. We assume that there are seven land tax brackets (as is the case under the current system), and the same distribution of land plots across brackets as there is now. A Linear programming routine is used to solve for revenue neutral tax rates¹¹.

Table 1 presents the new land tax schedule. Column 1 details the land tax brackets based on the land value per m². There is a tax exemption below a land value per m² threshold of \$286.54¹². Column 2 lists the number of land plots in each of the land tax brackets. Column 3 shows how the marginal tax rates rise in a linear fashion from 0.9% to 1.4% in the top bracket. The top marginal rate cuts in once land values (per m²) reach \$5697.08. As we move up the tax brackets, the rates rise by 0.09 percentage points. Column 4 details the average annual land tax liability for each tax bracket. The overall average is \$1,458¹³. Column 5 shows the dollar value of revenue would be generated from each tax bracket and column 6 the percentage of total revenue. Over 50% of landowners are in the second tax bracket and could expect to pay an average land tax liability of \$1,306 per annum. These tax liabilities account for 2.7% and 2.4% of the median household disposable income as computed for Melbourne households in 2006¹⁴.

¹¹ The land tax estimates are based on assessments of unimproved land values.

¹² All dollar values for tax thresholds and tax liabilities are at 2006 prices.

¹³ The land tax liability would be equivalent to \$2,164 in 2011 prices if indexed according to the Melbourne house price index movements produced by the Australian Bureau of Statistics.

¹⁴ The median Melbourne household income in 2006 is \$53,325, based on population weighted income estimates from the 2006 Household, Income and Labour Dynamics in Australia Survey.

More than half of revenue is generated from the second lowest tax bracket and 84% from the second and third lowest tax brackets. The revenue generated by each successively higher bracket quickly tails off. Under 2% of total tax revenue is raised in the highest bracket despite high average land value per m²; this is because there is a very small amount of land with such high values (approximately 17 hectares, or 0.02% of all assessable land).

Table 1: Proposed land tax schedule

Land tax bracket	Number of land plots	Marginal tax rate (%)	Average annual land tax (\$)	Aggregate revenue (\$ million)	% of aggregate revenue
Less than \$286.54	305,166	0.00%	\$0	\$0	0%
\$286.54 to less than \$974.45	593,904	0.92%	\$1,306	\$776	51%
\$974.45 to less than \$2000.22	104,152	1.01%	\$4,839	\$504	33%
\$2000.22 to less than \$3025.30	19,197	1.10%	\$6,600	\$127	8%
\$3025.30 to less than \$4145.28	6,907	1.19%	\$8,004	\$55	4%
\$4145.28 to less than \$5697.08	3,075	1.28%	\$9,367	\$29	2%
\$5697.08 and over	790	1.37%	\$20,342	\$16	1%
Total	1,033,191		\$1,458	\$1,507	100%

On considering the spatial impacts of this new land tax schedule we find the impact will vary across the city because of substantial variation in per m² land values that typically decline as distance from the CBD increases. In Table 2, we report land tax measures at progressively more distant 10 km concentric rings around the CBD. The table also describes typical stamp duty liabilities across the same concentric rings thereby giving a sense of how net tax burdens will change across the city. There is a radical change in spatial incidence with land tax burdens concentrated in the inner ring of business districts and suburbs. For example, almost half of the land tax revenue is raised from residential land plots within 10 km of the CBD, where land is most expensive (a mean value of \$1,335 per m²). But less than one third of stamp duty revenue is levied from property transactions within the same 10 km ring. On the other hand, the tax burden will be lower on the urban fringe where land is comparatively cheaper at around \$300 per m². Our findings show that the formal incidence of the broad-based land tax will be felt most keenly where pressure on land use is most acute. This is in part due to progressive marginal rates of land tax; land with higher per m² values attract a higher marginal rate of land tax. By recommending a progressive instead of flat rate schedule, the Henry Review recommendations could miss the opportunity to encourage a more compact urban form. Owners of land in the more expensive inner suburbs can sell up and buy land of equal value on the urban fringe thereby lowering their land tax liabilities. On the other hand, the higher land tax rates on expensive inner area vacant land might speed development as developers find liquidity constraints tightened by their higher land tax liabilities.

Table 2: Aggregate revenue from proposed land tax and stamp duty regimes, by distance from CBD (10km)

Distance to CBD (10km intervals)	Proposed land tax				Stamp duty			
	Aggregate revenue		Total land area (million m ²)	Mean land value (\$ per m ²)	Aggregate revenue		Number of transactions	Mean property price (\$'000)
	(\$ million)	(%)			(\$ million)	(%)		
0km < 10km	686	46%	89	1,335	302	29%	8,375	684
10km < 20km	572	38%	238	553	327	32%	14,194	459

20km < 30km	152	10%	179	377	173	17%	11,530	323
30km < 40km	34	2%	107	278	87	8%	7,217	272
40km < 50km	29	2%	65	309	73	7%	4,926	318
50km < 60km	12	1%	27	295	26	3%	1,811	312
60km < 70km	20	1%	36	310	35	3%	2,141	342
70km <	2	0.2%	3	318	2	0.2%	128	356
Total	1,507	100%	744	576	1,025 ^a	100%	50,322	414

Note: a. The aggregate amount of revenue generated by stamp duty (\$1.025 billion) is less than the amount generated by the proposed land tax schedule because approximately 25% of stamp duty transactions in the VG data could not be matched to their property characteristics in the Valuation data.

An important question is whether this increasingly unequal geographical distribution of the tax burden turns out to be more equitable because it requires better off communities to shoulder more of the tax burden. We have analysed the formal incidence of land tax and stamp duties across local government areas (LGAs). We find that per capita land taxes are much higher in LGAs where income per capita is correspondingly high¹⁵. The relationship is a strong one with a correlation coefficient (between per capita land tax and per capita income) exceeding 0.8. The better off communities will then pay more.

Turning now to the impact on land prices, as land is immobile and its supply fixed, existing landowners bear the burden of a broad-based land tax in the form of a reduction in land values (see figure 2). Assuming an infinite property life and a 2006 pattern of land taxes that remains constant in real terms, discounting the stream of land taxes to infinity at a suitably chosen real discount rate¹⁶ allows estimation of the decline in real land values as a result of the capitalisation of land taxes (see Henry Review, p.248)¹⁷. The estimated fall in land values if taxes are fully passed on into lower land values is analysed spatially across the Melbourne metropolitan area.

We find that the average plot with a *land value* of \$335,000 (at 2006 prices) will decline by \$24,000, or approximately 5%. However, the expected decline in *land value* will be greatest in those suburbs in and around the CBD (at around 12%), where land is currently most expensive. The 12% reduction in average *land values* will make housing closest to the CBD, where jobs are still concentrated (see Tsutsumi, 2006), more affordable for those seeking to locate closer to employment opportunities in the city. However, in suburbs further away from the CBD, the percentage decline in mean *land value* will be lower. Within the 60-70km ring, the percentage decline in mean land value is only 3%. These estimates are conservative because they do not include estimates of the fall in land and house values that will eventuate due to the elimination of stamp duties. Their inclusion will mean that owner occupied housing is more affordable under the proposed reforms, since the aggregate fall in house prices will exceed the capitalised value of land tax payments.

Table 3: Reduction in mean land values due to the proposed land tax, by distance from CBD (10km ring)

Distance from CBD (10km ring)	Mean Assessed Land Value \$	Mean Reduction in Land Value due to Capitalisation \$	% Decrease in Mean Land Value after Capitalisation
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¹⁵ Income estimates are taken from BITRE's (2007) estimates of 2004-05 taxable income per taxpayer, inflated to 2006 prices using the Consumer Price Index. Taxpayers are Federal income taxpayers. Land tax per taxpayer by LGA is derived by dividing each LGA's aggregate land tax revenue by the number of Federal income taxpayers in each LGA.

¹⁶ The Victorian state government recommends a real discount rate of 6% in economic appraisals (Department of Infrastructure, 2005).

¹⁷ Full capitalisation can be assumed under a flat rate land tax such as that analysed in figure 2. The estimates in table 3 should be regarded as a guide to impacts on land values since the Henry Review recommends a progressive rate structure. The broad based land tax will not be neutral when applied non-uniformly. This is because land holders in inner suburbs where land is expensive can sell up and buy land of exactly the land value in cheaper outer suburbs but with lower land tax burdens. With a flat rate tax reinvestment of land sale proceeds in the purchase of land in cheaper suburbs leaves land tax burdens unchanged.

0km < 10km	551,099	65,657.80	12%
10km < 20km	365,163	27,411.82	8%
20km < 30km	257,852	10,561.33	4%
30km < 40km	196,434	4,322.37	2%
40km < 50km	245,891	6,686.88	3%
50km < 60km	238,185	6,977.59	3%
60km < 70km	271,739	8,940.75	3%
≥ 70km	319,904	14,681.14	5%
Total	334,877	24,311.09	5%

4 The Tax Forum and the Politics of Property Tax Reform

It is undoubtedly a marker of significant progress in national housing policy debate that the issue of housing affordability was prominent throughout the Tax Forum. Only four years ago, in a national policy forum on housing affordability, discussion of tax reform was at best marginal, at worst ‘radical’ – a fringe topic. That the national Tax Forum highlighted the importance of tax reform for housing affordability is significant. That speakers from a diverse range of sectoral interests recognised the benefits of such reforms, suggests that not only are these tax reforms on the agenda but with some State Treasurers present at the Tax Forum acknowledging the benefits of these reforms, there is some likelihood of this agenda being advanced, providing the right set of transitional arrangements can be agreed. .

The logic would seem inescapable. If Australia seeks:

- i. downward pressure upon house prices;
- ii. faster redevelopment of old industrial sites;
- iii. easier entry to home ownership for first home buyers;
- iv. increased supply of private rental accommodation;
- v. a reduction in the number of taxes (by one), and;
- vi. removal of a barrier to labour mobility;

then it would remove stamp duties on residential property transactions whilst extending land tax to owner occupiers, applying it on a per property basis.

What might bring the opportunity for reform closer still is a set of transitional arrangements that ‘smooth the path’ for potential losers. As much as the main ‘winners’ of these reforms are those currently unable to afford home ownership and tenants paying rents higher than necessary, key amongst the ‘losers’ are existing home owners. Not only do these reforms place downward pressure on house prices, we estimate an average 5% decline in land values (see page 10), but if the proposed reforms were introduced overnight existing home owners would likely decry the impost of an annual land tax on their property (estimated to be on average \$1458), having already paid a stamp duty at the time of purchase. This is particularly important for elderly home owners whose retirement incomes are insufficient to meet land tax payments, and/or plan to release housing equity to fund post-retirement living standards.

How might this be addressed? If properties were moved from the current stamp duty regime to the new land tax regime as they were sold, then no current home owner would pay land tax on a property for which they had already paid stamp duty.¹⁸ Since no stamp duty is paid on that next purchase current home owners would have an upfront transaction tax replaced by a recurrent annual tax when they next purchase. The timing of that substitution would be at the discretion of current home owners; our modelling indicates that the typical homeowner will on moving begin paying an average annual land tax of \$1458 *instead of* an average up-front stamp duty of \$18,900 (at 2006 prices). One might argue that this discretionary substitution will adversely affect mobility because current home owners can defer paying land taxes by not moving. However, under current tax

¹⁸ Those transitioning from renting into home ownership also begin paying land tax once they make their purchase.

arrangements, home owners can avoid stamp duty by not moving. So the proposed transitional arrangements that remove upfront stamp duty on the next purchase and then replace it by an annual land tax, should at least be neutral with respect to residential mobility. After all, instead of paying a high upfront charge, home buyers are instead spreading this out over their term of ownership.

Table 4 below sheds some light on how quickly a broad based land tax could be introduced *for existing owner occupied housing* under such transition arrangements. It shows the number of Australian homeowners in 2001 who moved house subsequently through to 2009. Under the proposed transitional arrangements as each property is sold it would then be included in the new land tax base. It shows that nearly 30% of the 2001 stock of owner occupied housing becomes subject to land tax by 2009.

Existing owner occupied housing is of course only part of the housing stock. There is also privately rented housing on which landlords are already paying land tax but under the existing land tax schedule. If the same transition arrangements apply then landlord owned properties would also transition into the new land tax base when they are next sold. The speed of transition on this part of the stock is likely to be faster. We estimate that one in four landlords holding a rental property between 2001 and 2006 sold their rental property within one year of first being observed as a rental investor (see Wood and Ong, 2011). A further consideration is newly constructed housing. If it transitions into the reformed tax base on purchase by home buyers (or investors) then all new additions to the housing stock automatically form part of the new tax base, and this will aid introduction of the new arrangements.

Table 4

Year y	Homeowners in 2001 who moved for the first time in year y	
	Number (population weighted)	%
2002	325,737	5.8
2003	357,133	6.1
2004	273,864	4.5
2005	213,356	3.4
2006	195,063	3.1
2007	169,344	2.6
2008	140,997	2.1
2009	119,143	1.8
All	1,794,636	29.4

Source: Authors' own calculations from the 2001-2009 HILDA Survey

Note the unit of analysis below is the person. Ideally we would want to track households / dwellings over time but we are unable to do that in HILDA. HILDA does not contain a unique household ID or dwelling ID that is the same across waves.

The transition of the housing stock onto a new land tax regime will clearly be a gradual one taking a number of years. A significant advantage of such gradual transition arrangements is that they would guard against the possible disruption in land and housing markets that might be triggered by the 'overnight' replacement of stamp duty by a broad based land tax. The importance of avoiding disruption to housing and land markets in a country where the national 'dream' is home ownership hardly needs stating. The fact that over two thirds of households are home owners and that home ownership comprises such a significant part of household wealth means that there is considerable merit in transition arrangements that allow for an orderly progression over time, at a pace controlled by home owners themselves.

However, a potential disadvantage of the gradual transition arrangements for state governments is the shortfall in their revenue stream through the transition period. The more gradual the transition to a broad based land tax, the greater the shortfall in tax revenue to a state government in the

interim. Given the importance of stamp duty as a source of revenue for state governments, it would be unreasonable to expect them to simply forego such revenue.

In a Federation where taxation powers and service provision are shared across levels of government, the community expects our governments to act in concert on tax reform matters. Notions of separate 'Commonwealth taxes' or 'State taxes' that are their business alone to reform hold little sway, particularly when the majority of tax revenues go to the Federal Government. There has to be negotiation and co-operation across governments when it comes to tax reform, and there is clearly a role for the Federal Government to assist in meeting the revenue shortfall that state governments would experience in a gradual transition to a broad based land tax. Emerging from the Tax Forum is a state tax reform plan to be developed by Treasurers Baird and Fraser through the Council of Australia Federation and, subject to agreement, to then be discussed by the Council of Australian Governments. Whilst the Federal Treasurer has indicated the Commonwealth is not in a position to fund state tax reform through increases to the GST or a state income tax, this should not prevent funding by the Commonwealth of time-limited, transitional funds. Such expenditure will do far more to improve housing affordability than the billions of dollars that have been spent on programs such as first home owner grants.

Moreover, this particular tax reform package offers both equity and efficiency gains; and this is uncommon. The reform package is one of the few opportunities where more efficient operation of housing and land markets can be achieved, while at the same time improving housing affordability for future generations of Australians, and in particular low income Australians. These are objectives consistent with Federal and State government policy objectives as expressed by their joint National Affordable Housing Agreement. Failure to act on these issues will make it more difficult for Australians to achieve the 'great Australian dream' of home ownership. The reform package is an opportunity for the current generation of Australians to bequeath to future generations a housing system with improved levels of affordability.

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