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Taxes on land rent

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Abstract

There is increased interest in land taxation in Australia and internationally, as reflected for example, in the Henry report on tax reform in 2010 and the UK Mirrlees Report in 2011. This interest stems from the immobility of land as a factor of production, which stands in contrast to other factors such as capital and labour. Logically, immobile factors can be taxed more heavily and with less efficiency cost than mobile ones. The interest in land taxation revisits the work of the 19th century reformer Henry George but in fact has antecedents going back to Ricardo and before. By making land more expensive to own, we can (somewhat paradoxically) make it cheaper to buy. At the extreme a 100 per cent tax on land rent reduces the capital value to the annual rental value; that is, to around 3-5 per cent of the untaxed value. A 5 per cent tax reduces the capital value of land by half, and a 1 per cent tax reduces it by 17 per cent. However the lump-sum nature of land taxes – and their high visibility to taxpayers - makes them politically very difficult to raise. The theoretical revenue available, which is one-third to one half of all Commonwealth tax revenue, may be practically unavailable.

Keywords: Land tax, tax reform, tax revenue, stamp duty, local rates, Henry review, Mirrlees report, efficiency

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1. Introduction

A tax on unimproved property values was originally introduced in Australia as a result of the strong political interest in Henry George's ideas, and this influence persists to the present day in state taxes on land value and in the local rate, both of which generally fall on the site (unimproved) value of land as advocated by George. [1] His most famous work, *Progress and Poverty* published in 1879, is a treatise on inequality, the cyclical nature of industrial economies, and the use of the land value tax as a remedy.

George argued that land gains value as a result of collective activities and the general improvement in industry and well-being, and the benefit of such gains should therefore not accrue to individual landholders but instead be taxed away. There are shades of this argument in current suggestions for 'value capture' arising from major infrastructure spending like rail projects.[2] Note that if land rent were fully taxed value capture would be automatic. In George's view land tax was the only tax necessary and appropriate to fund the activities of government, as all other taxes had harmful side-effects – hence his advocacy of the 'single tax'. In modern economies George's single tax would not finance the total activities of governments, as I examine below.

George's ideas might appear radical or even utopian. However they can help inform our current views on land tax reform.

George was really only taking the ideas of Ricardo on land rent to their logical conclusion. Ricardo[3] pointed out that as cultivation was taken to the margins that were economically viable, all production on non-marginal land produced a surplus (above the cost of production) which accrued to land-owners.[4] Ricardo's insight about agricultural land is mirrored in modern big cities, where nearness to the city

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[1] There exist still societies dedicated to spreading the word on land taxation in the Georgeist tradition. See for example http://www.hgfa.org.au/, http://www.henrygeorge.org/

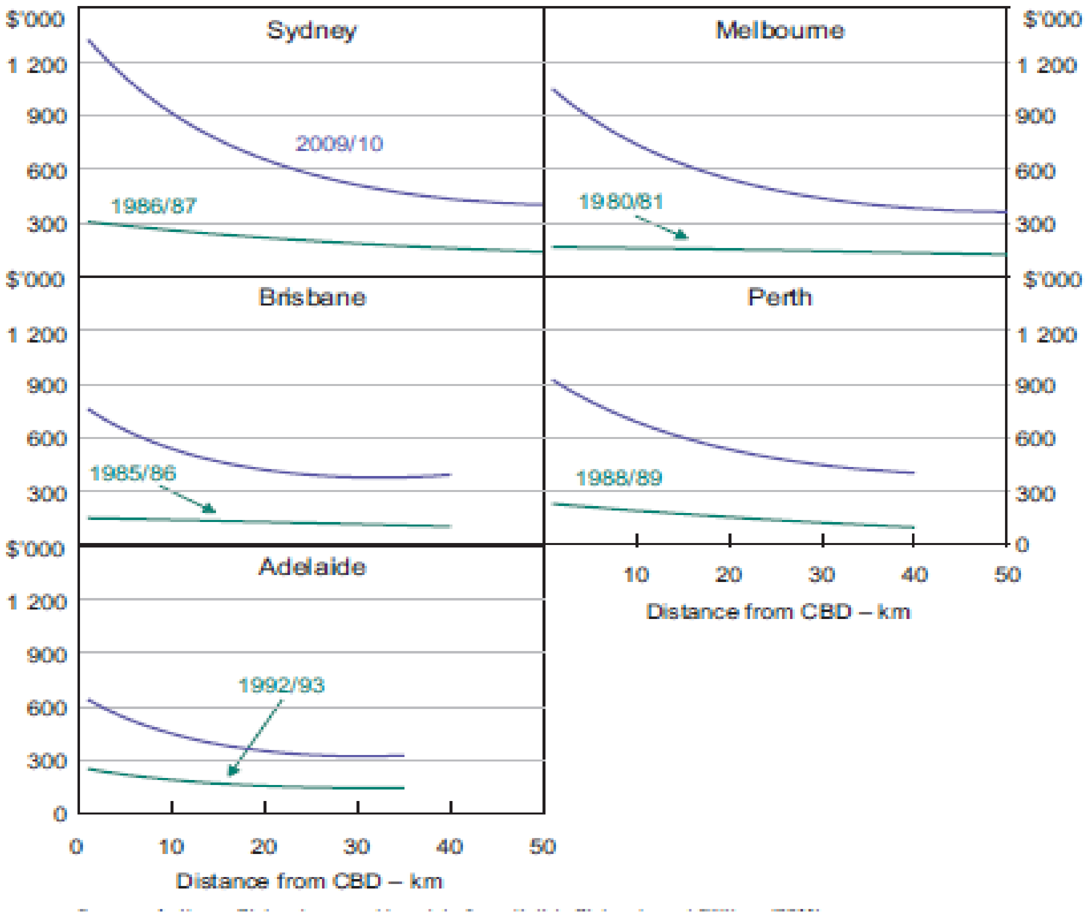
[2] 'Value capture refers to an array of measures that raise funds by taxing private beneficiaries—landowners—who are impacted upon by their proximity or access to infrastructure…Tax increment financing (TIF) is another value capture mechanism…TIF:...uses the expected increase in property tax revenue as security to finance the infrastructure. This involves hypothecating a portion of future revenue from property taxes to underwrite loans and/or bonds that finance a project. The hypothecation usually ends after a fixed period, such as 25 years.'
http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Scrutiny_of_Government_Budget_Measures/Budget_Measures/Second%20Interim%20Report/c05

[3] Ricardo (1817). Adam Smith and Ricardo were advocates of land rent taxation.

[4] See McLaren (2014, pp. 4-8) for a discussion of the notion of land rent

centre is being increasingly valued and rewarded (Figure 1). So urban rent has taken over from agricultural rent as the main source of rent, but the total rent does not appear to have diminished over time (Dwyer 2003, p. 37).

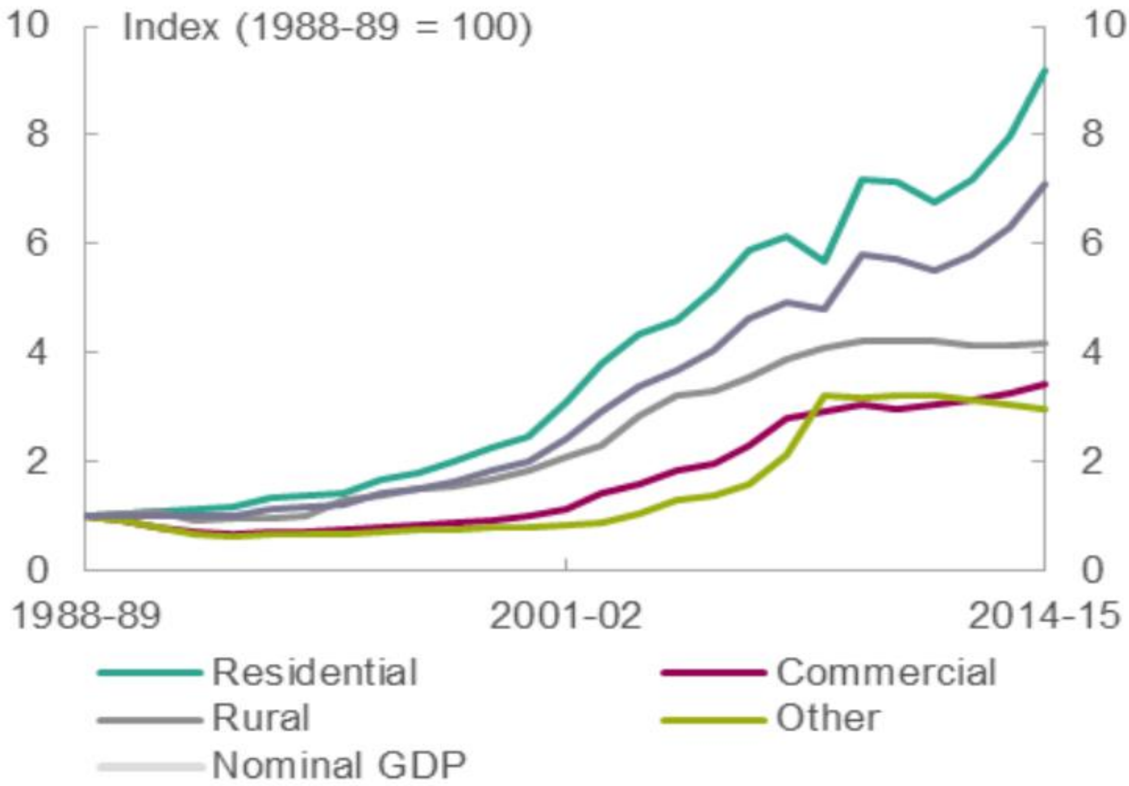
Figure 1: Real house prices by distance to the CBD (2009/10 dollars)



Source: Yates (2011 Figure 5 p 273)

Aggregate land values in Australia are rising rapidly as shown in Figure 2. This is particularly so for residential property values, which have outstripped GDP growth by a factor of over 2. However, the increase in total land rent has been less than the rise in aggregate land value, as capitalisation rates are falling as rental yields fall. Falling capitalisation rates are a corollary of the very low official interest rates now prevailing.

Figure 2: Growth in land values since 1988-89, index numbers, by type of land



Source: BCA (2016 Figure 18 p 67)

A uniform land tax is one of the least economically distorting of all taxes, with estimates of marginal excess burden (MEB = economic cost) just above zero. This compares with a MEB for stamp duty of around 80 per cent (Daley and Coates 2015, Figure 8 p. 12). On the face of it, this is an argument for maximising the land tax contribution to revenue while reducing or abolishing other distorting taxes.

However we find that there are difficulties in pushing this argument to its logical (Georgeist) conclusion, which is to expropriate almost the entire amount of land rent via the land tax. Indeed, there are difficulties in even taking the first step, which is a low proportional tax on all land including residential land, which could subsume council rates. In economic terms the land tax is a sort of lump sum wealth tax (paid in instalments) which is the reason it is efficient; it is also the reason it raises issues of horizontal equity as it is phased in.

Unfortunately the Georgeist remedy of a penal tax on land rent (sufficient to tax all the rental value) while having attractive attributes as a tax, would result in an effective once-off levy on the current land wealth of property owners as land values would fall. This means that any such tax could involve difficult issues of compensation and also equity, vis-à-vis holders of assets in other forms. If land owners are fully compensated for such a tax, there might be little net revenue from it. Alternatively it needs to be phased in very gradually – e.g., over 50 years. It is hard to conceive of such a policy in a democracy as opposition parties would campaign on promises to cease the transition. The costs of the land tax are obvious; the costs of the distorting taxes it might replace far less to.

There are other issues, as well. Property also gains value as a result of landholder's expenditure on infrastructure and the like – for example in the conversion of land at the city margin to residential subdivision. If rents were fully taxed, this would work against development of new subdivisions. One option is to have a land tax holiday of, say, 10 years for new subdivisions.

A broader tax on property values inclusive of improvements (as utilised in the United States, for example, to fund local schools and services), is an alternative to land rent taxation. Another alternative is a tax on all wealth whether in the form of real estate or otherwise. All these taxes have advantages and disadvantages. A land rent tax could usefully co-exist with an annual wealth tax, but the property tax, despite its superficial attraction, appears to have limited economic rationale unless it were specifically designed as a means of taxing imputed rents. In this role it becomes a (theoretically desirable) part of the income tax.

However a property tax is not a full substitute for a tax on imputed rents. This would require a base of either a percentage of the property value less interest costs, or a percentage of the owners' equity. Repairs and maintenance also need recognition, although the simplest way is to lower the relevant percentages to reflect expected net-of-cost returns.

One advantage of heavier land taxation would be, by reducing site values, to reduce the up-front costs of those seeking to buy a home. This is becoming a big issue for first-time home buyers who are increasingly being frozen out of the property market as cashed-up (and often negatively geared) investors move in. First home buyers recently constituted only 13 per cent of buyers, a near-historic low (Harper 2013)[5]. Land taxation should not be seen as a panacea in terms of access to home ownership, but by reducing the deposit gap it might reduce barriers to entry.

Land taxes could help alleviate the revenue squeeze being faced by state governments (as Commonwealth education and hospital funding, for example, is tightened) as well as the vertical fiscal imbalance which is endemic in the Australian federation. Daley and Coates (2015) note that land values tend to rise at least as fast as GDP and, over the past 25 years, much faster (p. 6). This is a natural consequence of the sort of location premia noted in Figure 1. Also, revenue from land taxes tends to be a lot less volatile than stamp duty receipts.

Daley and Coates (2015) advocate a 0.2 per cent land tax using the council rate base or a 0.1 per cent property tax, either of which would raise around $7 billion per annum for state and territory governments and finance abolition of some current distortionary taxes on land (p. 4). These suggested rates are so low that the theoretical impact on land values can be disregarded. I discuss the property tax further below.

2. Current taxes on land

There are three main taxes on land values at the moment: state conveyance duties, state land taxes and local rates. The Commonwealth collected land tax from 1910 to 1952 but vacated the field; however there is no constitutional obstacle to it re-entering it (McLaren 2014, p. 8).

2.1. Stamp duties

Stamp duties raise $16 billion for State governments[6] and this impost is rising rapidly with the general inflation of house values. Total taxes on property - $26b - represented 38% of state government revenues ($69b) in 2013-14 (ABS, 2015).

In general stamp (conveyance) duties are on a rising scale as the property value increases. Often there are discounts for first home buyers. Stamp duties are a relatively volatile revenue source as they depend on the strength of the property market in each state (Treasury 2010c, p. 254). They have high economic costs as

[5] There is some debate about whether these figures are all that accurate.

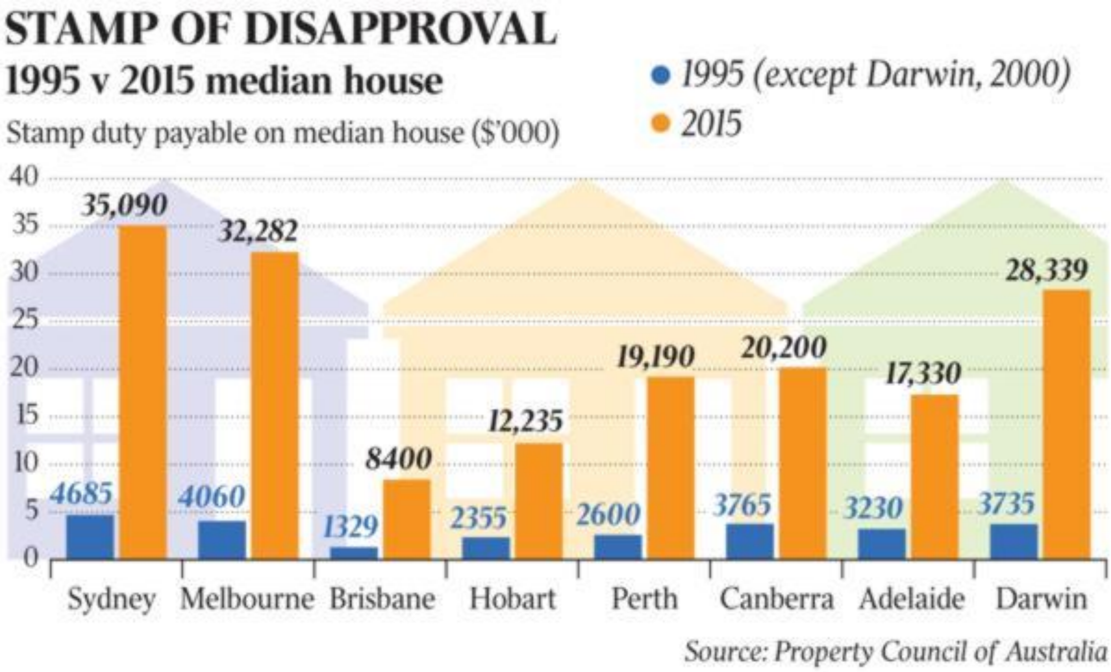
[6] In 2007-08 stamp duties raised $14.4 billion for State governments (Treasury 2010b, p. 251). The more recent figure is reported in Balogh (2015)

they discourage people from moving and business from making appropriate investment decisions. They are highly inequitable in their excessive burden on those who have to move often. The Henry Review called for stamp duties to be abolished and for heavier reliance on land taxes (Treasury 2010c, pp. 263-4)[7].

The stamp duty payable on a median value house in 2015 was $35,090 in NSW and $32,282 in Victoria. These figures are lower for other states and territories but are everywhere rising rapidly – Table 1 and Figure 3. There are some concessions for first home buyers but these may have the effect of raising prices (Freebairn et al 2015, p. 17).

Stamp duty is a volatile source of revenue and inferior to land tax in terms of stability and predictability. It has been rising markedly – Figure 3.

Figure 3: Stamp duty bracket creep, 1995 vs 2015 median house



Source: Property Council of Australia (2015), reproduced in Balogh (2015)

Removing stamp duties financed by raising land taxes would involve an approximate doubling of land taxes. There is unanimity among economists that this would produce a net benefit to society because of reduced efficiency costs. There is also unanimity that land taxes should be reformed to be more uniform (Freebairn et al 2015, p. 21), with flat rate structures.

[7] For detailed Henry recommendations see Appendix 1

2.2. Land tax

Land tax is levied by all States except the Northern Territory on the 'unimproved' or 'site' value of land at progressive rates including a base exemption. A range of land uses are exempt, including primary production, owner-occupied residential, child care and aged care. Land tax raised $4.3 billion in 2007-08 (Treasury 2010c, p. 260); I currently estimate up to $10 billion. This is small relative to total land rent which I later estimate at up to $200 billion. The exemption of owner-occupied housing removes about 60 per cent of land by value (and 75 per cent of residential land) from the tax base. Primary production accounts for another 10 per cent.

The average land tax rate was 3.25 per cent of the property value in 2005; the highest rate is 7 per cent in NSW for residential properties valued above $3 million.[8]

Freebairn et al (2015) suggest that 'together, the base exemption and the progressive rate schedule have turned the state land tax into an inefficient tax, and the exemption adds to the regressive redistribution of the tax burden' (p. 16). With such rate structures, it is hard to be sure if or by how much land taxes impact property values; they may well act as imposts on capital income from certain landholdings.

Henry noted that the higher tax on aggregate holdings discouraged large-scale investment in land; this may contribute to the investment housing market being (inappropriately) dominated by small investors (Treasury 2010c, p. 261). Because owner occupied housing is exempt, land tax is not fully shifted back to land-owners; rather, 'the burden of land tax on residential investment properties is probably borne by renters through higher rents' (Treasury 2010c, p. 262).

In NSW the threshold is $412,000 with a rate being $100 plus 1.6 per cent above this up to the premium threshold of $2,519,000 above which a rate of 2 per cent applies[9]. Other states have similar regimes but there are differences as to rates and thresholds. For example the ACT has a relatively low threshold for investment property. Figure 4, excerpted from the Henry Report, summarises the different state regimes.

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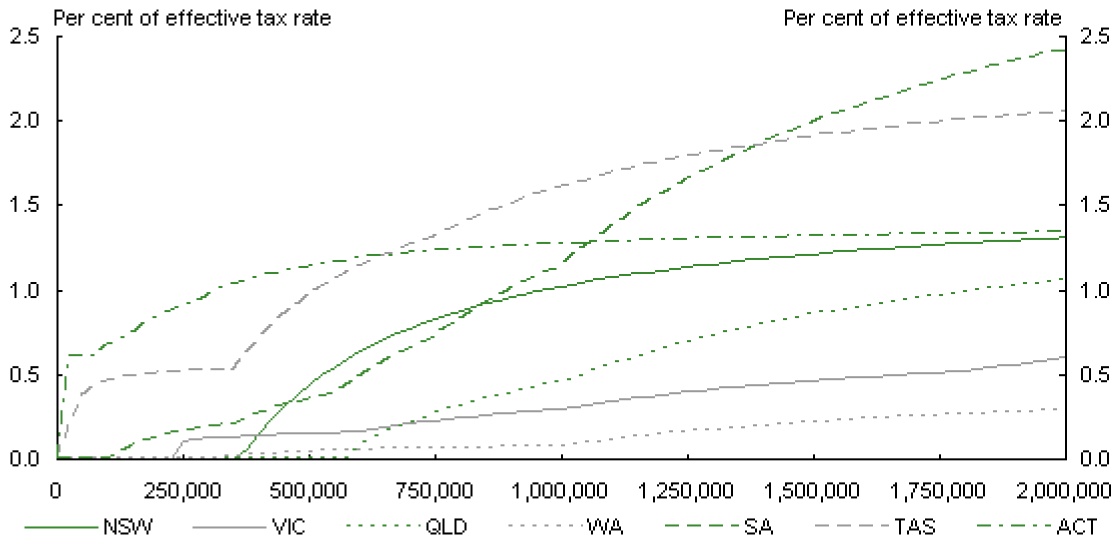
[8] Owner-occupied properties are exempt

[9] http://www.osr.nsw.gov.au/taxes/land/rate, accessed June 2016

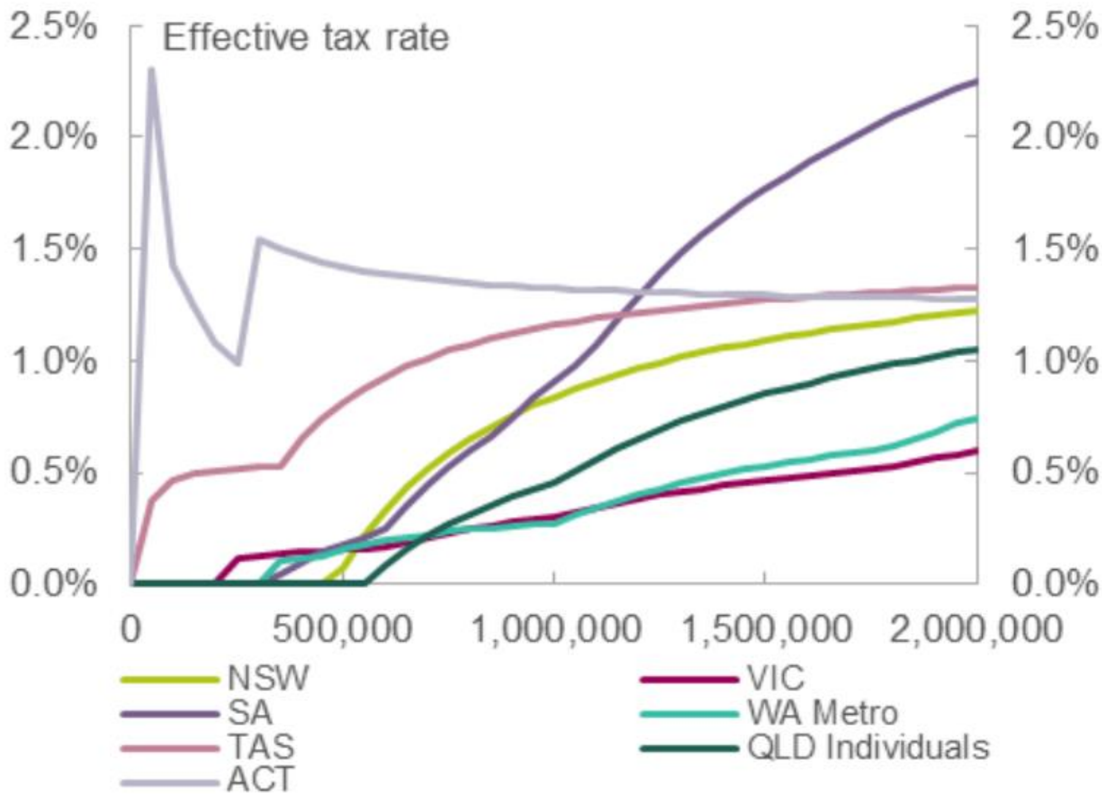
Figure 4: Thresholds and average rates of land tax



Note: Land tax in the ACT is determined on a value per property, not on aggregate holding. Source: Treasury (2010b, p. 260).

This graph has recently been updated by the BCA (Figure 5).

Figure 5: Effective land tax rate by land value and State



Source: BCA (2016 Figure 18 p 67).

2.3. Local rates

Council rates raised $10.2 billion in 2007-08 (Treasury 2010c, p. 257). Rates represent some 37 per cent of total local government revenue (McLaren 2014, p. 1).

In general they are based on unimproved land values (UCVs) or site values but in some states on the full property value. Western Australia uses capital improved value. A mix of improved and unimproved values is used by local councils in Victoria, South Australia and Tasmania. All other states use unimproved values. Improvements, nationwide, are about the same value as unimproved land (Freebairn et al 2015, p. 16).

There is often a flat rate component to the rate as well as the percentage value tax. Henry assessed local rates to be relatively efficient, simple and fair taxes, but with reservations about differential rates based on the zoning of land and the inclusion of improvements in the tax base in some jurisdictions (Treasury 2010c p. 258). Henry felt that 'land value taxes are a good base for local governments as there is a direct connection between the level of services delivered and the residents who benefit' (Treasury 2010c p. 259).

Generally, local rates are at lower percentages of value than land taxes but rates vary between local council areas, with rich (high value) areas being able to charge a lower percentage of land value in order to finance their activities. This is mitigated, but incompletely, by the provision of Financial Assistance Grants to all councils.[10] For example northern suburb councils like Hunters Hill in Sydney (a high value area) would have a lower rate, expressed as a percentage, than would most councils in western Sydney.

In addition, local councils have a range of fixed charges; e.g. for water and sewage. In the ACT the local rate varies between 0.23 and 0.43 per cent depending on the value of the property in addition to a fixed charge of $626; there are much higher rates for commercial property. General rates are rising over time to cover the cost of abolishing conveyancing duties in the ACT; this is a reform consistent with the recommendations of the Henry report (see next section), but not necessarily a popular one.

[10] Henry considers this issue in Section G3 Local government (Treasury, 2010c)

One option is to centralise the administration and collection of existing property taxes (rates) and, ideally, abolish the fixed component of rates. If local government were financed by a state or Australia-wide land tax the difference in the (percentage) rate between rich and poor areas would disappear; on the face of it this reform would be quite redistributive. However, there might be an issue in so far as it reduces the autonomy of local councils in terms of their ability to balance the desires of residents for reduced taxation versus better services.[11] On balance, however, I see this as a desirable direction for reform.

3. Land taxes can dramatically impact property prices

Even a 1 per cent land tax can in theory reduce property prices by 20-30 per cent. This is because the expected yield on land, like that on most investments, is in the order of 3-5 per cent real per annum. (I here use 5 per cent, I discuss this rate later.) A 1 per cent land tax reduces the net yield to approximately 4 per cent and so has a near 20 per cent negative impact on the land value (in fact the theoretical impact is 17 per cent - Treasury (2010b, p. 270) - for reasons explained below). Because of this, any changes to increase the taxation of land would need to be phased in very gradually.[12] Obviously the phase in is easier when land values are rising strongly.

I use the terms 'approximately' and 'near' because there is a mathematical relationship between the property tax rate and the degree to which economic rent is expropriated. Basically the degree of expropriation approaches 100 per cent gradually (but never quite reaches it) as the tax rate approaches 100 per cent, because higher tax rates feed back into reduced land value and reduce the tax take.

For example, suppose the average land rent is 5 per cent of the capital value and we levy a 5 per cent land tax aiming to tax all rent. If the capital value in the absence of tax is $100 the initial tax is $5 per annum. But this reduces the land value. In the following year the land value falls to $50; the tax becomes $2.50 and the tax ends up taking half the land rent. If we double the tax to 10 per cent the land value falls and

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[11] The taxing authority, whether federal or state, would allocate tax revenues to local councils based primarily on their population (per capital grants) and also on their special needs. Rural areas in particular have high costs in providing services.

[12] The alternative is to compensate land owners. In theory, the compensation costs are the same as the net present values of the expected future revenues, which suggests that compensation is not a good strategy. But it might make some sense if the government's costs of funds (the bond rate) are less than the time discount rate of taxpayers.

so on with additional increments so the tax take gradually approaches \$5. When the tax rate is 100 per cent, the land value is just under \$5 and the tax take is just under \$5. In practice these price and revenue adjustments are anticipated by the market as the tax is phased in, so we do not observe large swings in land value, merely a diminution over time depending on the tax rate.

Note that the relationship between the tax rate and the tax yield is parabolic; we get half the potential yield with a tax rate of 5 per cent and diminishing returns thereafter, so that we do not get (almost) all the potential yield until the tax rate reaches 100 per cent. Even if the tax rate were 1000 per cent the revenue would be only marginally greater than at 100 per cent, because of feedback from a lower property value. But even at much lower rates the government takes on a de facto role of landlord (or at least part owner) as distinct from just a tax collector.

I note that at a 5 per cent rate there would be a general halving of land values relative to an untaxed regime (but not quite half, as there would be some offset from the fact that rents are partially taxed already and I assume these pre-existent taxes would be folded into any new regime). It follows that increased or new land rent tax is a sort of lump sum tax on existing property owners; in effect the revenue authority becomes a part-owner of the land. Its efficiency properties flow from this but so too do the political difficulties. In particular it would be hard to collect the land tax annually; the government may need to charge tax (say) fortnightly, just as if it were charging rent.

Not all land rent is economic rent in the pure sense. Some part of land values incorporates the cost of moving land out of rural or similar use which, with modern infrastructure requirements, is a very expensive proposition. There are similar difficulties in assessing improved and unimproved values in rural land. One approach, used now, is simply not to fully tax rents. Another way to handle the cost of infrastructure is to have specific provisions for tax holidays for newly released (sub-divided) land; e.g. the first 10 years could be tax-free or nearly so. Agricultural improvements could be treated similarly.

If this were done there is no *economic* reason for not having land tax rates as high as 100 per cent. Because of the impact of land prices, this would need to be phased in over a very long period of time; perhaps as long as 50-100 years. Over time this would become a very efficient source of government tax revenue. The big problem is that opposition political parties would have an incentive to stymie this phase-in at any stage by promising to halt the process, and the temptation to do this might be almost irresistible. The other big problem is the equity issue involved in levying what amounts to a lump sum tax on landowners but not on other wealth holders, an objection which is eased but not really overcome by the phasing-in suggestion.

Land tax and rates revenue has in some studies been grouped in with other taxes on land ownership to suggest that this sector in fact pays its fair share of taxation. However this procedure is inappropriate if in fact land tax falls on site values and its incidence is therefore on the original owner at the time the tax was introduced (or raised). But as I noted earlier, assessing incidence is difficult if only some landowners are subject to taxation or if there is a sliding rate scale, as is the general case with state land tax. Land prices will reflect the average of the tax regimes prevailing, not the specific taxes faced by the landowner.

4. How much revenue from land rent taxation?

Suppose we set out over time to expropriate the full amount of land rent. The gross value of land in Australia is over $4.5 trillion.[13] If the land yield is 5 per cent this is $225 billion per annum; 12 per cent of GDP. This compares with total commonwealth tax receipts of $405 billion (25 per cent of GDP), so land tax could theoretically furnish nearly half of federal government revenues. I note, however, that some of the revenue would need to be returned to state and local government as the 100 per cent land tax appropriates a major revenue source for these levels of government.

Dwyer (2003) estimates that land value tax could replace both the personal income tax and company tax. These taxes raised $250 billion in 2013-14,[14] or around 60% of the total $435 billion raised that year from taxation – 27 Per cent of GDP. So Dwyer's estimate is that land rent is around 16 per cent of GDP (p.35).

Yates (2011), for 2005-06, estimates that the owner-occupied exemption from land tax costs an aggregate $3.5 billion (p. 287). This is only a fraction of my theoretical

[13] Lowe 2015 notes that land represents 34 per cent of our national assets of $12.5 trillion – i.e., $4.25 trillion. I round up to $4.5 trillion to conservatively reflect the increase since end-June 2014.
[14] http://www.abs.gov.au/ausstats/abs@.nsf/mf/5506.0

revenue estimate. However this figure is affected by the very large exemption for low-valued property under the normal land tax rate structure. The Grattan Institute (Daley and Coates 2015, p. 5) suggest that a property levy using the council rate base could raise about $7 billion a year at a .02% rate. As BCA (2016) note, this flat rate could fund the abolition of all existing land taxes (p. 66). Daley and Coates (2015, p. 5) also suggest that a property tax on improved values could raise $7 billion at a 0.01 per cent rate.[15] This is consistent with land representing about half of total property values.

On any of these estimates, land rent is a lot of money even if we net out current taxes on property of $26 billion; a net $160-200 billion addition if all land rent could be taxed away. There is however some impact in terms of reduced Commonwealth revenues, as land tax is a deductible expense against the income tax.

Henry George sought to expropriate the full amount of land rent. Inquiries such as the Henry Review and the Mirrlees Review have been less ambitious. However there is no *economic* reason why they should so be, as the arguments for heavier reliance on land taxation appear to suggest that this tax base should be exploited to the maximum extent possible. But the political economy case is, as I have noted, more complicated.

4.1. Can we impute a 5 per cent real return?

I am troubled by Dwyer's (2003) inclusion of smoothed capital gains on land which may not necessarily appear to be really part of land 'rent' (p. 36). Presumably under land rent taxation, land capital gains would almost cease. The 5 per cent figure I use is consistent with observed real yields from property investment of over 7 per cent per annum historically (Kohler and van der Merwe 2015, p. 22). However this includes capital gains; average net housing rental yields are now around 3 per cent[16].

According to the latest Russell Investments Long-term Investing Report, comparing the total returns over 20 years- after fees and including income payments – 'an investment in residential property returned a 9.9 per cent gain, beating both

[15] Daley and Coates (2015, Figure 2 p. 5) state that all Australian land was valued at $4.3 trillion in June 2014 and all other improvements are worth $4 trillion.

[16] http://www.abc.net.au/news/2015-03-11/janda-no-evidence-of-a-property-bubble-not-quite/6304244

Australian shares at 8.7 per cent and global shares at 8.0 per cent.'[17] Netting out inflation at 2.5 per cent gives us real returns of 7.4 per cent in property and 6.2 per cent in shares. Most of these gains flow from land, as buildings depreciate (as recognised in tax law[18]).

I conclude that my 5 percent figure was – in the past - reasonable for calculating land rent, but perhaps not with a high degree of confidence. With current rental yields around 3 per cent (net of costs) it might be more appropriate to use this figure and this lowers the estimated revenue from taxing all land rent to $135 billion or one-third of current Commonwealth tax receipts. While my calculations use the higher figure this caveat should be borne in mind.

5. Potential efficiency gain from comprehensive land taxation

Kerin and Findlay (2015, p. 29) and Treasury (Cao et al 2015, p. 43) put the marginal excess burden from land tax as being somewhere between plus 9 and minus 10 per cent – broadly we can say zero. Compare that to company tax which raises $70 billion but has a marginal excess burden of 50 per cent on Treasury estimates. A sufficiently robust land tax could finance the abolition of company income tax and if we assume that the average excess burden is 50% of the marginal burden[19] then this tax mix change would generate efficiency benefits in the economy of $15 billion annually.

In fact, on the Treasury figures[20], the most potent tax mix change is to first abolish stamp duty, costing $13 billion with efficiency savings of $10 billion. We can raise sufficient to also abolish company income tax as well as other distorting taxes. Of course efficiency gain estimates are highly contentious[21], but the point is pretty clear, that there are big potential economic gains from land tax reform.

[17] See Russel report, http://www.asx.com.au/documents/resources/russell-asx-long-term-investing-report-2015.pdf

[18] New structures can be depreciated at 2.5 per cent per annum.

[19] Kerin and Findlay (2015) suggest an average excess burden of 17% and a marginal excess burden of 29% in aggregate. Assuming we can apply these estimates to the company tax the saved excess burden is 17/29 = 58.6% of the MEB. We here use a lower figure of 50%.

[20] These figures appear to differ from those in a Treasury Working paper – see Cao et al 2015. This paper estimates the MEB from the company tax to be 50%. Other studies have suggested even lesser gains; this is a disputed area.

[21] Treasury find that the MEB from stamp duty is 72 per cent – clearly a much lower estimate than Kerin and Findlay 2015.

Daley and Coates (2015) argue that abolishing stamp duties in all states and replacing them with a broad based land tax could add $9 billion a year to GDP (p. 11).

John Hewson argues:

> *'In terms of inefficiency, the marginal excess burden analysis emphasises that our system overall is much more inefficient than others, with the most inefficient taxes currently imposed by the States, especially gambling and insurance taxes, stamp duties, motor vehicle registrations and payroll tax. Somewhat ironically, the States/local governments have access to one of the most efficient taxes, namely land tax, but they have generally managed its use poorly (Hewson 2015).*

Stewart et al (2015) make a similar comment:

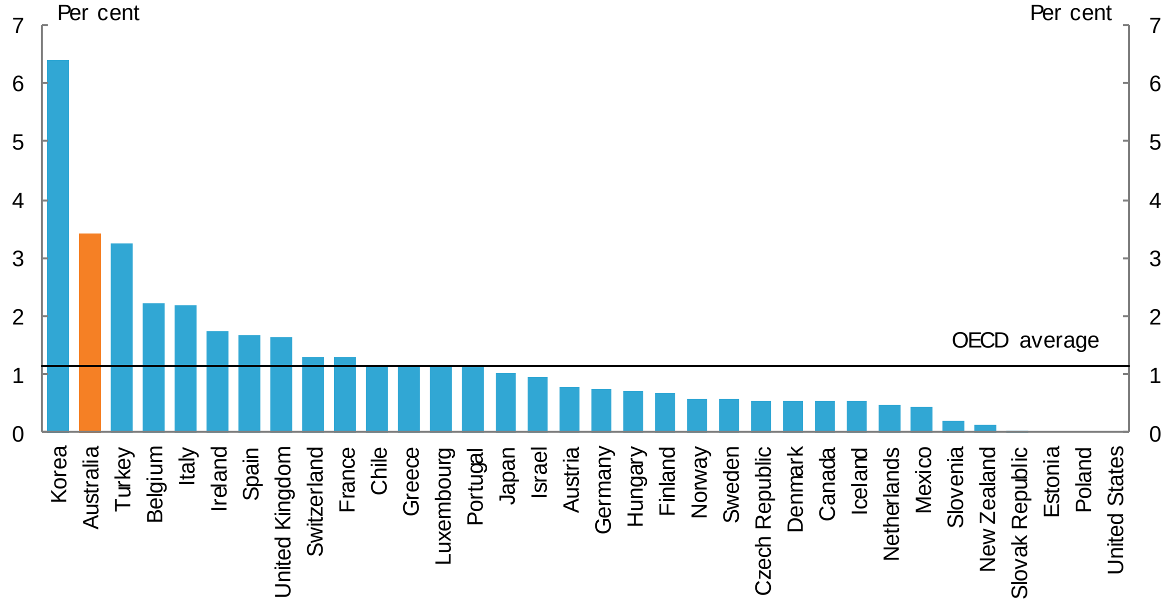
> *'State and Territory property taxes are designed less efficiently than they could be. Land taxes and council rates are the most efficient taxes, according to economic models, but the base warrants reform.' (p. 71)*

6. Land tax in various inquiries

6.1. Tax Discussion Paper (Treasury 2015)

Treasury notes that Australia's reliance on stamp duties gives the revenue source a high importance relative to most OECD countries – Figure 6.

Figure 6: Taxes on financial and capital transactions as a percentage of total taxation, OECD countries, 2012.



Note: Taxes on financial and capital transactions include taxes on the issue, transfer, purchase and sale of securities, taxes on cheques, and taxes levied on specific legal transactions such as validation of contracts and the sale of immovable property. Source: OECD (2014), reproduced in Treasury (2015 Chart 9)

Treasury (2015, p. 145) argue that:

> *"Stamp duties are some of the most inefficient taxes levied in Australia. Unlike broad-based taxes on consumption or payrolls, they are levied selectively on activities or products and are taxed on the total transaction value, rather than the 'value added' component. Such transaction taxes are more likely to discourage turnover of taxed goods, as taxpayers attempt to reduce or avoid paying the tax...*
>
> *…Stamp duties also impact on consumers by increasing the cost of buying and selling houses. As house prices increase over time, unadjusted progressive tax rates also increase the tax burden associated with stamp duty. For example, the burden of stamp duty on a median-priced house in Melbourne has almost doubled over the past 20 years — from 2.67 per cent of the sale price in 1988 to 5.16 per cent in 2011. (Real Estate Institute of Victoria 2011)"*

Stamp duties clearly add to transaction costs and contribute to Australia's high (by international standards) costs of moving (Andrews et al 2011, p. 61). These costs can discourage householders from moving to housing that best suits their needs and can be an important barrier to labour mobility (Van Ommeren and Van Leuvensteijn 2005, p. 695). A number of reviews have found that, by dampening the number of house sales, stamp duties can also add to commuting times (Independent Economics 2014 and Treasury 2010b). Stamp duty can also be inequitable — those who move more frequently face higher costs than those who move less frequently, even if their circumstances are otherwise similar.

6.2. Land tax in the Henry report

> *'Well-structured taxes on land and natural resources are a highly efficient means of raising revenue. Existing taxes on land and resources fall short of this ideal, and should be reformed so they are a more effective means of raising revenue.' (Treasury 2010a, p. 47)*
>
> *'Broadening the base of land tax would provide a reliable and stable source of revenue to State governments.' (Treasury 2010b, p. 247)*

Henry wished for a new system of land taxation to completely replace inefficient land transfer taxes. It would be broad-based:

> *'The structure of land taxes could be improved by broadening the land tax base to eventually include all land. Land tax rates should be based on the value of a given property, so that the tax does not discriminate between different owners or uses of land.' (Treasury 2010a, p. 48)*

However Henry could imagine the difficulties in extending this scheme to agricultural land – notwithstanding that much the same arguments apply. Hence:

> *'A tax-free threshold based on the per-square-metre value of the land could be set such that there would be no tax liability on most agricultural and other low-value land. Higher-value land could be taxed at differentiated rates based on the per-square-metre value of the land.' (Treasury 2010c, p. 265)*

This was preferable to using zoning as a proxy for economic rent. For asset rich but cash-poor owners there would be provision for tax to be deferred with a debt attaching to the property (ibid, pp.265-266).

Henry made no detailed recommendations about the rate structure that should apply under a new broad-based land tax (for the Henry recommendations, see Appendix 1). Nor did the review make recommendations touching on local rates. Henry noted a recent OECD Report which suggested that a 1 per cent switch to land or property tax away from income tax would improve long-run GDP per capital by 2.5 percentage points (Johansson et al 2009). The economic efficiency discussion, above, suggests that even greater gains are achievable by abolishing other more distorting taxes like stamp duties.

6.3. Land tax and the Mirrlees report

The Mirrlees Report was commissioned by the UK Institute for Fiscal Studies in 2010 as a successor to the 1978 Meade Report. Both reports have been (or are likely to be) quite influential among tax theorists.

Mirrlees argued:

> *'The supply of property, and especially land, is not very responsive to its price, which means that it can be taxed without significantly distorting people's behaviour' (Mirrlees 2011, p. 368).'*

Further:

> *'Owners of land on the day such a tax is announced would suffer a windfall loss as the value of their asset was reduced. But this windfall loss is the only effect of the tax: the incentive to buy, develop, or use land would not change.' (ibid, p. 371)*

However Mirrlees, unlike Henry, thought there were also arguments for taxing improvements: 'there are in fact good reasons for taxing housing as well as the land on which it stands' (ibid, p. 377) - but not business premises. In the UK business are taxed on the estimated rental value of their property, and Mirrlees thought this should cease as it adds to business costs, to be replaced by a land value tax (LVT) at a rate of around 4 per cent; ‘Ideally, such a tax would also replace stamp duty land tax on business properties’. (ibid, p. 377)

As for housing, there would be no land tax but its consumption value should be taxed as a VAT equivalent (the UK has a VAT rate of 17.5 per cent) with a housing services tax, called HST, of 0.6 per cent. This is a form of property tax. It should be noted however that housing inputs are not taxed under the UK VAT unlike in Australia; conceptually one or the other (housing inputs or services) should be taxed but not both. The HST would replace local government (council) tax which is loosely based on property values including improvements.

Mirrlees thought the biggest practical obstacle to the implementation of a land value tax is that it would require the valuation of land separate from any structure erected on it. This is not an issue in Australia as we already record and tax land valuations. Nor did Mirrlees see this obstacle as major, drawing in part on the Australian example.

The general tax treatment of housing proposed by Mirrlees is meant to be consistent with the *rate of return allowance* proposed for taxing all forms of capital income (ibid, p. 400). So there would be some taxation of housing capital gains and imputed rent, but not to the extent indicated by the comprehensive income tax as the first X per cent of total gains each year would be exempt, where X is close to the nominal government bond rate.

7. Transitional mechanisms

Because land tax can have such a big impact on land values, it is essential that the transition to any new system be properly managed and that it proceeds relatively slowly. Henry payed close attention to such issues.[22]

This of course makes change politically difficult, as an opposition party can promise to repeal the new system at a time when, initially, the costs of doing so are not large.

In the ACT the government has initiated a Henry-like reform of getting rid of stamp duties over a 20 year period, making up the revenue loss in the local rate. The ACT labor government was subject to a scare campaign over its introduction (‘your rates

[22] see Box C2-5 in Treasury (2010b p. 269)

will double'); the experience is not one likely to appeal to other governments contemplating similar reforms. Maybe only in the Labor-aligned ACT electorate could a government implement such a change and even in the ACT there is speculation that the Government may now (after almost 5 years of the transition) be watering down its commitment to this reform (for details, see Appendix 2).

7.1. Redistributional issues

There is one large caveat to the efficiency gain estimates presented earlier. That is, land tax amounts to a lump sum tax on existing land holders. Lump sum taxes are traditionally the most efficient taxes, having deadweight cost of (almost) nil. But their inherent nature is to confiscate part of the value of existing assets and it is not clear why this confiscation should be restricted to land owners. For example, if lump sum taxes were politically feasible we could have a lump sum tax on all net worth – a capital levy – then invest the proceeds in say equities (or the Future Fund) and use the annual income from this revenue to abolish the sort of distorting taxes noted above.

Alternatively we could use the revenue to compensate land holders for the immediate imposition of the full land rent tax; in effect the government buys all the land and locks in an income stream in perpetuity. This sounds like a bizarre scheme, but it shows the importance of thinking about land tax changes in a holistic way. The lump sum nature of land taxes is the reason they are so difficult to reform and they also give rise to significant issues of equity as between various classes of asset owners.

Lump sum taxes sound ideal but can involve issue as to the transition from here to there. If land rents were to be fully expropriated by governments (100 per cent tax rate) the necessary transitional period could be as long as 50-100 years. Otherwise the change would amount to a selective capital levy on land-owners, particularly on land owners not presently subject to land tax. This would be both unfair and politically unsustainable. In effect the Government would nationalise land ownership and rent land back to the title holders. (I note that this was the original intention of the Canberra land lease system, but it was watered down and has become a de-facto freehold system.[23])

With a 50 year transition the required land tax rises would not, to be even over time, be in 2 per cent annual increments as that would front-end the land price impacts. If we restrict price impacts to 2 per cent per annum this would allow them to be absorbed in the annual price appreciation that could normally be expected, which historically is in the range of 3-4 per cent in real terms. For the first year price impact to be 2 per cent the initial land tax rate is a mere 0.1 per cent but this would rise exponentially over the transition period to finally reach 100 per cent in year 50.[24]

Governments are likely to move very slowly on the land tax rate (as suggested by Daley and Wood) and ratchet it up over time. The key first step is to make the land tax as broad as possible, and make the rate uniform.

8. Land tax versus property tax

In the UK and the US property taxes based on site valuation are less common; the more usual practice being to tax some measure of the improved valuation. At face value this might seem like a fairer system; however closer examination reveals that this is not necessarily so.

In the ACT there is a concern that as local rates rise (and conveyancing duties fall), more of the tax burden falls on landowners and proportionately less on owners of apartments (where typically the land component is much less). This concern makes a property tax superficially appealing, as both types of owner are seen as benefitting equally from the services which the revenues fund.

The issue here is that land tax does not impact on investment decisions; its impact is – at least in theory - fully absorbed in the land price and doesn't affect anything else. Tax on improvements impacts on decisions to make those improvements and is therefore not neutral except in the context of some over-arching tax on wealth such as an annual wealth tax.

[23] https://www.prosper.org.au/2008/01/16/canberra/
[24] Actually the time frame is longer than 50 years as the value lost in each year is a fraction of a diminishing total

Mirrlees' proposal for a UK housing services tax is a form of property tax, but it has a specific logic, as a means of taxing housing services equivalently to other taxable services under a VAT. It compensates for the non-taxation of housing inputs under the UK VAT. This is a logical tax in this context.

The property tax is in fact a partial wealth tax but it doesn't take into account the net property value, which is reduced by outstanding loans. There is a case for taxing wealth whether it is held in the form of property or any other form, and in fact property comprises about 55 per cent of all household wealth in Australia. But efficiency and horizontal equity demand that any such tax be of general application and be restricted to net worth, not the gross value of assets (Ingles 2016, p. 9).

If however it were decided to tax property imputed rents under a comprehensive income tax[25] then one option is to impute income based on the gross value of the property, with a deduction for interest costs on any mortgage (the other option is to impute income to the net value of property holding and disregard interest costs). But that is a whole other story. It does not constitute a general argument for taxing the value of real property. On the other hand relatively modest property taxes, like that suggested by the Grattan Institute, are not likely to have very great economic costs and are a viable alternative to a land tax at the low rates suggested by Daley and Coates (2015).

Note that the case for an annual wealth tax is quite independent of the case for taxing economic rents. The latter tax would reduce the base for a wealth tax, but the two taxes can co-exist quite happily. The land tax need not be rebated from the wealth tax, as no 'double taxation' arises. Note also that the need to tax housing capital gains is reduced under land tax proposals which reduce land values (and land value accretion), but the case for capital gains tax, like that for an annual wealth tax based on net worth, is really independent of the land tax situation. This contradicts the suggestion in McLaren (2014 pp. 11-13) that the land tax is a means of taxing unrealised housing capital gains. This is true only of the more draconian land tax options considered in this paper.

[25] The non-taxation of imputed asset income is considered a tax expenditure under an income tax base, but is not regularly estimated in the Treasury Tax Expenditure Statement. Only the capital gains exemption is normally included.

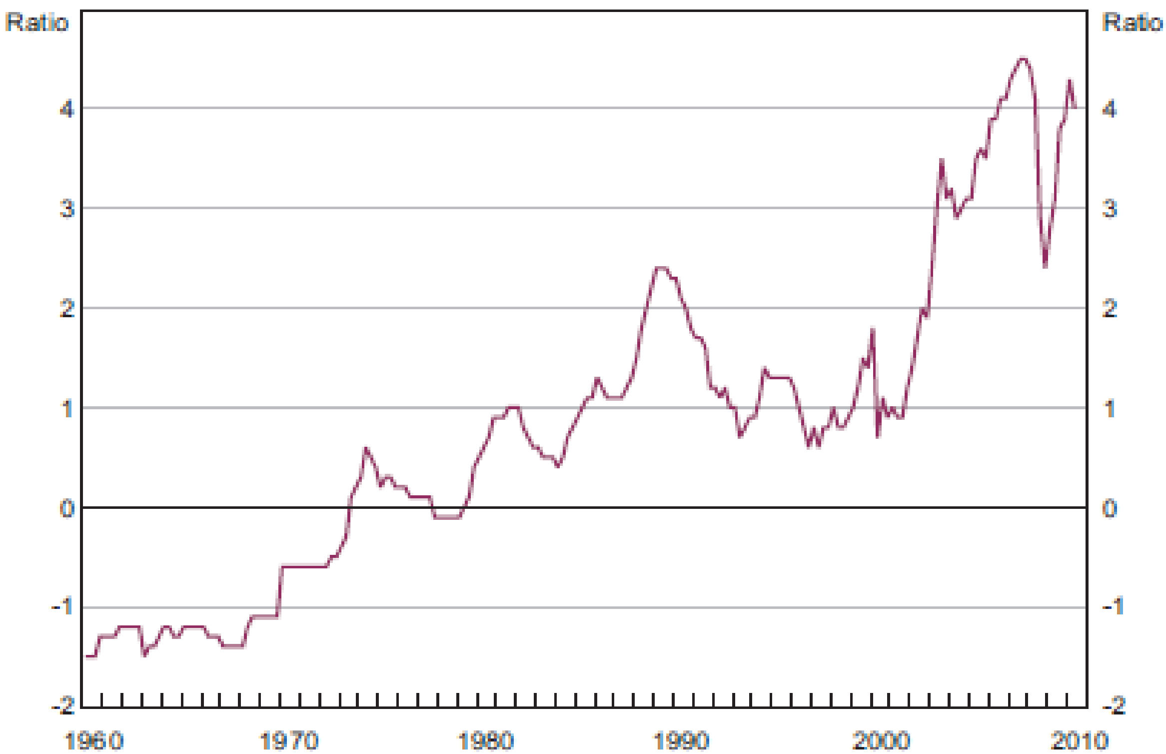
9. Does the land tax make home buying easier?

On the face of it the large reduction in land values that would flow from increased land taxation would make purchasing cheaper, and improve access for first home buyers. This is particularly so for properties (detached houses) where land is a large fraction of the property value; less so for apartments and the like.

However, cheaper ownership is counterbalanced by increased holding costs, so that the net internal rate of return from home ownership could be expected to be broadly unaffected. This is also true for property investors, so first home buyers would continue to compete against investors on the same terms as currently.

There is however one big consideration: the deposit gap. Yates has documented how bridging the deposit gap has become a bigger and bigger problem for first home buyers as house prices have risen in relation to household disposable incomes: Figure 7. The deposit gap is now over 4 times average annual income (and rising); this is a lot to save unless parental help is available.

Figure 7: Deposit gap as percentage of average annual income



Source: Yates (2011, p 281)

The deposit gap would fall dramatically under full taxation of land rents. For houses where land constitutes half the value (which is not uncommon) the gap would almost halve. In effect, the buyer would be purchasing the bricks and mortar but renting the land from the government: an implicit form of buy-rent scheme[26].

There is also the likelihood that speculative holdings of land or empty houses would become less attractive, thus improving the supply situation. Data on water usage has been analysed to suggest that between 1 and 4 per cent of the housing stock is completely unused (Cashmore 2015, p.4). Similar recent analysis shows a degree of non-usage of new housing stock bought by overseas investors. Ten per cent of the housing stock is said to be empty at any one time – only a quarter of these would be holiday homes.[27] Some housing investors simply prefer not to have the hassle of having tenants.[28] A robust land tax regime could be expected to make holders of second properties re-evaluate the cost-benefit equation in relation to such properties, and bring some of them to the rental market.

Victoria University of Wellington Tax Working Group (2010) considered the impact of land tax on affordability and concluded that it would improve the prospects for low income earners but have a minimal impact on existing owners with a mortgage. However McLaren (2014) notes that 'the consequences for banks and other financial institutions that have lent money against the value of the land may be significant especially with highly geared loans by individuals or companies using land as security' (p.3). It might appear counter-intuitive that raising taxes on home owners would make home ownership more accessible. But that appears to be the situation.

10. Conclusion on land tax reform

I conclude, consistent with Henry and Mirrlees, that economic rent is a good subject for taxation and it should be taxed by robust, broad based taxes with very few if any

[26] The ACT has such a scheme, but it is hedged about with restrictions and take-up appears to be low.

[27] "The information on unoccupied dwellings that the department has access to is drawn from the 2006 census data. The National Housing Supply Council (the Council) published data on unoccupied dwellings in its 2nd State of Supply Report (2010 Report) using this source. This now dated information indicates that about one quarter of vacant dwellings are holiday homes. It also indicates that two to three per cent of all housing stock is empty at any one time due to demolition, sale, and refurbishment or re-letting. The proportion of unoccupied dwellings has been relatively constant since 1976 at between nine and ten percent of all dwellings (as shown in Table 3.6 of the 2010 Report)." Senate Standing Committee on Environment and Communications Legislation Committee (2011)

[28] Anecdotally, this is a common view among wealthy Chinese investors

exemptions. In particular the exemption for residential housing needs to end, and taxes on that and other land need to be at a flat rate with no thresholds.

Any such tax reform could appropriately incorporate local rates, which currently entrench inequalities in spatial wealth by allowing rich councils to tax at relatively low rates. A state or national land tax could incorporate per capita grants to local councils in lieu of the rate system. There could be some mechanism for councils to rebate part of their tax share to residents if such residents preferred to have lower taxes and fewer services. As Freebairn et al (2015) observe, 'Local government rates provide a good foundation for a reformed state land tax' (p. 16).

There is no economic reason we should not, at least in theory, contemplate land tax rates approaching 100 per cent of land value. Such taxes would reduce land prices by up to 95 per cent and would involve the government taking on the role of part owner with land tax being a sort of regular rent payment. While I have emphasised the political difficulty, this might be achievable if the change is spread over a long enough period of time. This might have to be 50-100 years.

Such high tax rates as are contemplated by full taxation of land rents would need to be accompanied by special concessions for newly subdivided and developed land, with tax holidays of say 10 years. There would be other special situations which also need to be addressed (e.g. where agricultural land was improved a similar tax holiday could be envisaged for the incremental value).

The Henry Review also noted that there may be owner-occupied homes where the owner is asset rich but income poor. It recommended that a system of loan arrangement be introduced so that the tax was paid when the property was finally sold. This might replace existing schemes of pension rate concessions, which have very dubious equity value as they allow what can be very substantial estates to pass intact to inheritors. But overall, such a tax regime is economically sensible and would allow a large chunk of state and/or federal tax revenue to be collected with low economic costs – quite unlike some of the taxes we have now.

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Appendix 1

Henry Review Recommendations (Treasury 2010b)

"C2 — Land tax and conveyance stamp duty

Recommendation 51: *Ideally, there would be no role for any stamp duties, including conveyancing stamp duties, in a modern Australian tax system. Recognising the revenue needs of the States, the removal of stamp duty should be achieved through a switch to more efficient taxes, such as those levied on broad consumption or land bases. Increasing land tax at the same time as reducing stamp duty has the additional benefit of some offsetting impacts on asset prices.*

Recommendation 52: *Given the efficiency benefits of a broad land tax, it should be levied on as broad a base as possible. In order to tax more valuable land at higher rates, consideration should be given to levying land tax using an increasing marginal rate schedule, with the lowest rate being zero, with thresholds determined by the per-square-metre value.*

Recommendation 53: *In the long run, the land tax base should be broadened to eventually include all land. If this occurs, low-value land, such as most agricultural land, would not face a land tax liability where its value per square metre is below the lowest rate threshold.*

Recommendation 54: *There are a number of incremental reforms that could potentially improve the operation of land tax, including:*

a. ensuring that land tax applies per land holding, not on an entity's total holding, in order to promote investment in land development;

b. eliminating stamp duties on commercial and industrial properties in return for a broad land tax on those properties; and

c. investigating various transitional arrangements necessary to achieve a broader land tax."

Appendix 2

ACT Government initiative (excerpt from McLaren 2014, pp. 8-10).

> *"The Australian Capital Territory (ACT) government undertook a review of its tax system in 2012 and one of the major recommendations was to broaden the land tax base to all principal places of residence and to gradually abolish stamp duty on the conveyances of real property. (Quinlan et al. 2012). By the year 2032, it is envisaged that there will be no stamp duty paid by the buyers of real property in the ACT. This approach generally follows the recommendations of the Henry Tax Review...*
>
> *The ACT does not have local government in the form of municipal councils. Therefore the Territory government acts in the capacity as an equivalent state government and the various local governments found in the States in Australia… The main policy consideration for the abolition of stamp duty on conveyances was the fact that only 9 percent of the population of the ACT contributed to a quarter of the total amount of tax collected through this source of revenue…*
>
> *The ACT government intends to abolish stamp duty on general insurance and life insurance over the next five years (20 percent each year) from 2012-2013 as a result of increasing the general rates. The ACT has both a land tax on investment and commercial property as well as a general rate which is imposed on all property with limited exemptions. By decreasing the level of land tax the government expects a greater level in the supply of investment properties …*
>
> *The general rate is levied on all property similar to rates imposed by local governments throughout Australia. The general rate is based on the average unimproved value of the property. The general rate has two components; a fixed charge and a valuation charge. The current fixed charge is $555 and the valuation charge is subject to assessment on progressive rates. The new land tax rates will result in seventy six percent of properties receiving a decrease in land tax and twelve percent an increase due to a change in the progressive rates.*

Under the new General Rates system properties with an average unimproved value (AUV) below $200,000, around 33,700 ACT households, will have a decrease in General Rates. Properties with an AUV above $200,000, around 108,000 ACT households, will incur an increase in General Rates. The ACT government allows for the payment of the general rates to be deferred and paid when the property is finally sold. Interest is imposed on the outstanding amount. This provides some relief for retired property owners unable to pay the increase in the general rates especially if the value of their land increases substantially over time. This is in line with the recommendations made by the Henry Tax Review.

The idea of the tax reform is for the general rate on land tax to increase as the revenue from stamp duty declines over the next twenty years. The general rate will increase as the value of land in the ACT increases and the progressive rates are applied to an ever increasing value. Ben Phillips from the National Centre for Social and Economic Modelling (NATSEM) undertook research into the likely level of rates if stamp duty was entirely replaced within twenty years. He found that the general rate on all real property would need to double relative to current levels being imposed on all property owners in the ACT."

Appendix 3

ACT Budget 2015 announcement: Cuts to stamp duty and insurance tax, released 01/06/2015[29]

> *"The ACT Government is continuing to deliver on its commitment to cut taxes, becoming the first Australian State or Territory to abolish tax on insurance policies.*
>
> *Next week's budget will also continue the abolition of stamp duty, with Canberrans saving thousands on unfair stamp duty taxes when purchasing a household in the ACT. The Government has cut stamp duty in every budget since 2012, and remains committed to further cutting the tax over the coming years.*
>
> *Through these reforms, we are leading the way on creating a tax system that is fairer, simpler and more efficient and that is building greater fiscal and economic sustainability for the ACT.*

Stamp duty cuts

> *Since the start of the Government's nation-leading tax reform program in 2012-13, conveyance (stamp) duty payable has been cut every year for all property values.*
>
> *The 2015-16 ACT Budget will reduce these rates even further, and from 3 June 2015:*
>
> - *The buyer of a $300,000 home will save about $2,900 in stamp duty compared to before the introduction of tax reform (a saving of $900 more in 2015-16 compared to the previous year);*
> - *the buyer of a $500,000 home will save $5,900 ($1,200 more in 2015-16); and*
> - *the buyer of a $750,000 home will save $7,775 ($1,200 more in 2015-16).*

[29] http://www.cmd.act.gov.au/open_government/inform/act_government_media_releases/barr/2015/act-budget-2015-announcement-cuts-to-stamp-duty-and-insurance-tax

> *Stamp duty reductions are also benefiting businesses, with the 2015-16 Budget delivering further reductions in stamp duty for commercial properties. For example the stamp duty on purchase of a $5 million commercial property in 2015-16 will be $60,750 lower than pre tax reform levels.*
>
> *In addition, eligible pensioners, persons aged over 60, and first home buyers are eligible for the concessional rate of stamp duty – meaning they pay only $20 in stamp duty. This will save buyers more than $15,000."*

However the ACT Government is coming under political pressures because of rate rises (they are an issue in the 2016 election), and there is recently speculation that it is softening this commitment. According to Kirsten Lawson for The Canberra Times on June 15, 2015:

"ACT Chief Minister Andrew Barr pushes abolition of stamp duty out 'decades'"

> *"ACT Chief Minister Andrew Barr is rethinking his plan to phase out stamp duty over 20 years, saying his primary aim is to have the lowest stamp duty rates in the country.*
>
> *The shift in thinking has implications for rates, which have been rising about 10 per cent a year since 2012 to compensate for cuts to stamp duty."*

"Stamp duty will remain a part of our tax system for a considerable time to come," Mr Barr said under questioning at an estimates hearing on Monday.

"It was never the intention to complete stamp duty reform in the first five years and it will take a number of decades. My immediate aim is to have lowest rate in the country. What that means for rates is that increases will be much lower."

Mr Barr said he would make detailed announcements in next year's budget, setting out a five-year tax plan, but "the heaviest of the heavy lifting" on rates was complete and future rates hikes would be lower." (Lawson 2015)

Notwithstanding this speculation, official policy is that the transition was always expected to take 20 years, and this transition is continuing.