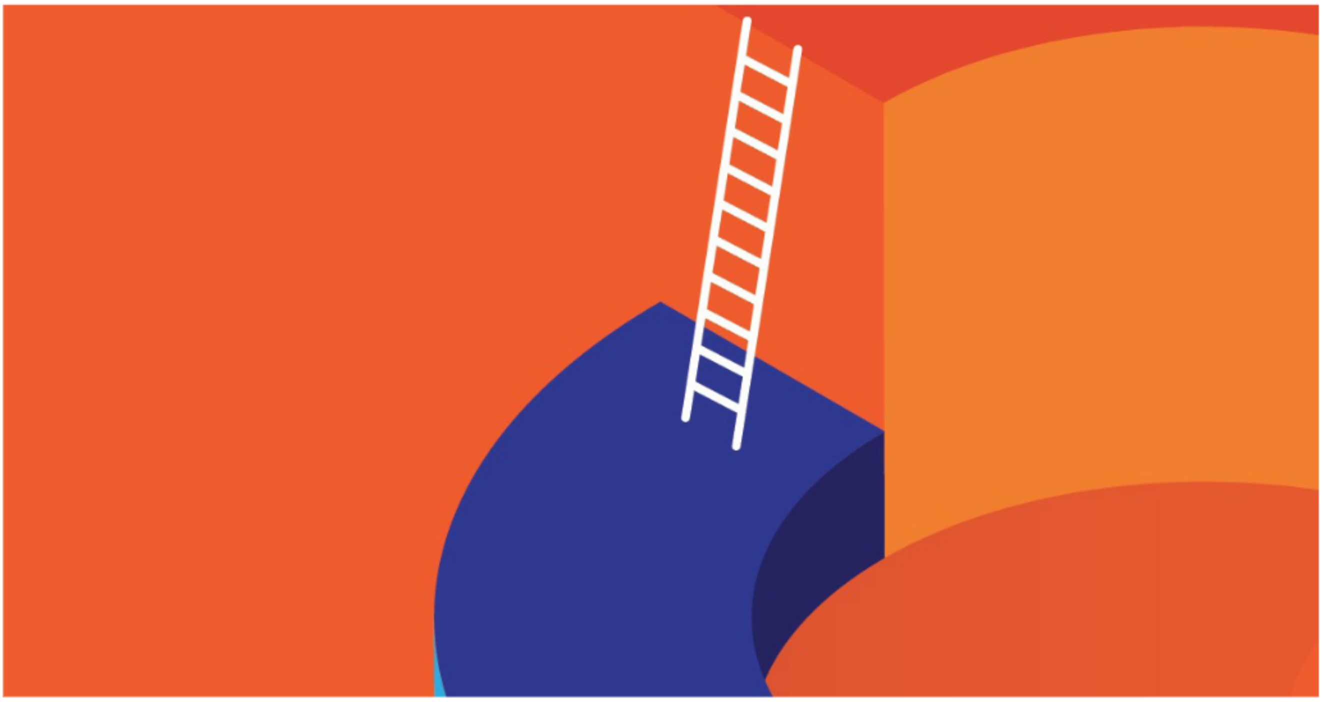
Stamp Duty to Land Tax: Designing the Transition by Tim Helm



This features select highlights from the report.

Almost everyone agrees that replacing state stamp duties with land taxes would be a worthwhile reform. Despite this, and despite the ACT beginning such a process, the politics of this reform elsewhere remain at best 'challenging'.

There are two separate reasons for this:

• Ongoing uncertainty about how best to introduce the new tax to avoid punishing recent dutypayers, losing tax revenue, or undermining the efficiency objectives of the reform; and

• Political difficulties inherent in the introduction of a new tax and in the nature of recurrent property taxes (i.e. unavoidable, highly salient, and requiring liquidity).

What transitional policies could best address these issues of principle and politics in order to minimise the persuasive task required of reform-minded politicians? This 'transition design' problem is the topic of the report.

In recommending abolition of stamp duty the Henry review suggested three basic models for the transition to a new land tax:

• Switch-on-sale: a full grandfathering model where current property owners are exempted from the new land tax until sale;

• Credit: applying the new land tax to all properties but granting some or all current property owners credit to be used in lieu of cash payments; or

• Gradual transition: phasing out stamp duty and phasing in land tax over time, as in the ACT.

Each model has its merits and has its champions. Yet there is still no agreement over the issues to be addressed and the objectives of any transitional policies, let alone discussion of the appropriate tradeoffs or consensus on the best model.

The report aims to lend order to the transition design problem by identifying six distinct issues of principle or politics arising in the transition, examining the merits of various transitional policies, describing the trade-offs involved, and arguing for a particular alternative to the ACT approach.

The switch-on-sale model has serious disadvantages: it loses too much revenue, poorly targets this cost at the real transitional inequity, and creates a disincentive to transfer property. A gradual transition has one major flaw: to avoid inequity for recent buyers it necessarily takes a very long time.

The efficiency cost relative to immediate abolition if the ACT model were adopted nationwide could be, on widely-cited estimates of the burden of stamp duty, as high as $170 billion.

A better transition approach centres on credit for recent buyers, and avoids unpalatable trade-offs by addressing the distinct transition issues with different policy instruments.

The package proposed here involves:

• Immediate abolition of stamp duty, not a phase-out;

• Partial credit for past duty paid for current property owners;

• Graduated introduction of land tax via a short phase-in period (a 'tax holiday');

• A limited-time 'opt-out' option for new buyers; and

• Revenue loss from the above funded by a temporarily higher land tax rate that makes the overall package revenue neutral over the transition period.

This package makes sense on its own, but could also be supported by a radical proposal: to allow widespread deferral of land tax until the next sale at commercial interest rates. Deferrals as default would make the land tax look like a 'vendor stamp duty' (and if politically necessary it could be framed as such), yet would avoid the inequity and most of the inefficiency of the current buyer duty. It could ease the politics of the new land tax, and could raise substantial interest revenue – since in economic terms states would be taking over the most low-risk, profitable, slice of the mortgage business. The deferral architecture could also be applied more widely (e.g. to council rates or value capture taxes).

The report presents modelling of tax rates, transition policy costs, cashflows and balance sheet impacts under the proposed package, using Victoria as a case study.

Providing some credit to all buyers over the last 10 years (almost half of all owners) is estimated to have a long run cost equivalent to 3.0 years' worth of tax revenue ($19 billion for Victoria). A three-year land tax phase-in and a three-year opt-out option would cost 2.3 and 0.1 years' worth ($14 billion and $0.4 billion) respectively. To fund these concessions in an overall revenue-neutral package, the land tax rate would need to be roughly 50 per cent higher over a 10-year transitional period than the long-run stamp duty-replacement rate (0.75% of land value per annum instead of 0.5% for Victoria).

Tax deferrals could generate substantial net interest: in 10 years the state's equity in the deferral scheme would be worth $3 billion (in Victoria), and in 20 years, $13 billion. This interest revenue alone would be sufficient to fund a 10% cut to payroll tax. Or, if the transitional land tax rate were retained permanently instead of sunsetting, payroll tax could be cut by half at the 10-year mark.

For progressive politicians searching for a circuit-breaker on state tax reform the proposed package offers generous but logical concessions for existing owners, some non-compulsion for future buyers, guarantees against hardship for all owners, and an attractive introductory period to secure support early on. It is complex at the (policy design) back-end but simple enough at the (taxpayer) front-end.

It provides any government willing to conduct unilateral reform with an alternative to the ACT approach that is arguably superior on both economic and political grounds. The major issues have been worked through and the proposed package is ready to model with state-specific data, test with stakeholders, examine within the bureaucracy, or commit to in local pilot form –

just as if a state wished to adopt the ACT model.

Proposed package

The essential tension is that two transitional issues – one principled issue around recent buyers, one political issue around long-held properties – are being addressed with a single form of concession. Why not separate these?

As a general proposition, to achieve multiple objectives requires multiple policy instruments. Section 4 identified at least half a dozen distinct issues arising in the transition, any one of which might be enough to change the political calculus.

Perhaps because state taxes are so complex already, and with business-as-usual politics a stamp duty replacement will be no better, there is an understandable reluctance to contemplate a complex package of transitional measures.[1] But it is complexity at the taxpayer 'front-end' – not the policy design 'back end' – that really matters. And multiple instruments and options are not synonymous with complexity for taxpayers. It is more often the redistributive slicing and dicing that state politicians cannot resist when designing each instrument that makes for a complex whole.

What could a package targeting each of the difficult transition issues look like?

A logical package would centre on the double-taxation issue, and address this with credit for recent buyers, framed as the necessary price of fairness. With wide eligibility, the constituency opposed is narrowed to the owners of long-held property, whose objections can be portrayed as pure self-interest on the part of people who have already done well out of existing structures. As well as paying less than their 'fair share' of stamp duty, long-held properties are almost guaranteed to have experienced significant capital gains – another point which can support the public messaging around introducing a new tax on these properties.

Nonetheless, to ease the politics, stimulate turnover, and protect asset prices from the effects of uncertainty, a short phase-in or 'tax holiday' may be politically valuable – if and only if the cost is recovered from LVT payers later.

Deferrals are the obvious solution to liquidity problems for retirees, and broadening the scope of eligibility could ease the politics of the new tax even further (as discussed next).

To address concerns of prospective buyers an opt-out option may be politically useful, assuming the costs can be kept low via time limits (as the modelling in section 6 suggests).

Finally, for reasons of efficiency and fiscal responsibility it would be sensible to 'internally fund' the cost of all these concessions by way of a temporary supplementary LVT rate that makes the overall reform package revenue-neutral. All this makes immediate abolition of stamp duty possible.

The following table summarises how these policy instruments map to the major transitional issues.

1 In a similar vein, the idea that both stamp duty and existing state land taxes should be replaced with a single instrument, despite the very different rationales for reforming these taxes, seems to be driven by a simplification goal.

Issue	Instrument	Design
Double-taxation of recent buyers	Credit for past duty paid	Wide eligibility, cash-out
Politics of new tax on long-held properties	Tax holiday + Deferrals (broad eligibility)	Short phase-in (e.g. 3 years) Commercial interest rates
Future buyers' concerns	Opt-out option	Short open period (3 years) Exemption period 20-30 years
Asset-rich cash-poor cashflow	Deferrals (narrow eligibility)	Commercial interest rates
Budget (revenue) impacts	Internally funded via temporary supplementary rate	e.g. 10 years
Other political economy issues (e.g. asset value fears, salience, resilience)	Tax holiday + Deferrals + Messaging	As above

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Tax deferral

Tax deferral has generally been seen in limited terms as a means of addressing issues of liquidity and hardship amongst a narrow group of the asset-rich income-poor (i.e. retirees). Existing rates deferral schemes work on this type of restricted-eligibility basis (PC 2017).

However it is a mistake to see such schemes as a costly concession when they can be a 'win-win' for both taxpayers and the state. Taxpayers benefit by being offered credit at lower cost (or less hassle) than via the alternatives. With interest on commercial terms, the state benefits by receiving payment in excess of borrowing costs.

Property tax deferral could be highly valued by taxpayers, it is revenue-positive, and it could make a substantial difference to the salience of a new LVT and the general politics of the tax switch. What principled reason is there for not broadening eligibility beyond pensioners?

There are several objections – but on closer scrutiny none appear critical.

REPAYMENT RISK

Is the state taking on risk? No – lending via tax deferrals is practically risk-free, since the lien (the tax charge on the property title, equivalent to a mortgage) can be made 'first charge' in the event of default, meaning the state is first creditor in line.[2]

The total loan can also be capped at a level that will take decades to reach and which no realistic price crash will touch. Coates (2017) estimates that even at a (prohibitive) 7% interest rate and relatively sluggish 2% annual property price growth, a fully-deferred LVT of 0.6% would grow to no more than 30% of the property value after 40 years.

POLITICAL RISK

Might a future parliament elect to 'forgive' tax debts, leaving future generations in the lurch? It is possible – but so is a future parliament legislating a massive giveaway that bears no relation to past taxes, which is an ongoing risk in any democracy without constitutional debt safeguards.

Although nothing can override the sovereignty of future parliaments, deferral laws could be written so as to create a strong presumption against change and make the consequences of doing so more transparent, thus raising the political costs of executive or parliamentary meddling.

DEBT

Another concern is the public debt impact, gross debt more specifically.

Tax deferral is a source of revenue, not expense. Since the interest charged exceeds borrowing costs, the value of the assets in the scheme (deferred tax plus interest) will exceed the value of the liabilities (amounts borrowed plus interest

2 Land tax legislation is an example of where unpaid tax is legally the first charge. See Australian Government Solicitor (2009), and the Land Tax Act (Vic) 2005, s96 for an example.

paid). Thus deferral will of course reduce net public debt.

But gross debt will rise substantially, and there is a risk that ratings agencies and lenders will take an unsophisticated view of the state's financial position based on this figure. While deferral scheme assets would be practically risk-free, they would also be highly illiquid. If the ratings agencies were to apply simple rules of thumb regarding debt serviceability that failed to recognise the fundamental soundness of the balance sheet, there may be a risk of credit downgrades.

One solution that would align with sensible and transparent governance practices would be to operationalise tax deferral via a Public Financial Corporation (PFC) that held all the assets and liabilities. The PFC could be legally bound to pay the state an annual dividend equal to the LVT due from taxpayers, and given other limited and transparent powers and functions. The balance of tax debt (assets) and loans (liabilities) held by the PFC – i.e. the cumulative net interest revenue – would appear as an equity investment in the general government balance sheet.[3]

Tax deferral is in economic terms profitable lending by the state secured against property, and should be seen as such.

Separating tax deferrals from the main business of government in this way would not only be more transparent, helping ratings agencies distinguish between sustainable and unsustainable debt, but would also maintain the desired public-facing imagery in the general government balance sheet and thus shelter governments against misleading debt politics.

PERVERSE INCENTIVES

In the context of capital gains taxes the 'lock-in effect' is the disincentive to sell an asset when tax is paid upon realisation of gains (i.e. when cash is receive d) instead of upon accrual (i.e. as the value grows on paper). Taxing realised gains discourages sale because money has a time value: delaying sale deflates nominal gains that have already accrued, reducing the present-value tax payable.[4]

Deferring tax at concessionary interest could have a similar effect, since to sell property would mean repaying a stock of cheap debt (the accumulated tax plus interest). However the potential disincentive would still be an order of magnitude less than under stamp duty, where selling property triggers a large tax payment each and every time, regardless of time elapsed since last sale. Thus if deferrals help facilitate the reform there will still be a net efficiency gain – even with concessionary interest. And by using commercial interest rates this problem is largely avoided.

To minimise disincentives the interest rates should be matched as closely as possible with taxpayers' investment alternatives, i.e. the likely use of freed-up funds if taxes are deferred.

For many homeowners the obvious choice would be to repay the mortgage faster, so a sensible comparison rate may be the mortgage rate. But savvier borrowers may be using low-cost mortgage credit to invest where there are higher risk- and tax-adjusted returns, e.g. superannuation, suggesting the interest rate could be pushed higher. On the other hand, this might push retirees with portfolios concentrated in low-yield cash to rationally prefer to pay tax rather than defer. Negatively-geared investors may have different incentives altogether.[5]

The optimal rate is clearly a design question requiring further investigation. Nonetheless it is clear that with appropriate design neither the risk of perverse incentives nor the investment risk, political risk, and gross debt objections are

3 See Australian Accounting Standards Board publication 1049 for definition and treatment of PFCs.

4 The principle is clear to anyone who has rationally deferred repaying a HECS debt.

5 A related lock-in objection is around asymmetry in response to cash and paper losses. Default deferrals that reduce the salience of the recurrent tax may arguably do less to encourage reallocation of land to more productive uses than a LVT that "builds a fire under sleeping owners" (Gaffney 2009). However the behavioural-bias reasons to expect a cash drain to prompt different behaviour to a paper loss crystallised upon sale apply mostly to less profit-driven taxpayers (i.e. households), who are not necessarily the main culprits in speculative withholding of land from productive use. And at the magnitude proposed, the LVT is unlikely to have strong impacts on speculation anyway. The prevalence of negative gearing is proof of how a (far more) substantial cash drain can be tolerated by calculating investors in the pursuit of longer-run gains.

major stumbling blocks.

DESIGN CONSIDERATIONS

The specific **cap** on tax debt at which the taxpayer must begin making repayments is a second-order issue, given how long it would take to reach. The key design consideration however should be protection of the state in the event of default.[6]

Broad options include a cap set in relation to property value, land value, or the owner's equity in the property. The first would reflect the most likely value of collateral, the second a lower-bound in case the improvements are uninsured, and the third would help protect mortgage lenders.

A second design consideration is **eligibility**. Revenue maximisation suggests universal eligibility as a starting point, but there may also be reasons to limit use in certain circumstances, such as where it is difficult to target indexation rates precisely at the cost of capital and there is a risk of perverse incentives. Land speculators facing high private borrowing costs, for instance, may use tax deferral heavily and face a growing incentive to delay development or mask transfers of ownership to preserve their stock of cheap finance from the state, which would otherwise be lost at the point of sale. If cheaper credit thus became an aid to speculation or a barrier to productive land use, the efficiency consequences might outweigh the state revenue advantage from continued lending. Either eligibility restrictions, different caps, or different indexation rates might be suitable to address such risks.

How much could the state charge in **interest** on deferred tax?

There is a balance required between three objectives: (1) increasing uptake in order to improve the political impact of the scheme; (2) avoiding turnover disincentives; and (3) maximising interest revenue. The first objective suggests setting rates lower, the second higher, and the third somewhere in between.

Recent RBA research into the distribution of mortgage rates provides indicative evidence of how high the interest rate premium over borrowing costs could be while still encouraging mortgaged property owners to defer.

As of December 2017 the bottom end of the distribution of owner-occupier variable rates was around 3.75%, and the lowest investor rates around 4%. Most borrowers pay significantly more, with median rates around 0.5 percentage points higher than the lowest rates (RBA 2018, graph 4). Commonwealth 3-year borrowing rates at the same time were around 2%, with states typically borrowing at a premium of around 25 basis points above this.

State borrowing costs are therefore – as a rule of thumb – around 1.5 percentage points lower than the lowest owner-occupied mortgage rates and 1.75 percentage points lower than the lowest investor rates.[7]

Tax deferral interest rates should therefore be no lower than the lowest mortgage rates, which are around 1.5 percentage points above state borrowing costs for owner-occupiers. Recognising that mortgage rates are higher for investors and commercial property owners, and indeed their marginal cost of capital (e.g. from unsecured borrowing) might be higher again, rates for non-owner occupied property should be at least 2.0 percentage points above borrowing costs.

SUMMARY

Deferring LVT appears radical at first blush, but on reflection is less so.

It simply enacts the same type of treatment as under CGT, where tax on an income is collected at a point of liquidity, rather than as a gain accrues in paper form or as non-cash benefits are consumed.

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6 From a questionable normative perspective, the PC (2017) also sees merit in capping to avoid "accumulation of a large amount of debt [that] may reduce the capacity to move as it reduces the amount available for a new purchase" and to "prevent debts accruing to a level that makes substantive differences to bequests".

7 See RBA statistics table F2.1 for Commonwealth 3-year bond yields. For state spreads see http://www.yieldreport.com.au/category/semi-government/monthly-semi-government/. Note that current margins are similar: mortgage specials in February 2019 include owner-occupier variable rates as low as 3.6%, 3-year fixed rates at 4%, and investor variable rates around 4%. Yields on 3-year maturity state bonds are currently around 2.1-2.2% (see YieldReport link), i.e. a discount of 1.4-1.5% on the lowest mortgage rates.

To better understand the rationale for deferrals, it helps to understand that implicit in the tax switch is a 'timing switch' – a change in the points in time across an owner's tenure in which they must financially contribute towards the government services that give their property value.

Stamp duty collects a lump sum upfront, before the duty payer has received the benefits of the state expenditure their tax contribution funds. In subsequent years other buyers pay their own lump sums, which in turn fund services benefitting the properties of earlier buyers. From the perspective of the taxpayer it is a 'pre-pay' model for funding government services.

LVT in contrast collects tax from each property over time as the benefits to the property are received, i.e. as the owner gains value from occupying (or tenanting) the land thanks to the services of the state.

Considered in relation to the lifecycle of property ownership, the tax switch is a sensible shift from a 'pre-pay' model to a 'PAYG' model for funding government.

It is sensible because it reduces the private financing task demanded of property buyers – it reduces what property buyers must borrow upfront to pay for the (uncertain) stream of services their asset will render. Via tax capitalisation and the timing of the legal requirements, LVT converts upfront housing costs to recurrent housing costs, thus aligning the timing of tax costs better with the timing of benefits.

Deferral takes this one step further, to a 'post-pay' model for funding government.

The advantage in this is that it puts a necessary financing task in the most capable hands.

Benefits to property from state expenditure are often not realised in cash form immediately. A new road or train line may boost landlords' cash income, but for owner-occupiers the benefits are in convenience or psychological value – and for both parties the capital gains exist only on paper until sale. An LVT that is not deferred demands that these beneficiaries finance the timing gap between state expenditure and private cashflow privately. That is, an LVT demands that taxpayers must save less or borrow more to pay the tax.

A post-pay model enacted by a deferred LVT allows payment at the point of liquidity (i.e. sale), the advantage of this being that the financing task required to bridge the timing gap between state expenditure and private cashflow is allocated to the party with the lowest borrowing costs – the state. This is a more economically efficient outcome (see Box 4).

There are precedents for deferral in other taxes and jurisdictions. Accelerated depreciation, to take one example, is simply an attractive deferral option relative to standard depreciation schedules. In Vancouver, B.C., expanding eligibility for property tax deferral to seniors over 55 years and any parents supporting children has seen substantial uptake.[8]

An LVT deferral architecture could also be used for other property tax deferrals. States which already administer rates deferral systems could fold these into the administration of a deferred LVT. The cashflow issues that make it challenging to operationalise 'value capture' (taxation of land value uplift from specific infrastructure projects or planning decisions) could also be overcome using deferrals, administered the same way.

A system of default LVT deferral would in practice make the new tax appear and act much like a 'vendor stamp duty', and if it were politically valuable, the reform could be framed as such. Indeed if continuity with the existing regime had major political advantages, administration of the new tax could require the deferred LVT and accrued interest on a property for sale to be legally submitted by the buyer, in the form of a property-specific duty amount that would be advertised at the time of sale. For profit-driven, calculating landowners, the annual accrual of LVT and interest that prospective buyers would take into account in their offers would create the same incentives for sale as if the LVT was paid in cash.

Framing tricks might substantially improve the politics, in other words, at minimal cost to efficiency.

8 "Property tax deferrals by seniors grow 53 per cent in four years", Vancouver Sun, 10 Jan 2019, https://vancouversun.com/health/seniors/property-tax-deferrals-by-seniors-grows-53-per-cent-in-four-years

Results

OVERALL IMPACTS

The net revenue impact is negative over the first four years to the tune of around $8 billion (or 130% of Victoria's annual stamp duty revenue). This is due to the combined effect of the tax holiday and drawdown of credit exceeding the additional revenue from the supplementary rate and from stamp duty paid by buyers opting out. From Years 4-10 the reform package is cashflow positive due to the supplementary rate, and from Years 11-20 mildly cashflow negative as credit continues to be used up (by Year 16) and as opters-out remain exempt from LVT (until Year 20).

The net effect is that the package is strongly stimulatory over the first four years, raising around one-third less revenue than in the baseline, then equally contractionary up to year 10.

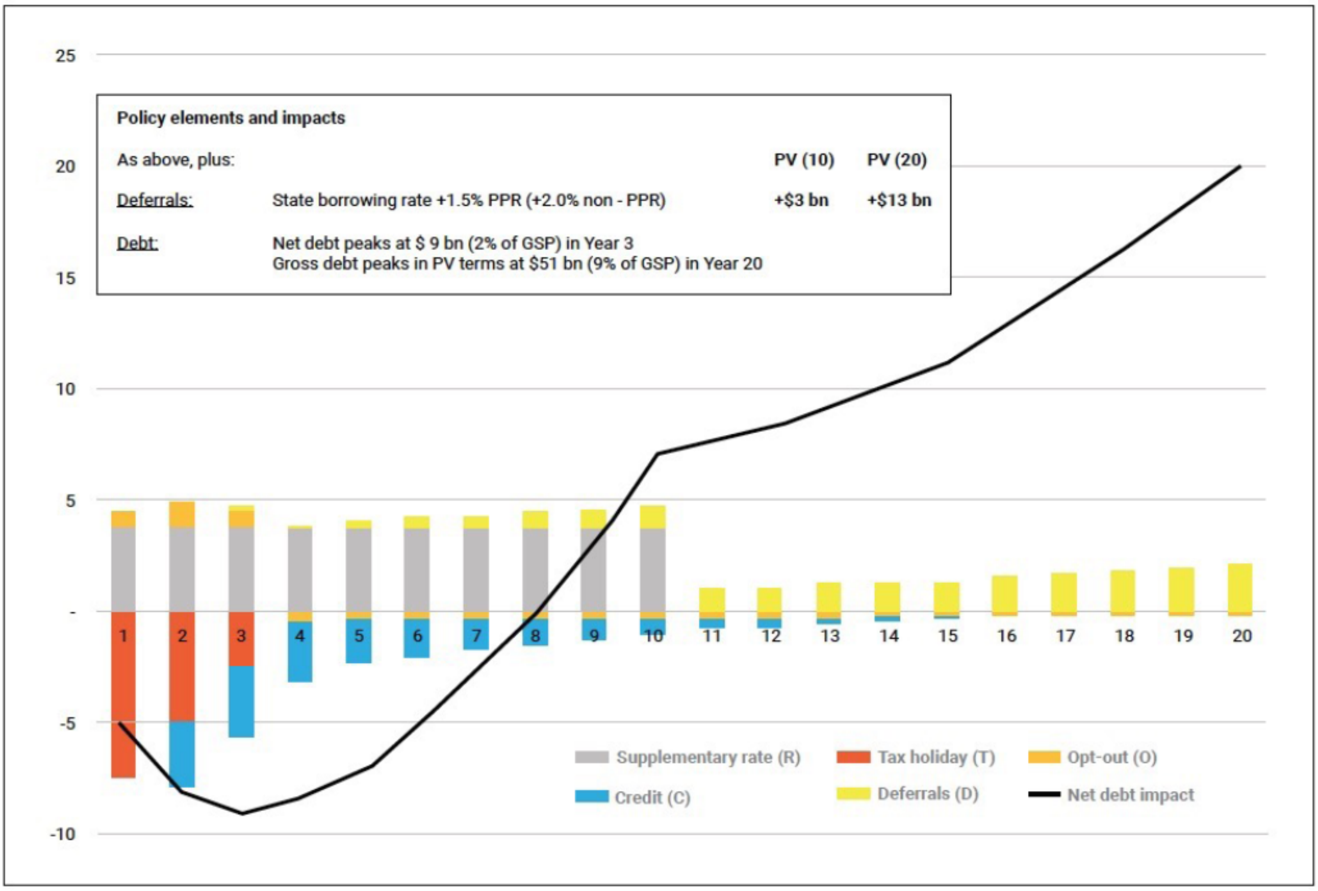
In PV terms the most significant concession is the provision of credit to existing owners, which costs $19 billion (or 300% of current annual stamp duty revenue). The 3-year tax holiday costs $14 billion (230% of annual revenue) and the opt-out option has a negligible PV cost of $0.4 billion (7% of annual revenue).

To raise additional revenue over a 10-year transition period adequate to offset the total $33 billion cost requires a supplementary tax rate of 0.28%, which represents another 60% loaded upon the base rate of 0.46% and raises an extra $3.8 billion per annum for 10 years.

The following table and graph summarise the reform package in detail and effect.

Parameter	Description	Value
Policy parameters		
Base rate	Revenue-neutral LVT rate to fully replace $6bn stamp duty on a $1.3tn Site Value (SV) base (2016-17 figures)	0.46%
Supplementary rate	Supplementary rate period	10 years
	Supplementary rate to achieve revenue-neutral package (long-run PV=0)*	0.28%
Tax holiday	Discount on sum of base and supplementary rates	Year 1 = 75% reduction Year 2 = 50% reduction Year 3 = 25% reduction
Final LVT rate	(Base rate + Supplementary rate) x (1 – tax holiday)	Year 1 = 0.18% Year 2 = 0.37% Year 3 = 0.55% Years 4-10 = 0.74% Years 11+ = 0.46%
Opt-out	Open: Option available	Years 1-3
	Exemption: Final LVT-exempt year for opters-out	Year 20
Credit	Calculation method	Backdated LVT method
	Indexation of past duty paid (+LVT)	Historical CPI
	Future indexation of net credit	2.5%
	Cash-out of net credit on sale	Yes
Deferrals	Interest rate margin over state borrowing cost	PPR**: +1.5% Non-PPR: +2.0%

Figure 2: Revenue and debt impact of recommended package with deferral (RTOCD) – Victoria – $ billion nominal



Conclusion

It is difficult to think of any other reform for which expert opinion and the forces of politics are so firmly in opposition.

If the stamp duty-to-land tax reform is by an order of magnitude the most significant action Australian governments could take to improve productivity, then a status quo approach that urges bravery in the name of reform and turns a blind eye to the real political barriers is not only futile, but costly.

If this reform is to proceed the politics must be accepted for what it is, and the policy design must work around that – not the other way around.

There are more and less principled ways to do the transition. The best way, this report has argued, is to provide credit to recent buyers and recover this cost from all taxpayers over time. That tackles the real equity issue, without sacrificing revenue or efficiency.

What looks most promising to ease the politics is to reconsider the role of tax deferral. The proposal here is radical, but grounded in economic logic. Unfamiliarity and conservatism seem the only reasons for not investigating it further.

Not least, the deferral proposal also opens a window onto fascinating and much broader questions about the merits of how we go about paying for land, who wins and who loses under these systems, and the possible roles for the state.

Read the full report: www.prosper.org.au/reports/