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"It's not unpopular for good economic reasons. It's unpopular in my opinion for one simple reason: it's the only tax left on the books for which people have to write a big cheque" – Milton Friedman

STAMP DUTY TO LAND TAX

Designing the transition



A Report by **Tim Helm**



About

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Executive Summary

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 duty-payers, 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 trade-offs 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 sunseting, 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.

Introduction

1.1 Why this report?

Eight years has passed since the Henry review put abolition of stamp duty at the top of the state tax reform agenda, and longer still since state taxation has been subject to any meaningful reform.

Stamp duty is the 'pantomime villain of tax reform' (Martin 2015), blamed for everything from expensive housing to unemployment to traffic congestion. Staggering estimates of its economic costs suggest an incredible dividend from abolition.

Land value tax is the obvious replacement. Borne by the same property owners, administratively simple, unavoidable and perfectly economically efficient, it finds favour with economists and progressives alike. It is "the least bad tax" (Milton Friedman) and a "no-brainer" (Martin Wolf). The economic case for it is "simple, and almost undeniable" (James Mirrlees).

A moment's thought suggests that it can be a more equitable way of funding government, too.

Land value tax is paid in proportion to what society deems a site worth. Land has no production cost, so this value is simply a measure of the benefits it provides. Those benefits are socially, not privately, provided. They are generated by infrastructure, services, regulation, culture and community, proximity to markets, and natural advantages (fertility, beauty, etc). So land value tax is like a generalised 'user charge' for the benefits society provides the landowner; as the benefits vary across space and time, so does the charge.

Stamp duty now has few friends in the Australian policy debate, and land value tax no principled objectors. Rightly or wrongly, there is near-consensus across the academic, political, business, and community sectors that the former should be replaced by the latter.

In 2012 the ACT led the way, beginning a 20-year transition process. Yet reform enthusiasm elsewhere is low. We seem stuck in an endless loop of calls for bravery, buck-passing between the Commonwealth and states, and lobbying by property interests for the easy half of the reform. The public remain lukewarm, and politicians apparently see little to gain.

What stands in the way of this 'tax switch' reform?

For one, no-one has developed a policy package attractive enough to convert this reform 'duty' into a political opportunity. The changes in the ACT prompted a political fear campaign and an electoral swing, and remain politically contentious seven years later. Long-term economic gains in exchange for short-term budget and political pains have never made for easy politics, and in the stamp duty context neither the inequity of the status quo nor talk of efficiency gains cut through much with the public, even if the policy fraternity are all on board. Reformist politicians need something more compelling to sell the change.

Two, there are political difficulties inherent in the very nature of the two taxes. Duty is paid once only, at a time of liquidity, is small relative to the overall outlay, and is seemingly voluntary, since it is contingent on a choice to purchase. Land value tax (henceforth LVT) is recurrent, unavoidable, and taxes an economic rent that may not match a cashflow. It is not quietly diverted from an income stream or hidden in prices but rather demands a 'big cheque'. This asymmetry in salience poses a challenge for reform.

Three, there are practical problems in the transition, particularly around the treatment of recent buyers.

“The challenge is one of policy design – to solve a political economy problem in order to minimise the persuasive task of the politicians.”

They have solutions, but there is no consensus yet over which of three broad approaches suggested by the Henry review is best, and if any bureaucracy has been asked to explore the implications and implementation of these options it has been kept well hidden. Politicians naturally will not commit to the reform destination without assurance about the fairness of the pathway, but even to examine the pathway is to signal openness to the reform, with all the political vulnerability that currently entails.

In short, the politics of this particular ‘tax on the family home’ remain unappealing (notwithstanding that we have another such tax in place already).

To pursue the tax switch we must tackle these issues. We can loosely label this the ‘transition design’ problem. The challenge is essentially one of policy design – to solve a political economy problem with as attractive a policy package as possible in order to minimise the persuasive task required in the politics that follows (consensus building, messaging, extracting Commonwealth cash, etc).

One pessimistic view ought to be confronted first. That is the idea that meaningful land tax reform, in place of stamp duty or otherwise, is entirely impossible either in the current climate or in general.

Part of the problem is Australia’s deteriorating reform capability, which Ross Garnaut in particular has drawn attention to. But in addition, as ANU economist Julie Smith has argued, the nature of land markets might make any substantial LVT an unstable political equilibrium in which the private capital gains realisable from cuts to rates and revenue prove so irresistible to rent-seekers and politicians that the new tax is inevitably unwound.¹

Perhaps the best we can therefore aim for in taxing land rents is to protect stamp duty against base erosion – or allow it to diminish until fiscal crisis prompts bold change. Either way, pursuit of rational reform in a transparent way is a political dead-end.

Yet the economic gains from the tax switch are enormous (if the modelling is to be believed). And the climate around tax reform generally and land tax reform in particular can change rapidly, as recent experience in the UK illustrates. It thus seems important to continue debating the best approaches to easing the transition and ensuring the new tax sticks, so that when the politicians or the political climate change a workable model is ready.

The questions addressed below are these: is there a policy package simple enough, fair enough, and compelling enough to be sold by politicians and bought by voters? Is the ACT model the best possible or can we do better? And can any necessary compromises from a principled design be made limited enough to make the whole exercise worthwhile?

If a reform is worth doing there are by definition winners whose gains

¹ The argument is based on the timing asymmetry inherent in capitalisation of future tax payments into current asset values, and so applies specifically to recurrent taxes on property – not to income tax or other taxes. In short, voters see the public cost of LVT cuts as four years of lower revenue and slightly higher debt. But markets see the prospect of an infinite future of lower-taxed land rents, and reprice the asset accordingly. Property lobbies and politicians see an opportunity. Smith’s conclusion is that “the perfectly ethical and rational revenue instrument contains the seeds of its own destruction... governments do not have the integrity and sophistication to maintain it” (Smith 2000).

outweigh the losses of the losers. So careful design can in principle arrive at a package that is both politically appealing and economically and ethically worthwhile. That premise motivates this report.

1.2 Overview

The report is laid out as follows.

Section 2 briefly sketches views on the reform end-point (i.e. the tax to replace stamp duty), on the rationale for reform, and on whether stamp duty abolition is even desirable.

Section 3 surveys the transition literature and the proposals that have been put thus far.

Section 4 identifies and describes a range of transitional and political issues and objectives, and discusses the potential policy options to address these.

Section 5 summarises the key trade-offs in the main transition proposals, and argues the merits of an alternative to the gradual reform model of the ACT. The essential insight is that transition design is a problem with multiple (often conflicting) objectives; it will take a package of measures to make this reform both feasible and worthwhile.

Section 6 presents modelling of the tax rates, policy costs, tax revenues, cashflows and balance sheet impacts of the proposed package, using Victoria as a case study.

The primary topic throughout is the transition – not design of the end-point or modelling of winners and losers. The focus is on policy design rather than on broader reform ‘strategy’ (Commonwealth-state arrangements, public messaging, engagement with interest groups, etc). The question of reforming existing state land taxes is also beyond the scope of the report, since it is one with different issues, politics, and stakeholders and is most sensibly tackled separately.

The report aims to provide a state government willing to conduct unilateral reform in the absence of federal leadership or support with a policy package to ‘go it alone’. The proposal is sufficiently worked-out to model with state-specific data, test with stakeholders, plan implementation within the bureaucracy, or commit to in local pilot form – just as if a state wished to adopt the ACT model. Naturally many minor decisions would be required in implementation, but the major issues and decisions have been worked through here.

What reform and why?

Key points:

- Stamp duty involves an arbitrary and inequitable distribution of the overall tax burden, and by deterring transfers of property also has detrimental effects on productivity.
- While some modelling suggests massive economic returns from abolition, there are credible arguments that these gains have been oversold.
- The simplest and most efficient replacement tax would be a single-rate, non-progressive land value tax, but some commentators favour either a progressive scale, or taxation of capital improved values, on redistributive or pragmatic grounds

“The standard arguments are a wholly negative case for the tax switch, based on the problems with the status quo.”

Stamp duty is, prima facie, inequitable. Those who sell property more often bear more tax than those who buy and hold, which appears arbitrary since there is no apparent link between selling property and any need for expenditure by government.²

Stamp duty is also charged with being highly inefficient, principally by discouraging transactions. In theory this could inhibit residential mobility, labour market matching, productive use of property, and transfer of business assets. In everyday terms this might result in longer commutes and greater congestion, a reduced willingness to move to better jobs between or within cities, and less ‘downsizing’ (which wastes housing space and makes upsizing more costly).

These arguments motivate the abolition of stamp duty. They provide a wholly negative case for the tax switch reform, based on the problems with the status quo.

But what form of property tax should replace it?³

There is now a substantial literature on the tax switch that includes work by government agencies, think-tanks, consultancies, and a small number of academics. It covers three broad topics:

- **The end-point:** design of the replacement tax, state-by-state rate calculations, and analysis of distributional impacts (i.e. winners and losers);
- **Economic gains:** estimates of the economic impact of the reform; and
- **The transition:** consideration of how to make the reform happen and overcome various transitional issues.

2 Stamp duty is submitted by the buyer, but presumably borne by the seller via a lower sale price (this is referred to as ‘capitalisation’ of the tax). That is, the economic incidence is on the vendor. Anything else implies systematic mispricing of assets above the net-of-tax income stream received by the buyer.

3 It is almost self-evident that replacing stamp duty with a hike in GST would be a bad idea: it would result in windfall property price gains, further reduce states’ autonomy over their revenue base, and be more difficult to implement (since it would require inter-governmental agreement, federal legislation, and compensation for low-income households through the tax and transfer system).

The remainder of this section discusses ideas for the end-point design (with estimates of the economic gains summarised in Box 1). Transition proposals are discussed in the next section.

The simplest and most efficient replacement tax would be a single-rate non-progressive LVT applying to all land equally without discrimination between land uses. It would be the most efficient because applying the same tax rate to every site creates no incentive to shift land between uses or alter decisions about subdivision and aggregation.

Tax rates under a single-rate LVT would need to be around 0.5%-0.7% of land value per annum to replace stamp duty – roughly double the size of council rates (Coates 2017). The LVT bill for an owner of a \$600,000 house on a \$400,000 site, for example, would be around \$2,400 per annum.⁴

As Freebairn (2017) discusses, this is the ‘benchmark’ reform from an efficiency perspective – one which we may well depart from for equity or political reasons.

The Henry review recommended replacing stamp duty not with a single-rate LVT but with a new progressive-scale tax. Unlike current state land taxes, however, the proposed progressive scale would be based not on aggregate land-holdings by an individual landowner but on per-square-metre values assessed at the site level (Commonwealth of Australia 2010a, section C2).

Under the Henry model higher-value land, such as inner-city land, would pay a higher average tax rate than lower-value land, such as farmland. Although this would certainly buy the support of farmers, it has no apparent equity rationale and minimal efficiency rationale.⁵

The LVT model being implemented in the ACT involves even more redistributive political ‘targeting’ than proposed by Henry. In the ACT, separate progressive rate scales now apply to residential investors, owner-occupiers, apartments, commercial land, and farmland (Murray 2016).

The Grattan Institute has argued that a tax based on Capital Improved Value (CIV) could be an acceptable alternative to a LVT, since it might minimise asset re-pricing effects and find easier political acceptance without imposing substantial efficiency cost relative to a pure land tax. AHURI researchers also support a CIV tax, although apparently this is on the grounds of easier valuation rather than redistribution or political pragmatism (Eccleston et al 2017, p4).

Another alternative entirely would be to convert stamp duty into a ‘land gains tax’ payable at sale on the growth in land value since the last sale (with tax liabilities accrued annually and indexed, to avoid discouraging sale). This would be equivalent to a capital gains tax limited only to real estate, and could function as an automatic, universal (not project-specific) means of implementing value capture principles.⁶

Detailed consideration of these end-point options is beyond the scope of this paper, however. There is no need to pass judgement on these in order to examine the transition – the major transitional and political difficulties arise under almost all options.

A more pressing question is whether abolition of stamp duty is a high priority at all.

The equity and efficiency views summarised above are widely held. However UQ economist Cameron Murray has recently put forward a range of challenging (and persuasive) arguments that question this accepted wisdom, and appear to undermine the idea that abolishing stamp duty should be a high reform priority (see Box 2).

Some of the transition policies proposed in this report presuppose abolition of duty and are relevant only for the stamp duty to LVT switch. They are options to facilitate that reform, should it be pursued. However the proposal regarding tax deferrals as well as much of the other discussion, remains relevant for LVT in any circumstances. The tax deferral proposal is a way to tackle the political economy problems of recurrent property taxes, whether introduced to replace stamp duty or otherwise.

4 This is roughly the Melbourne median detached house price. Detailed work on rate calculations and distributional impacts has been undertaken by the Grattan Institute (Daley and Coates 2015, Coates 2017), AHURI (Wood et al 2012, Eccleston et al 2017), and KPMG (2016).

5 The argument put by the review was that land-improving capital expenditure such as clearing or maintenance of soil fertility, which might be inadvertently reflected in land valuations and would typically form a more significant portion of overall land value for farmland than urban land, would – by virtue of the de facto exemption for farmers – not be discouraged. However this risk could of course be addressed in other ways, like basing liabilities on average values across multiple properties or allowing deductions for expenditure.

6 See Helm (2016). John Stuart Mill in his *Principles of Political Economy* favoured this kind of tax as a practical means of capturing land rents while avoiding some of the inequity associated with introduction of a LVT.

Box 1: Land tax and stamp duty – economic impacts of reform

What little empirical work there is in the Australian and international literature on the economic outcomes of reducing distortionary taxes, such as stamp duty, in favour of recurrent property taxes supports the view that the benefits of doing so are large in comparison to the gains from other potential reforms.

Theory strongly supports the efficiency of recurrent property taxes, LVT in particular (recurrent taxation as a category excludes transaction taxes such as stamp duty). LVT is at worst 'neutral', i.e. non-distortionary, and hence imposes no efficiency cost. And by spurring land into more productive use it can arguably also be 'better-than-neutral', i.e. efficiency-improving (Tideman 1999, Tideman et al 2002). In contrast to LVT, improved-property taxes deter investment so are acknowledged to have some minor but non-zero efficiency cost.

Empirical work on the gains to be had from greater use of land or improved-property taxes turns largely on the economic cost of the distortions imposed by the taxes being replaced.

At the international level, a 2008 OECD report (Johansson et al 2008) produced a 'growth ranking' of taxes that now underpins much of the OECD's country advice. Recurrent property taxes were at the top of the list, followed by broad-based consumption taxes (e.g. GST), personal income taxes, and then corporate income taxes. The empirical work in the report indicated that a shifting from income tax to recurrent property tax had economic benefits 3-4 times those from a shift to consumption taxes. A shift of tax revenue of 1 percent of GDP from income tax to recurrent property tax was estimated to improve long run GDP per capita by 2.5 per cent, although the authors caution against relying too heavily on the estimated magnitudes of change (p43 and Table 11, column 5).

Tideman et al (2002) more directly considered the question of the gains to be had from shifting taxation away from distortionary taxes (e.g. income tax) and onto land as much as is possible. Their CGE modelling using US data suggested that a maximal-land tax strategy could raise wage rates by 35 per cent and output by 25 per cent over a 30-year horizon.

In the Australian literature, CGE modelling of the impact of stamp duty beginning with Econtech's modelling for the Henry review (KPMG Econtech 2010) has found that they are particularly inefficient taxes. This agrees with several overseas findings (see the studies cited by Coates 2017).

The Henry review modelling found the Marginal Excess Burden (MEB), or reduction in economic welfare (i.e. value of economic activity foregone) from each additional dollar of stamp duty raised was 34 cents. The Average Excess Burden (AEB), a better measure of the total welfare gains from abolition, was slightly lower at 31 cents. Current state land taxes levied on narrow bases with progressive rate scales were found to have MEB and AEB of 8 cents and 6 cents respectively.

The most recent in a series of iterations of this modelling was produced by the Commonwealth Treasury for the 2015 tax review process (Cao et al 2005). It estimated a MEB for stamp duty of 72 cents, more than twice the earlier estimate (AEBs were not estimated). A broad-based LVT was modelled as being slightly positive for domestic welfare (with a negative 10 cent MEB) due to the transfer effect of taxing foreign-owned land.

The Grattan Institute (Coates 2017) has used the difference between the 72 cent figure and the -10 cent figure from the Cao et al (2005) results multiplied across the total stamp duty revenue raised by Australian states to suggest that the economy-wide welfare gains from the tax switch could be as much as \$17 billion per annum. That dollar figure is equivalent to 1% of GDP each and every year – suggesting an incredible economic dividend. It is the equivalent of \$1,800 per household or, if these gains were ultimately capitalised into property prices, a capital gain in the region of 5%.¹

Modelling by KPMG (2016) of the household impact finds similar results – a \$1,400 per household long-run consumption gain – based on a similar CGE approach.

To compare potential reforms, the Productivity Commission (PC) in 2017 used an earlier version of the Grattan figures based on the Econtech modelling to conclude that the tax switch is overwhelmingly the

¹ In 2016-17 GDP was \$1765bn (ABS 5206.0 Table 1), there were an estimated 9.2m households (ABS 3236.0), and dwellings were worth \$6484bn nationwide (ABS 6416.0 Table 6). Capitalisation assumes a 5% rate.

most beneficial of a set of reforms aimed at realising the productive potential of land (the others included reducing planning restrictions, streamlining development assessments, etc). The expected economic impact was around 6 times larger than the combined benefit of all other reforms considered by the PC – and on the more recent Cao et al figures the impact would actually be 12 times larger.

A PwC report for Infrastructure Australia (2017) reaches similar comparative findings. Of a suite of ‘productivity-enhancing reforms’ that include energy privatisation, public transport franchising and others the tax switch was seen as the most significant reform, with an economic impact exceeding all others combined. This is entirely driven by an assumption of a 3% capital productivity improvement that is difficult to reconcile with other empirical evidence, however, so the PwC findings should be taken with a grain of salt.

The economic costs of stamp duty across these studies can all be fairly classed as ‘high’ (relative to the zero or negative costs of LVT). However there are reasons for caution before treating them as definitive. One is that all these figures are based on similar CGE modelling (or are simply assumption driven, in PwC’s case), which may be problematic given Murray’s (2018) critique of the validity of modelling transaction taxes in a CGE framework. Another is that incremental revisions to this framework have significantly changed the results (e.g. the increase in MEB from 31 to 72 cents from 2010 to 2015), raising questions about robustness.

Box 2: Subbing off the best player on the field?

Murray (2018) has recently put forward a range of arguments that question the accepted wisdom around the effects and merits of the tax switch, and which appear to undermine the idea that abolishing stamp duty should be a high reform priority.

He argues that:

- The asset repricing (capitalisation) impacts of stamp duty are not identical to those of a LVT, and even a revenue-neutral tax switch may create windfall property price gains;
- The Computable General Equilibrium (CGE) models which have produced dramatic and widely-cited estimates of the economy-wide costs of stamp duty are structured inconsistently with what is known of the incidence of stamp duty, and CGE models are anyway inherently incapable of measuring the allocative inefficiencies of transaction taxes;
- Uncertainty over future land rents, a pervasive feature of land markets, means that many land transfers are in essence ‘gambles’ over different futures rather than productivity-enhancing changes in use, challenging the presumption that there are necessarily real foregone gains from trade when transfers are inhibited by a tax; and
- There is reasonable evidence that stamp duty is less of a deterrent to productive trades than is supposed.¹ This means that its most significant effects may be to slow speculative activity, partially capture capital gains, and act as an automatic stabiliser for the macroeconomy.

None of these claims undermine the case for LVT or imply the tax switch is completely without merit. Murray concludes rather that the tax switch would be “subbing off the best player on the field to bring on the best player on the team” – and that a better reform model would be to fund reductions in payroll taxes or other distorting taxes with LVT while retaining stamp duty.

¹ For instance, of the residents surveyed by Kelly, Weidman and Walsh (2011) who were unhappy with their current housing arrangements only 10 per cent identified tax considerations as a reason for not moving.

Existing thinking on the transition: three options, zero consensus

Key points:

- If a stamp duty-replacement land tax were imposed on current owners of property at the full, revenue-neutral rate then recent purchasers would bear an unfairly high share of the total tax burden. This is the major rationale for transitional policies.
- The Henry review suggested the issue could be dealt with one of three ways:
 - » **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 that can be used in lieu of cash payments; or
 - » **Gradual transition:** phasing out stamp duty and phasing in land tax over time, as the ACT has done since 2012.
- Various commentators favour each of these models, but thus far there have been limited attempts to define clear objectives for transition policies or discuss trade-offs.

The Henry review provided some considerations and guiding principles for the transition, suggesting three broad arrangements (Commonwealth of Australia 2010a, section C2):

- A model that can be referred to as full grandfathering or **switch-on-sale** (Coates 2017), in which an exemption from LVT is granted to existing owners, while new purchasers are liable for LVT but are no longer required to pay stamp duty;
- A **credit** model with immediate abolition of duty and application of LVT to all property, but with existing owners provided some amount of credit to be used against their tax liabilities;
- A phase-out / phase-in or **gradual transition** model as in the ACT, whereby rates of duty for new purchases are gradually reduced and LVT gradually increased over time (e.g. 10 years);
 - » In the version of this proposed by Henry, the initial phase-in period would apply to future buyers only, with existing owners remaining exempt for a different period (e.g. 15 years) before facing a similar gradual phase-in period to the full rate of LVT.

The most significant transitional issue these proposals are intended to address is that of recent duty-payers, who will have a legitimate claim to being taxed twice if they are immediately liable for LVT.

Henry also discussed an **opt-out** proposal not targeted at the double taxation issue but at avoiding compulsion for future buyers. Under this option future buyers could choose to either pay duty and access an LVT exemption, as per current policy, or avoid paying duty and be liable for LVT.⁷ It was discussed by Henry as a voluntary version of the switch-on-sale approach, but in fact an opt-out option could equally be paired with a credit model. Section 4 discusses this further.

⁷ Henry also proposed that once a property had been opted-in to the land tax system, it could not leave.

Finally, to address liquidity issues and potential hardship for asset-rich cash-poor owners (e.g. retirees), the review proposed that low-income owners be allowed to **defer** their tax payment at interest via a debt attaching to the property that is discharged on sale.

Henry suggested that the clearest need for a transition mechanism was for owner-occupied land, and the schemes above were presented in that context. The reasons for this were not fleshed out, but presumably relate to political acceptance and avoidance of personal hardship. The double-taxation issue applies more widely, however, as might the cashflow issue, and of course nothing would prevent any of the proposals being extended to other property types.

The only jurisdiction to move yet on the tax switch has been the ACT.

A taxation review the ACT undertook in 2011-12 recommended a phase-out / phase-in approach over 10 years, with additional 'credit' for recent buyers providing in effect a full exemption from the replacement LVT for up to 10 years of this transitional period.⁸

The policy announced in May 2012 and enacted from 2012-13 adopted a gradual transition model with a phase-out and phase-in over a 20-year period. However it did not adopt the recent-buyer exemption/ credit recommendation. Thus all properties of a given value and type pay the same rate of LVT regardless of when they were bought.⁹

The structure of the new LVT appears also to have redistributed the aggregate burden of property tax away from rural property and on to commercial and high-value owner-occupied residential property, with little change for lower-value owner-occupiers or residential investment properties.¹⁰

In 2016 the Australian Greens endorsed as election policy an alternative to the ACT model, the 'switch-on-sale' scheme described above, in which states would no longer charge stamp duty on new purchases but LVT would apply from the purchase date, with existing owners exempted indefinitely.

The Greens' proposal included a financing scheme whereby states would cover the revenue shortfall relative to continuation of stamp duty via a Commonwealth loan with interest at cost. The terms of the loan would require full repayment by 2030, the implicit assumption being that states would set LVT rates for revenue-neutrality over a 13-year period (the specific tax rates were not modelled).¹¹

This switch-on-sale model was also favoured by the NSW Lambert Inquiry (NSW Treasury 2011) and the McKell Institute (Bentley and D'Cruz 2016).

The Grattan Institute (Coates 2017) argues that a gradual transition as in the ACT, combined with tax deferrals for retirees, is the best overall approach to balance three major competing objectives:

- Fair treatment of recent duty payers;
- Revenue stability during the transition; and
- Avoiding hardship for asset-rich income-poor households.

Coates (2017) emphasises that the gradual transition preserves cashflow and revenue, at a price of losing some flexibility over the land tax rate (since to substantially alter the pathway would risk credibility), but the switch-on-sale model in contrast involves a potentially lengthy loss of cashflow which must be funded from elsewhere.

8 ACT (2012a, p154). The proposed 'credit' would have fully exempted recent buyers from the increase in general rates (i.e. the portion that replaces stamp duty) until a future year defined as the purchase year plus 10. For purchases 5 years back a 5 year exemption would apply, for purchases 6 years back a 4 year exemption, etc.

9 ACT Government (2012b, section 3.2).

10 Murray (2016).

11 Parliamentary Budget Office (2016).

AHURI's recent "pathways to housing tax reform" inquiry also proposes a model for national implementation of stamp duty reform. Like Grattan, the AHURI researchers argue in favour of the phase-out / phase-in approach of the ACT as the specific policy model for the tax switch.¹²

However the AHURI researchers also propose a number of actions by federal and state governments in a multi-stage process to prepare for this change. This is described as a "nationally co-ordinated incremental strategy with short, medium and long-term objectives". Box 3 comments on AHURI's proposal.

John Freebairn (2017) has argued, contra Grattan and others, that the model of credit for recent buyers addresses the double-taxation problem in a way that is superior on efficiency grounds to either the ACT model or switch-on-sale model. The full efficiency benefits would arise from day one, since unlike in the ACT stamp duty would be abolished immediately. And there would be no disincentive to sell, since unlike under switch-on-sale, the decision to sell would trigger no change in land tax treatment.

12 Eccleston et al (2017).

Box 3: AHURI's tax switch strategy: a long road to the wrong place

Although broader implementation strategy is beyond the scope of this report, the prospects of the tax switch of course depend on both the strategy taken with respect to inter-governmental co-operation and the starting position for reform. This box comments on how AHURI's proposal to reform stamp duty via a four-stage process might influence these prospects (Eccleston et al 2017).

Stages 1 and 2 are described as foundations for subsequent reforms. Stage 1 involves intergovernmental agreement to reform valuation processes and data arrangements. Stage 2 involves simplifying each state's duty into a single-rate-with-threshold structure aimed at cutting the duty paid by a majority of properties (e.g. 60% under the authors' suggested rates).

Stage 3 involves further shifting the duty burden from low-value to high-value owner-occupied property, as well as onto investors. Stage 4 is a gradual shift from this modified stamp duty to a recurrent property tax, using the phase-in / phase-out approach of the ACT.¹ The authors envisage the latter requiring national leadership and incentive payments from the Commonwealth.

There are interesting questions about whether either the 'nationally co-ordinated' or 'incremental' aspects of this proposal are likely to promote or hinder reform.

The ACT's tax switch involved neither. However AHURI argues that "given the complexities of housing markets, a national approach including all levels of government and key stakeholders will be required if reform is to be achieved". The National Competition Policy (NCP) reforms are cited as precedent.

How likely is national agreement on property tax?

Property lobbies see replacement of stamp duty by non-property taxes, such as GST, as their goal.² Even a LVT reform that is broadly distributionally neutral will from their perspective be considered a loss, one that carries meaning and will be seen as a precedent. This is likely to

1 Note that AHURI propose a version of a capital improved value (CIV) base under a new valuation system whereby valuers would produce an assessment of the CIV under "highest and best use" (e.g. highest density allowed on the site), in order that the tax base be independent of land use, like LVT is.

2 "Scrap stamp duty and increase GST, says Property Council of Australia", SMH, 15 June 2015,

forever preclude support from the right wing of politics for the tax switch.

If national agreement in practice thus requires party political alignment between the Commonwealth and most of the major states, then a reformist state government unwilling to go it alone might be waiting a long time.

Would a sequenced approach be sensible?

There is a major problem with enacting less significant preliminary reforms benefitting a majority (or appearing to do so), which is that there are fewer gains to be redistributed via subsequent more important reforms and therefore less chance of building a majority constituency for the latter. For a sequence of changes to arrive at the desired end-point, each and every one must achieve majority support – but a one-off package only needs to achieve majority support once. The principle is familiar from contexts such as international trade agreements.³

In the tax reform context Brys (2011) lays out a number of reasons why bundling reforms and moving quickly, a.k.a. the big bang approach, is generally preferable to sequencing. Not least amongst these reasons is “the risk of getting stuck at a partial reform equilibrium”.

In the present case, pleasing a majority of homeowners with duty cuts in AHURI’s stages 2 and 3 make it less likely that the stage 4 transition will be politically feasible. Stage 3, in other words, is likely to be a ‘partial reform equilibrium’.

Indeed under the stage 4 design, which for each state has a single LVT rate and the same threshold as the simplified duty structure in stage 3, there are no major redistributive effects from moving to stage 4. The stage 4 reform simply replaces a low-salience transaction tax with a high-salience recurrent tax. If there were a ‘Milton Friedman rule’ of smart tax design to match the quote at the beginning of this report, this idea would surely breach it.

The gradual transition in the ACT has proven politically difficult even with tax rates skewed to provide redistribution in favour of the majority; it is likely to be impossible without it.

There is also serious doubt about whether the proposed stages 2 and 3 would be fairer or would improve housing affordability as AHURI expect (p2, p35). An appreciation of the economic incidence of stamp duty implies that rejigging duty rate scales causes windfall gains and losses for the current cohort of owners – but might not improve affordability for future buyers. Just as it is logical to expect stamp duty to be capitalised into sale prices in general, so too is it logical to expect a progressive scale stamp duty to be capitalised into prices of more or less expensive housing to varying extents.

AHURI’s “layered reform framework with inbuilt flexibility designed to reflect and respond to current government policy environments” might therefore end up worse than doing nothing. It might leave states with a narrow-base high-rate transaction tax to match their existing narrow-base high-rate land taxes, while doing little for fairness or affordability.

Some elements of AHURI’s reform proposal (e.g. harmonising valuation methods) look valuable in their own right. But there are strong reasons for progressive state governments to focus their efforts on unilateral reform undertaken quickly, rather than waiting for national leadership.

Indeed part of the case for change that a unilateral reformer can make is that there are tax competitiveness reasons, i.e. a first (or second) mover advantage, for going it alone. A more plausible scenario for national reform may be that the example set by the early movers and the economic advantages it yields makes it easier and more critical for other states to follow.

3 Commenting on how a wide constituency of support was secured for the NCP reforms, the PC (2005, p125) concluded that “a broadly-based reform program improves the prospect that those who might lose from a specific reform still gain overall. This can make it easier to progress reforms that might be difficult to implement on a stand-alone basis.”

Issues and options in detail

Key points:

- Characterising the transition as a policy/political problem with objectives, options, impacts and trade-offs can help in moving towards consensus over the best model – or can at least make clearer the inherent tensions involved in each choice.
- There are at least six distinct issues of principle or politics to be addressed:
 - » Double taxation of recent buyers;
 - » Potential impacts on asset values;
 - » Liquidity problems for the asset-rich cash-poor;
 - » Some future buyers being made worse off;
 - » Budget impacts from lost revenue; and
 - » Other political difficulties relating to the unpopularity of new taxes and the nature of recurrent property taxes.
- Transitional policy options include the three basic models suggested by the Henry review – **switch-on-sale** (full grandfathering), **credit** for current owners, and a **gradual transition** – and several complementary policies:
 - » A phase-in to full land tax rates or **'tax holiday'** (other than as part of a gradual transition);
 - » An **opt-out** option for future buyers to choose between paying land tax or stamp duty;
 - » **'Internally funding'** the costs of these various concessions via higher land tax rates to make the reform package revenue-neutral over a defined period; and
 - » Allowing **deferral** of land tax either on a restricted eligibility basis (e.g. means-testing) or for taxpayers more broadly.

This section explores in detail the key issues and objectives and the potential transitional options and their impacts.

Six key issues of principle or politics are identified, and a range of transitional policy options are discussed.

To assess the impact and cost of each proposal it helps to begin from a 'base case' transition model relative to which each can be described and evaluated.

A suitable base case is what Freebairn (2017) calls the 'cold turkey' approach – full abolition of stamp duty and immediate introduction of a revenue-neutral LVT replacement to be paid by all properties,

“A ‘base case plus’ framing lets us ask the same question of each transition proposal: what are we buying, and what is the cost?”

including properties bought before the reform date.¹³ This transition model is revenue-neutral immediately and has the best efficiency properties.

Deviations from it via transitional policies intended to address specific issues of principle or politics arising in the base case may have costs to revenue, efficiency, fairness or simplicity.

This ‘base case plus’ framing lets us ask the same question of each proposal: what are we buying – i.e. what objectives are we achieving relative to the base case – and what is the cost?

4.1 Transition issues

‘DOUBLE TAXATION’

This is the most significant transitional issue arising in the base case.

Existing property owners have paid stamp duty on the understanding they would not also face a land tax. If the reform explicitly exchanges one tax for the other, then to require those who have recently ‘pre-paid’ their quotient of property tax to now also ‘PAYG’ via LVT would lead to claims of double taxation, i.e. an unfair distribution of the overall tax burden.

The extent to which these claims are legitimate, the extent of actual unfairness as opposed to annoyance at lost privilege, arguably depends on how recently duty was paid (i.e. how many years of tax-free tenure have been enjoyed already). Pinning this down to define a fair period of future use for past tax paid is hard, especially since a rationale based in fairness for stamp duty has never been put forward. The average tenure is an easy default option, but a case could also be made for a period linked to the benefit already derived from ownership, which would be consistent with the ethical principle behind the new tax in the absence of one behind the old.

The inequity of stamp duty is that the trigger for tax and the distribution of the overall burden is arbitrary. The tax is based for historical reasons on the decision to transfer property, which is an action that costs the state nothing and arguably has some social benefits (i.e. higher productivity). Yet the base case reform would create the same kind of inequity, by penalising some taxpayers according to the equally arbitrary factor of when they transferred property.

This is a matter of principle but also of politics. One does not easily persuade taxpayers they are correcting a structural unfairness by creating an obvious transitional unfairness. A transparent and fair treatment of recent duty payers thus seems important to signal that the reform in general is based on rational, principled grounds.¹⁴

13 Note that a ‘cold turkey’ approach to the transition need not preclude various exemptions and concessions, such as progressive rate structures, being built into the new tax.

14 The question sometimes arises of whether, if the economic incidence of stamp duty is on property sellers, the ‘double taxation’ problem is one of perception but not economic impact. This is not the case; the problem is real. The transitional owner who already paid stamp duty now faces the legal responsibility for land tax, and because future buyers facing LVT pay less upfront in response, there is no compensating asset value change.

ASSET VALUE IMPACTS

“The case for special treatment is about what the Mirrlees tax review in the UK called “fairness with respect to legitimate expectations.”

Freehold land tenure as an institution involves more than enough inherent risk already.”

It is important to note that the principled case for special treatment of existing owners is not about compensation for asset repricing.

Unlike the introduction of a new LVT in isolation, an LVT introduced as a revenue-neutral replacement for stamp duty is likely to have only minor asset price impacts. There will be minor ups and downs depending on the structure of the new LVT relative to the old stamp duty, mirroring the patterns of previous tax advantage relative to the new system. But fears of a substantial shock as LVT is capitalised into asset prices are unfounded since they ignore the equivalent (or greater) uplift caused by abolishing stamp duty.¹⁵

The case for special treatment is only about people who will, in the years until sale, need to pay a tax unforeseen (or at least not legislated) when they bought their property. It is about what the Mirrlees tax review in the UK called “fairness with respect to legitimate expectations” (Mirrlees et al 2011), in the context of an unavoidable tax that is “inextricably related to very long-lived assets and often deep-rooted social beliefs and norms” (Slack and Bird 2014). Freehold land tenure as an institution – i.e. full payment upfront for an infinite and uncertain stream of returns – involves more than enough inherent risk already.

There seems no obvious policy design response to unfounded fears of major asset price shocks. Rather this is a matter of senior advisors and politicians understanding and being capable of communicating tax capitalisation. If this appears too challenging, the reform in general is likely a bridge too far.

LIQUIDITY PROBLEMS

“While cases of true hardship may be few, the spectre of this is fodder for fear campaigns.”

Asset-rich cash-poor landowners unable to free up liquidity may encounter hardship when facing a new tax which must be paid in cash. Yet on principle there are no grounds for exemption, especially for long-held properties that have not recently paid stamp duty, since the hardship is not one of inherent ability to pay – i.e. wealth – so much as the structure of asset portfolios.¹⁶

While cases of true hardship may be few, the spectre of this is fodder for fear campaigns.

The obvious solution is to allow deferral of tax payment with debt discharged on sale. Such arrangements are well established for rates deferral in several states (PC 2017). The Pensions Loan Scheme, in which the Commonwealth lends money to pensioners who pledge real estate as security, is run along the same lines.

Liquidity issues may go beyond pensioners. A new LVT might put pressure on people suffering an employment shock, on heavily mortgaged owners including recent buyers, lower-income households, and negatively geared investors, and on long-held business premises no longer earning a

15 If stamp duty and LVT are capitalised into land prices differently, which is plausible, the tax switch seems more likely to generate windfall gains than losses (Murray 2018).

16 Bentley and D’Cruz (2016) express the issue like this: “Is it fair for a government to levy tax in such a way that homeowners are forced to sell their family home? Is it fair for individuals who own property to avoid taxation because of the manner in which they structure their assets, while often simultaneously benefitting from other forms of taxpayer assistance such as the aged pension?”.

commercial return on assets that have substantially appreciated in value.

IMPACTS ON FUTURE BUYERS

There are two issues that may affect the politics around future buyers.

One is that the change may leave some prospective buyers, particularly those on the brink of buying a family home they expect to occupy for a lifetime, worse off in that their expected future LVT liabilities exceed the duty they would have paid under the current system. This is not a principled objection, since at present long-stayers bear a disproportionately low share of the tax burden and the reform is intended to correct this. However it may bear on political acceptability. Avoiding compulsion to enable a limited “no worse off” promise might be a necessary element for reform.

Another issue is that future buyers may worry about the unpredictability of future LVT liabilities relative to the certainty of an upfront stamp duty. This worry could be based on unexpected land value growth, in which case the real concern is about cashflow pressures rather than fundamental ability to pay, or could be based on perceptions of policy risk with regard to future tax rates. If such views were widely held then these perceived risks would be reflected in a higher risk premium in housing yields and lower upfront prices. However this point is unlikely to be appreciated by prospective buyers.

BUDGET IMPACTS

While the base case is revenue neutral, some transition proposals have budget implications.

Grandfathering tax-free treatment for current owners, for example, could lead to substantial revenue loss given that only around 5-6% of properties are bought and sold each year.

The problems with this are about both the principles and politics of reform. A sizeable revenue gap may mean less efficient state taxes remain higher than otherwise, worthwhile spending proposals are deferred, or excessive debt is passed to future taxpayers. Politically, a deterioration in headline budget balance or sharp increase in debt may derail the reform by leading to charges of fiscal irresponsibility.

Even a reform package designed as fully funded, i.e. where a temporary revenue gap is matched by a subsequent surplus and the long-run debt impact is zero, might be subject to a scare campaign over the deficits and debt in the early years. Or – in an asymmetric battle that is difficult to win – such a model might be instead vilified as a ‘tax increase by stealth’ and subject to criticism precisely because it collects more tax in the long run than stamp duty does at present.

The imagery presented in the budget is politically significant. Much effort and ingenuity goes toward massaging the operating forecasts, and political aversion to debt is one reason that states favour private finance structures (e.g. PPPs and asset sales) even where they impose net losses on taxpayers.¹⁷ It is an issue to be cognisant of in transition design, even if the rules of this fiscal responsibility game are blurry and ever-changing.

THE POLITICAL ECONOMY OF PROPERTY TAX

Then there are a host of other issues based in perceptions, fears, or self-interest, rather than ethical principle, that weigh on the political saleability of this reform and in aggregate may tip the scales against it. Some are inherent in the nature of LVT, some can be minimised by design.

Most obviously – it is a new tax. Long-held properties enjoying tax-free tenure will no longer do so under a reform that upends the existing social pattern of who funds government and how. Even for taxpayers who paid duty long ago, face no liquidity issues, and are relatively wealthy, the loss of privilege will make the change unpopular.

¹⁷ Hermans (2018) estimates the recent privatisation of the Victorian land titles office will cost taxpayers a net \$32m per annum, for instance.

“The politics of pure self-interest may not be overwhelming where a strong equity case can be made for the change.”

This issue, the politics of pure self-interest, cannot be ignored. However it may not be overwhelming where a strong equity case can be made for the change. Ken Henry during his review cautioned against pessimism, arguing that “we underestimate the power of equity to promote worthwhile tax change” and that equity “is usually a more intuitive and, indeed, more meaningful way for many in the community to understand and become interested in tax reform” (Henry 2009). On this view, the message to ease the politics is about the arbitrariness of how the overall tax burden is distributed under stamp duty, and the coherence of distributing it instead according to the pattern of benefits from the spending government undertakes.

Another dimension of the politics is about the salience of LVT relative to stamp duty, as mentioned in the introduction. However this aspect of the tax is not entirely immutable. Recent reforms in Ireland, for instance, address it by allowing property taxes to be deducted at source from salary or pensions (Slack and Bird 2015). There is also evidence that US jurisdictions with greater use of ‘tax escrow’, where tax is bundled with mortgage payments and submitted on the taxpayer’s behalf by the lender, end up with higher property tax rates (Cabral and Hoxby 2012). Default tax deferrals could have a similar effect – as discussed below.¹⁸

The resilience of the reform should also be of concern in transition design. This is not just about the “seeds of destruction” described in the introduction – the inherent asymmetry in the political costs and benefits of cutting LVT – but also the immediate concern over whether a reform stalled or reversed immediately after the next election would leave the tax system in a better or worse state.

Then there are various other prickles that make the politics of LVT painful and seem to have solutions only in messaging and persuasion, not policy design.

For instance, LVT can be demonised as a discriminatory wealth tax. It arguably even amounts to the state ‘stealing property rights’ since, as Ingles (2016) puts it, “its inherent nature is to confiscate part of the value of existing assets”. There is an element of truth here, though not for the tax switch.¹⁹

LVT is also unpopular since it cannot be avoided, it bears no relation to the taxpayer’s actions, it raises the holding costs of land, and it purports to tax not a cash income but an invisible quantity economists identify as ‘economic rent’. Economists, of course, consider all these merits.

“LVT is unpopular since it cannot be avoided, bears no relation to the taxpayer’s actions, raises the holding costs of land, and purports to tax not a cash income but an invisible quantity economists identify as ‘economic rent’. Economists, of course, consider all these merits.”

18 Are attempts to minimise salience unprincipled on transparency and accountability grounds? Only in a trivial way. A recurrent property tax escrowed, deducted from salary or deferred would remain far more transparent than many other taxes. In the context of how little the public understands of public finance, service delivery, and beneficiaries, reducing the salience of a recurrent property tax is a third-order accountability problem.

19 The idea is that a new LVT has economic effects due to capitalisation that are equivalent to appropriating a silent-partner equity share in land. Private wealth falls by the present value of future tax payments, and if the public balance sheet recognised rights to future tax as an asset then the private and public impacts would balance. The offsetting windfalls from duty abolition mean this point is irrelevant for the tax switch, however.

SUMMARY – TRANSITION ISSUES

Some of the issues described above arise once only in transition; others are inherent in the new tax and thus bear on the political feasibility of the reform. Some are about principle – they relate to efficiency or equity – while the others are purely political.

Table 1 summarises these issues, and the next subsection considers how they map to potential solutions.

Table 1: Transitional design issues

	One-off (transitional)	Ongoing
Principled	<p>Double taxation: of recent buyers</p> <p>Budget: potential funding gap or long-run increase in debt</p>	<p>Liquidity: difficulties and hardship for the asset-rich cash-poor</p> <p>Political economy: resilience/ political sustainability of new system</p> <p>Future buyers: all buyers face more uncertainty in tax burden</p>
Political	<p>Budget: fiscal responsibility politics around short-run impacts</p> <p>Asset values: fears of negative shock</p> <p>Asset values: minor ups and downs</p> <p>Future buyers: those expecting long tenure are worse off</p>	<p>Political economy: new tax for long-held properties, high salience, perceptions of discriminatory wealth taxation, etc</p>

4.2. Transition options

The proposals introduced in section 3 (and some others) are discussed in more detail here. To structure this discussion, each proposal is described in terms of deviations from a base case transition model in which LVT applies to all properties immediately. Each is described as follows:

- What LVT concession or other benefit is granted relative to the base case?
- Who receives the concession?
 - » Recent buyers – i.e. a subset of current owners;
 - » Long-held properties – i.e. all other current owners;
 - » Future buyers; or
 - » Everyone – i.e. all current and future owners.
- Which of the above transitional issues are addressed?
- Which tax policy design principles are most affected, and which are prioritised over others?
- What are the key design options or parameters?

SWITCH-ON-SALE

The **switch-on-sale** model provides concessional treatment to all current owners by granting an exemption from the new LVT until sale. It can be described as a ‘full grandfathering’ approach in the sense that no current owner will be worse off: their tax status prior to the reform is preserved

“Switch-on-sale prioritises consistency of tax treatment through time, and preserving the privilege that exists under current law, over all other considerations.”

indefinitely, just as if the reform had not taken place.

Switch-on-sale solves the double-taxation problem, but also goes furthest towards easing the difficult politics of the new tax by extending concessional treatment to long-held properties too. However the revenue cost will be commensurately higher than under proposals with ‘partial grandfathering’ where concessional treatment is targeted more tightly at recent buyers.

The value of the LVT exemption is contingent on continued occupation under this switch-on-sale model, but not under other proposals where the concession for current owners is defined in terms of dollar value or time (as in the credit model and gradual transition model respectively). This creates an incentive to defer sale, which works against the efficiency objectives of the reform.

Switch-on-sale effectively prioritises consistency of tax treatment through time and preserving the privilege that exists under current law over all other considerations including the impact on taxpayers more broadly, the concept of fairness in tax burdens implied by the new tax regime, and economic efficiency. Switch-on-sale prioritises, in other words, ‘fairness with respect to legitimate expectations’ over other policy principles. The expectation to be respected here is that the tax deal at the time of purchase is not altered to the detriment of past purchasers in any substantial way. Implicit in this is that buying property has a special status amongst economic activities.

There are essentially no specific design choices within this option, since by definition the LVT exemption is of indefinite length, lasting until sale.

CREDIT

Under a **credit** model current owners would be granted some amount of credit to put towards future land tax liabilities (or to cash out).

This approach could be used to address both the double-taxation issue and the general political difficulties of a new LVT to varying extents, depending on design (e.g. eligibility and value).

What distinguishes a credit model as a way of extending concessional land tax treatment to current owners is that the effective tax exemption is denominated in dollar value, rather than time (as under a phase-in approach or indeed under any other form of time-limited concession).

There are many possible options for the calculation. The Henry review suggested three:

- Credit based on the **past duty paid**, over a defined past period and based on a sliding scale:
 - » e.g. properties bought in the year of the reform receive credit equal to 100% of duty paid, in the previous year 80%, in the year before that 60%, etc;
- Credit based on the **expected LVT payable** over a set period of ownership:
 - » e.g. each owner is provided an amount expected to be adequate for 5 years’ worth of LVT on their property, based on some standard assumptions about land value growth;

- A **flat dollar amount** per property:
 - » e.g. a standard \$5,000 per property regardless of value.

Each has different implications:

- Sliding-scale credit based on past duty paid more directly targets the double-taxation problem by allocating the most credit to the most recent buyers. It requires a policy choice over how far back to extend credit, which could be the average period of property ownership (around 15-20 years) or any other chosen period;
- Credit based on expected future LVT, in contrast, would benefit all current owners equally regardless of year of purchase. It would be designed to provide all owners with the same duration of exemption, with higher-land value owners therefore benefitting most in dollar terms. The key design parameter is the intended duration of LVT exemption (e.g. 5 years) but the actual duration would depend on land value growth;
- A flat dollar credit would similarly be popular with owners of long-held properties (lower-value properties in particular) while addressing the double-taxation issue only bluntly. The key design choice is the amount per property.

For a given dollar cost the first model most clearly targets the actual equity problem, the second focuses the spend on the wealthiest landowners, and the third targets vertical equity and buys the broadest base of support.

Prosper have previously suggested an alternative model which, like the sliding scale model, would be based on past duty paid.

Under the Prosper model the credit provided to a property would be equal to the past duty paid minus the hypothetical LVT payable from the purchase date to the reform date had the new tax already been in place. Statutory valuations would be used to calculate the 'backdated' LVT, and there would be inflation indexation for both the past duty paid and the hypothetical LVT. There would be a minimum credit, obviously, of zero.

This method would be equivalent in economic terms to refunding the duty paid by current owners, then retrospectively applying the new LVT.

Like a sliding scale model, it would effectively provide the most credit to the most recent buyers, addressing the double-taxation issue more than the general politics of a new tax.

Unlike the sliding scale model, however, there would be no choice under Prosper's model of how far back to extend eligibility for credit. This time limit would effectively be determined as a function of historical patterns of land value growth and the new LVT rate. Any property which would have paid more LVT since purchase (had the LVT been in place) than was actually paid in stamp duty receives zero credit.

Prosper's model would also be more complex to implement and explain, and may be seen as unfair by property owners who disagreed with their previous statutory valuations but are no longer legally able to challenge them.

The key difference between sliding scale credit and the Prosper model is in the fairness criterion each embodies.

While a sliding scale expresses the idea that paying duty grants each property the right to an equal period of tenure, Prosper's model expresses the idea that a fair period of use in exchange for past duty paid also depends on the land value of the property. In this way it effectively backdates the redistributive effects and ethical values of the new LVT in the calculation of credit. Land-rich properties (e.g. vacant blocks) get less credit under this model, capital-rich properties (e.g. densely developed sites) get more. In other words, Prosper's model retrospectively implements the equity principle

“Prosper’s model is equivalent in economic terms to refunding the duty paid by current owners, then retrospectively applying the new LVT. It retrospectively implements the equity principle underlying the overall reform.”

underlying the overall reform.²⁰

In practice, however, both the Prosper model and a sliding scale will distribute credit to much the same properties in much the same proportions when compared to other credit models which are not based on past duty paid and which do not discriminate according to duration of tenure.

Two design choices that arise under all credit models are whether to cash out unused credit upon sale, and how to index credit in the future (and in the past, under the sliding-scale and Prosper models). If unused credit is lost upon sale there will be an incentive to retain ownership, as in the switch-on-sale transition. However if cash-out is allowed, and indexation broadly reflects taxpayers’ time value of money, a credit model will create no incentive to either delay sale or sell prematurely.

The switch-on-sale and credit models are mutually exclusive options. However credit could be provided in conjunction with a phase-in to the full LVT rate, such as under a gradual transition or a ‘tax holiday’.

GRADUAL TRANSITION

A **gradual transition** has two sides to it, each with different purposes.

The **‘phase-in’** of LVT effectively bestows a time-limited LVT concession on current owners. As part of a gradual transition, as in the ACT, it addresses the same concerns as the switch-on-sale and credit models, i.e. immediate full introduction of LVT will be unfair on recent buyers and might provoke a ‘tax revolt’.

However unless there is an additional credit or time-exemption for recent buyers, the concessional treatment granted by a phase-in period applies indiscriminately to recent buyers and long-held properties alike. It resolves the issues of both fairness and politics relating to existing owners simply by slowing down the introduction of the new tax to minimise (or perhaps drag out) the grumbling. Much of the cost of a phase-in (i.e. LVT revenue lost relative to base case) is thus not targeted at recent buyers, but benefits longer-held properties instead.

The **‘phase-out’** of stamp duty has different goals. Primarily it avoids significant revenue loss while the new LVT is being phased in. But it also means buyers do not experience radically different tax treatment depending on whether their purchase precedes or follows the reform date. Adjustments to property markets, i.e. the minor ups and downs in asset prices resulting from differences between old and new tax structures, are therefore likely to occur gradually. Perceptions amongst buyers that the reform makes them worse off will also be dampened (putting aside objections to redistribution of the aggregate burden across property types and values, as in the ACT). However the turnover disincentive of stamp duty remains in place for longer, with associated efficiency cost. As section 5 explains, this cost might be considerable.

²⁰ Lest this retrospectivity be seen as unprincipled, it is worth bearing in mind that existing duty structures contain no implied concept of fairness in tax burdens nor of a ‘fair period’ of occupation. The sliding scale credit approach therefore backdates a particular contemporary notion of fairness as well. Legally, payment of duty simply bestows the right to have a change in land title registered, nothing more, regardless of the amount paid or the duration of prior or future tenure. Nothing in the current law helps define fairness in designing the transition; every possible choice of credit calculation imposes one or another contemporary idea of fairness.

“Credit could allow a faster phase-in (e.g. 10 years instead of 20), since instead of potential unfairness for the most recent buyers dictating the pace of change it would be the politics of taxing long-held properties that is the limiting factor.”

A phase-in of land tax is a necessary complement to a phase-out of stamp duty since otherwise new buyers would be taxed twice during the transition period.

But a short phase-in of land tax could also be enacted in conjunction with immediate abolition of duty and some other means of appeasing recent buyers (i.e. credit). Reasons to do this are discussed under the ‘tax holiday’ heading below.

A gradual transition (phase-out plus phase-in) could feasibly be paired with credit for recent buyers. This was recommended by the Henry review and the ACT review but not included in the ACT reform. It would mean owners of long-held property were liable for LVT immediately, albeit at a low rate to ease the introduction, while recent buyers were granted some additional period of tax-free tenure. This type of credit could allow a faster phase-in (e.g. 10 years instead of 20), since instead of potential unfairness for the most recent buyers dictating the pace of change it would be the politics of taxing long-held properties that is the limiting factor.

A gradual transition in conjunction with switch-on-sale, however, would have limited utility. Because switch-on-sale fully exempts current owners from the new LVT, there is no rationale in the politics of imposing a new tax on current owners to slow down the transition to LVT and the associated realisation of efficiency gains. The only remaining reasons to do so are revenue preservation and avoiding shocks to property markets.

TAX HOLIDAY

“A tax holiday could aid the politics of the reform in several ways.”

A ‘**tax holiday**’ refers to a short phase-in period before the full rate of LVT applies. The purpose would be different to that of a lengthy phase-in as part of a gradual transition.

A tax holiday would have an obvious cost to revenue that depended on the duration and rate discounts chosen. However it could aid the politics of the reform in several ways.

First, current owners not eligible for credit would have several years to get used to the reform before full-sized cheques were required.

Second, prospective buyers – primarily first home buyers, but also existing owners upsizing – would have some incentive to bring forward purchases to enjoy duty-free purchase plus lower LVT in the initial years. This could encourage turnover, thus supporting at least in appearance the claimed benefits from abolishing stamp duty. Higher turnover could also support asset prices, mitigating fears of price shocks and avoiding the effect that market uncertainty and any ‘pause’ in market activity might otherwise have. It could help produce the promised reform results prior to the next election, in other words.

Third, the revenue cost of other concessions or the impact of any unanticipated property market weakness would effectively be masked within the cost of the tax holiday. A fiscal responsibility fear campaign would be more difficult to mount when revenue-negativity can be explained away as the result of deliberate temporary ‘relief’. With credit framed as the necessary price of fairness, and the tax holiday as a generous sop to long-held properties, fiscal conservatives would find it difficult to campaign against deficits which appear largely to the benefit of their own voters, and this could improve the politics of the reform in general.

A tax holiday could be enacted as a standalone transition policy – but this would leave the recent buyer double-taxation issue largely unresolved. Thus it would be most sensibly combined with credit targeted for recent buyers based on past duty paid (either the sliding scale or Prosper model). As well as aiding the politics around long-held properties, as discussed, the tax holiday would delay the point in time at which creditor properties exhausted their credit and were required to submit cash.

There would be limited purpose to combining a tax holiday with switch-on-sale, however, for the same reasons as applied to a gradual transition (i.e. when current owners are exempt from the LVT there is no reason to slow down the transition).

OPT-OUT

“An opt-out model would not be revenue neutral but would have a long-run cost via ‘adverse selection.’”

An **opt-out** option would allow future buyers to choose between paying stamp duty and accessing an LVT exemption, as per current policy, or avoiding duty but being liable for LVT. Opt-out would be targeted at bringing onside future buyers, not current owners.

By making the change voluntary it would allow a kind of “no worse off” promise to be made to prospective buyers, and provide a means for buyers most concerned about predictability in future taxation to secure more certainty.

Opt-out would tend to be taken up by buyers favoured by the current duty structure: those expecting longer-than-average tenure, and those purchasing properties with high land value relative to improvements value.

Retaining some stamp duty would help prop up cashflow in the early years of the reform. But as with stamp duty, there would be an efficiency cost from opters-out being reluctant to sell and lose their LVT-free status. As Coates (2017) has noted, an opt-out model would also not be revenue neutral but would have a long-run cost via ‘adverse selection’. Buyers expecting long tenure and a total LVT liability exceeding their stamp duty liability would be more likely to opt-out, reducing the LVT base by more than is retained in the duty base.

The take-up and cost would be critically dependent on several design parameters.

First, the option could be restricted in eligibility to various types of buyers or properties (e.g. first home buyers only, or residential properties only).

Second, it could be time-limited in two different respects:

- The ‘open period’ during which the option is available could be limited;
- A maximum ‘exemption period’ beyond which all properties (including opters-out) must pay LVT could be defined either by specifying a particular year (e.g. the reform year +20) or a particular tax-free tenure (e.g. 20 years from purchase).

Since there is limited principled rationale for offering this option – the objective is largely about politics – there would be sense in restricting the open period to the minimum necessary to buy the approval of prospective buyers for whom the reform is likely to be highly salient (e.g. 3 or 4 years).

Limiting the exemption period also has several advantages over allowing exemption until sale:

- reducing the rate of opt-out, since many buyers would be less likely to receive payback in terms of LVT exemption for the duty paid before their exemption expires;
- lowering the long-run cost of the policy, since long-tenure opters-out will eventually lose their exemption and return to the LVT base;
- removing the sale disincentive for opters-out following the exemption period; and
- avoiding the complexity of maintaining a register of LVT-exempt properties in perpetuity.

There would be sense in selecting an exemption period only long enough to assuage prospective buyers' fears over tax uncertainty, which are likely most critical early in the tenure, and to make a (carefully worded) 'no worse off' promise defensible. The average period of ownership (e.g. 15-20 years) or the standard 30-year mortgage term could be sensible exemption periods.

An opt-out option for future buyers could be paired with either a switch-on-sale or credit model for current owners. It could also be combined with a LVT tax holiday.

However there would be limited utility to buyers in allowing opt-out under a gradual transition model, because the opt-out open period would coincide with the early years of the transition, in which the forward tax profiles of opting-out and opting-in would be similar and the de facto commitment by the state to a LVT rate pathway already provides a measure of certainty over rates.

'INTERNALLY FUNDED' CONCESSIONS

The ACT's gradual transition approach is intended to be revenue-neutral in each year: the time profile of revenue from the taxes phased out mirrors the profile of taxes phased in.²¹

The other models involving LVT concessions will necessarily have a revenue cost in the early years as well as in present value terms. An opt-out option will be revenue-positive early on (relative to the base case), but with a net long-run cost.

How should these transition concessions be funded?

The options are to:

- **Externally fund** these costs by increasing other taxes, cutting spending, or debt financing the revenue gap and passing the funding problem to a future government; or
- **Internally fund** these costs through higher LVT rates legislated as part of the transition package (e.g. a 'supplementary rate' on top of the base LVT rate that applies only for a defined transition period before sunset).²²

External funding means the tax switch reform package is revenue-negative in each year, and overall.

Internal funding means it is revenue-neutral overall while being revenue-negative upfront and revenue-positive later (prompting a need for temporary debt financing).

Discussion of the transition is often premised on the LVT rates being long-run revenue-neutral, in the sense that once transitional concessions are exhausted the new LVT will raise no more per annum

21 ACT (2012b, p54). Note the reform package includes elements besides abolition of stamp duty, including abolition of insurance duties, payroll tax cuts, and consolidation of commercial land taxes.

22 Davis (2017) and others have also proposed securitising future LVT receipts, as a financing 'solution' to enable reform – an approach formerly known as 'tax farming'. Like some private-finance PPP structures, the problem this might solve (depending on the exact structure and accounting treatment) is the political problem of debt on the balance sheet. Securitisation in this case would provide the state upfront cash in exchange for a stream of later payments (or rights to tax paid) which are real liabilities but may not be recorded as such. Obviously accounting tricks like this do not solve the underlying funding question. In this case they worsen it, since the state will also bear the difference between private finance costs and public borrowing costs via higher repayments. It is clearly economically and fiscally inferior to ordinary debt financing.

“Future buyers (as owners) might legally submit LVT, but they will not bear it in economic terms.”

than stamp duty would have – or in other words, that under the new system the average LVT payable by a property owner with the average tenure will be equal to the average stamp duty that would otherwise have been paid under the old system.

This is perhaps implicitly seen as an expression of fairness, since it means future buyers on average can expect to pay no more or less in property tax across their tenure than they would have before the reform.

The implication of this approach to setting tax rates is that the costs of any transitional concessions must necessarily be funded through the general budget.

But the logic of tax capitalisation suggests that this approach is not actually to the benefit of future buyers relative to internally funding the transition through higher LVT rates. Tax capitalisation is based on future buyers factoring LVT rates into the prices they pay for property. But if this is the case, then the incidence of the new tax including any temporary supplementary rate will be on sellers. Future buyers (as owners) might legally submit LVT, but they will not bear it in economic terms.

Tax capitalisation therefore implies that an overall revenue-neutral package, with the costs of transitional concessions internally funded via a higher land tax rate (e.g. a sunseting supplementary rate), leaves future buyers no worse off than if the general taxpayer shoulders the burden instead.

The economic impacts of the supplementary rate are only on the cohort of owners at the time of the reform. Those impacts take the form of higher LVT liabilities during the supplementary rate period, and a lower sale price for property sold during that period. Whether a supplementary rate is fair is part and parcel of the larger transition question of equitable treatment of current owners, in other words.

The obvious advantages of internal funding are that the reform package can be marketed as revenue-neutral, and that the efficiency loss from funding transition costs with distortionary taxation is avoided.

The key design choice for an internally funded transition is the duration of the supplementary rate period. The rate itself will depend on the present-value cost of the transitional concessions.

A supplementary rate would have consequences for the budget and economic efficiency impacts of other transition proposals:

- The incentive to delay sale under switch-on-sale would be (temporarily) exacerbated;
- Any given dollar amount of credit would be exhausted faster under a credit model; and
- The incentive for new buyers to opt-out would be increased during the supplementary rate period.

Accurate estimation of a revenue-neutral supplementary rate would need to take these into account.

TAX DEFERRAL

As discussed earlier, **tax deferral** is an obvious solution to the asset-rich cash-poor issue. It recognises that the fundamental problem is one of

“There are also arguably no grounds in revenue protection, equity or efficiency for not extending the scope of tax deferral far more widely.”

liquidity, not solvency.

Deferrals can in principle work with any other transition arrangement. The key design choices are the eligibility criteria, the indexation (i.e. interest) rate applying to deferred tax, and the level of any 'cap' on accumulated deferred liabilities.

Rates deferral systems already exist in several states as an alternative to concessions or rebates. The PC (2017) describes these and discusses how the concept might be enacted for the tax switch.

The Henry review recommended indexing deferred taxes at a non-concessional rate of interest such as the standard variable mortgage rate. In contrast, the PC (2017) recommends that tax debts be charged interest reflecting state borrowing costs – “consistent with the policy objective of deferment” – despite also noting the potential for deferral schemes to create perverse incentives. The most significant of these distortions is the potential for indexation below the taxpayer’s time value of money to discourage sale, since delaying sale deflates nominal tax liabilities in present value terms. This ‘lock in effect’ is like that arising under a realisation-based capital gains tax.

Deferral policies as usually conceived apply only to a subset of current owners, such as pensioners or low-income owners passing a means test. The Henry review, the PC (2017), and the Grattan Institute (Daley and Coates 2015) all see deferral in these terms.

Deferral schemes of this type that restrict eligibility and address a limited policy objective are clearly superior on revenue, equity, and efficiency grounds to ignoring liquidity issues altogether, or to providing costly tax concessions.

But there are also arguably no grounds in revenue protection, equity or efficiency for not extending the scope of tax deferral far more widely – and a more widespread deferral policy could shift the politics of taxing land both to replace stamp duty and in general. Since this proposal is a major part of the proposed transition package it is explained in more detail in section 5.

SUMMARY – TRANSITION OPTIONS

The discussion above suggests four basic transitional packages (aside from the base case) which are feasible and sensible combinations of the various proposals. These are shown in the columns of Table 2 below. The rows in the table describe the nature of the concessional treatment provided under that package to the four categories of LVT payer: recent buyers, long-held properties, future buyers, or everyone.

Table 2: Transitional options – LVT treatment under various feasible policy packages

	Cold turkey (base case)	Gradual transition		Switch-on-sale	Credit*
		ACT model	+ credit		
Recent buyers	None	Phase-in	Phase-in + credit	Exemption until sale	Credit
Long-held properties			Phase-in		None
Future buyers		Phase-in (+phase-out of duty)		None or opt-out	
Everyone		Options include internal funding (rate supplement), deferrals**			

Notes: *Could be combined with a tax holiday. **Could be restricted in eligibility.

Better and worse in the transition

Key points

- Switch-on-sale and a gradual transition have serious disadvantages:
 - » With only around 5-6% of properties changing hands each year, the revenue loss from exempting current owners indefinitely would be substantial. This cost would be poorly targeted at the real transitional inequity – the double taxation of recent buyers. Switch-on-sale would also create a disincentive to sell property, undermining the efficiency objectives of the reform;
 - » To avoid inequity for recent buyers a gradual transition necessarily takes a long time, meaning the efficiency benefits are slow to arrive. Even a 10-year transition would give the most recent duty payers the equivalent of only 5 years free of land tax, whereas duty payers in the past enjoyed an average tenure of 15-20 years tax-free. The nationwide efficiency cost of a 20-year transition relative to immediate abolition could be as high as \$170 billion.
- The essential tension in these models is that multiple objectives – revenue, efficiency, equity – are being addressed with a single instrument, making trade-offs unavoidable.
- A better approach targets different issues with multiple instruments within an overall package of policy measures:
 - » Immediate abolition of stamp duty to realise the efficiency benefits without delay;
 - » Credit limited to recent buyers, to avoid the inequity of double taxation while minimising the revenue cost and avoiding perverse incentives;
 - » A short phase-in of land tax (e.g. over three years) to ease the politics, encourage turnover, and avoid asset price impacts in the early years of the new tax;
 - » A time-limited ‘opt-out’ option to avoid opposition from prospective buyers (e.g. open for three years and granting a tax exemption for 20); and
 - » ‘Internally funding’ the revenue costs of these policies via a higher land tax rate over a defined transition period, so the overall reform package is budget-neutral.
- Tax deferral should be used to alleviate liquidity issues for asset-rich cash-poor taxpayers.
- More widespread tax deferral could also be used to ease the politics of the new tax and generate revenue. Deferral as default at commercial interest rates would make the new land tax act like a ‘vendor stamp duty’, but without the inequity and most of the inefficiency of the current buyer duty. By effectively taking over the lowest-risk, most profitable slice of the mortgage lending business the state and taxpayers would benefit at the expense of the banks.

This section summarises the main trade-offs in the major transition proposals, and outlines the elements of a package that seems to best balance budget considerations, equity in the transition, and achieving the efficiency objectives of the reform as fully as possible.

The package aims for minimal concessions, chosen for maximal political impact. If the politics are feasible – and this is for politicians to decide – the suggested package is close to first-best on principled grounds.

This section also explores how widespread tax deferrals could ease the politics of the new tax and have other benefits for taxpayers and the state.

5.1. Key trade-offs

“Committing to a particular reform approach that precludes another is like committing a site to a particular building – it is a real options decision.”

As explained in section 4, the switch-on-sale or full grandfathering model prioritises consistency of tax treatment over all other goals, including economic efficiency and the interests of other taxpayers. It has major disadvantages:

- Since only around 5-6% of properties will join the LVT base each year, the revenue loss from exempting current owners will be large;
- That fiscal cost is poorly targeted at the real inequity – i.e. the double-taxation of recent duty payers – with much of the benefit going to properties that paid duty long ago;
- The disincentive to lose tax-free status by selling will inhibit turnover, undermining one of the main objectives of the reform; and
- If higher LVT rates are used to fund the revenue cost of the exemption, the sale disincentive and associated inefficiency will be even worse.

The sole advantage of switch-on-sale is that it appears politically painless (fiscal responsibility politics aside). Yet on the threshold question of whether the cost of such a transition still leaves the reform worthwhile overall, the answer, arguably, is ‘no’ – and the optimal approach if this is the only politically feasible model is therefore to ‘wait’.

Committing to a particular reform approach that precludes another is like committing a site to a particular building – it is a real options decision. Just as the prospect of building larger later can make delay more profitable than committing to a smaller development today, so too can the prospect of an improved reform environment in future make commitment of political capital to a sub-optimal tax switch worse than doing nothing.

Coates (2017) has argued that the disadvantages of switch-on-sale make the ACT model of gradual transition the least-worst approach. However a gradual transition has its own disadvantages.

If the CGE modelling is to be believed, stamp duty has a cost to economic welfare in the region of \$17 billion per annum nationwide (see box 1 in section 2). Relative to immediate abolition, a 20-year straight-line transition imposes the equivalent of 10 years of this cost. But an efficiency cost of \$170 billion is a staggering price to pay simply to ease the politics of a change that could, in principle, be enacted immediately.

This total cost is roughly equivalent to 10% of annual GDP, or \$18,000 per household. Or, if this efficiency loss were ultimately capitalised into property

“If the reform is worth doing, as the CGE modelling suggests, then it is worth doing fast – and the ACT model fails on this count.”

prices, it would mean foregoing a 2.5% boost in real estate values. The idea that the nation works for free for a month and the produce is vaporised, because our policy designers and politicians cannot find a better alternative, or that the collective of property owners offered a 2.5% aggregate gain in exchange for some hard truths would not wish to accept it, is a bizarre and depressing one.

If the reform is worth doing, as the CGE modelling suggests, then it is worth doing fast – and the ACT model fails on this count.

But to pursue a gradual transition faster – e.g. over 10 years – would involve unfairness to recent buyers, and an efficiency cost that remains substantial. Under a 10 year transition a duty payer in the final pre-reform year will receive the equivalent of only 5 years of tax-free tenure, whereas past duty-payers enjoyed an average of around 15-20 years.²³

Under a ‘quick’ gradual transition some form of credit for recent buyers is therefore necessary to avoid inequity, as both the Henry review and ACT taxation review recognised.

Yet this raises the question of why, with a credit scheme in place, the transition should be drawn out at all. The sole reason remaining is the political difficulty of imposing a new tax on long-held properties which, it is agreed, bear an unfairly small share of the tax burden at present. As the next section argues, there are better options to overcome this political hurdle.

5.2. Proposed package

“The essential tension in switch-on-sale and a gradual transition is that two issues – one principled, one political – are being addressed with a single instrument. Why not separate these?”

The essential tension in the above 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.²⁴ 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

²³ This average duration of ownership is based on annual turnover rates of around 5-6% of the stock.

²⁴ 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.

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.

Table 3 summarises how these policy instruments map to the major transitional issues, and how they ought to be designed to best target these issues within the overall package.

Table 3: Suggested reform package for the tax switch transition

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

Even without the proposal to expand eligibility for tax deferral, this package has a number of merits over switch-on-sale or a gradual transition:

- It targets the tax expenditures on the double-taxation equity problem more precisely;
- It avoids sale disincentives (and efficiency losses);
- It contains front-loaded concessions that can be adjusted as deemed best by politicians to aid the politics of the reform; and
- It is long-run revenue neutral.

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

5.3. Tax deferral

As noted in section 4, 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. Tax deferral is in economic terms profitable lending by the state secured against property, and should be seen as such.

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.²⁵

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

²⁵ 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.

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.²⁶

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 received) 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.²⁷

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 savvy 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-g geared investors may have different incentives altogether.²⁸

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 major stumbling blocks.

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

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

28 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.

“Neither the risk of perverse incentives nor the investment risk, political risk, and gross debt objections are 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.²⁹

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.³⁰

29 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”.

30 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.

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.

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.

“The tax switch is a sensible shift from a ‘pre-pay’ model to a ‘PAYG’ model for funding government.”

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 tenancing) 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, and puts a necessary financing task in the most capable hands.

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

“Framing tricks might substantially improve the politics, at minimal cost to efficiency.”

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.³¹

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.

There are several outstanding questions that would be useful avenues to explore this proposal:

1. What could this be worth to the state in net interest revenue? Section 6 looks at this question;
2. How can this proposal be an economic win-win for both state and taxpayer? Is value being created from thin air – from improved economic efficiency – or does somebody lose? Box 4 explains that the answer is ‘both’; and
3. How will mortgage lending change in practice, and what does this mean for the design and legislation of a widespread deferral scheme?

While an answer to the third question would require close examination of the mortgage business, and is left for future work to consider, one broad prediction is that private credit might be withdrawn at the same rate as public credit expands in order for lenders to hold their risk exposure constant at their currently-preferred levels. To take one example: since interest-only loans would involve growing exposure as the amount of secured public lending to a property via deferrals grew, such loans might in future be limited by lenders to lower loan-value-ratios or replaced by slow-repayment loans designed to hold the total (private plus public) loan-to-value ratio on a property constant. The overall effect on credit provision, private plus public, might well be neutral.

³¹ “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>

Box 4: Economic rents in the mortgage lending business

The tax switch converts an upfront tax to a recurrent tax. For buyers this means no longer needing to borrow to pay stamp duty, but paying an annual tax instead which reduces the income available for debt repayment. For banks this means issuing smaller mortgages, and seeing them repaid in smaller annual amounts – with potentially no change in typical mortgage terms or the total stock of outstanding debt.

But a tax switch with deferrals means smaller mortgages, paid off just as quickly as before the reform – and therefore a reduction in the overall size of the mortgage business and associated profits.

Mortgages and tax liens are enacted similarly, via a charge on the title, and are effectively identical instruments. Mortgages allow privately-financed deferred payment of housing costs (vendor price plus tax), securing the debt against property. Tax liens allow publicly-financed deferred payment of housing costs (the tax portion), securing the debt against property.

Security against property makes most mortgage lending a very safe business. The risky part is at the margin, when high leverage makes it more feasible that payment default combined with a price crash will leave the lender with inadequate collateral. At lower loan-value ratios the risk faced by the lender is lower, since the extent of the price crash needed to wipe out collateral is higher. As loan-value ratios decline throughout the term of a mortgage, the risk to the lender declines too, but for most mortgage products the interest rate does not, allowing the lender to collect economic rents. Pricing strategy seems closer to a 'loss leader' model – possibly a reflection of limited competition in the sector.

Stamp duty, capitalised into the purchase price, still demands the buyer borrow as much as if there were no tax. LVT, capitalised, allows the buyer to take a smaller loan but makes repayment slower; total finance costs may well remain unchanged. But LVT, capitalised with payments deferred, could in contrast shrink the role of private finance in absolute terms, by shifting a portion of the overall task of financing payment for the perceived value of the property from the private sector to the public sector.

This shift in who finances property ownership has two effects.

The first is that a slice of the economic rents from profitable lower-risk mortgages is transferred to the state and taxpayers. Taxpayers who opt to defer are effectively borrowing at a lower rate from a state lender to reduce their higher-rate borrowing from private lenders, and any rents on that private lending are thus transferred to the state and taxpayers too.

The second is that there is an overall efficiency improvement as borrowing by the banks at relatively high cost, reflecting the risk banks take at the lending margin, is supplanted by state borrowing at lower cost. A financing task has been shifted to the party best able to bear it – a net social gain.

The apparent magic pudding of risk-free lending by the state at a substantial interest margin appears to be one part an appropriation of economic rents from an uncompetitive financial sector, one part a reflection of an actual improvement in resource allocation.

Modelling

Key points:

- Modelling of the tax rates, policy costs, cashflows and balance sheet impacts of the proposed package using Victorian data as a case study suggests that a relatively generous transition package can be funded with land tax rates around 50% higher than otherwise over a period of 10 years.
- The estimated costs of the proposed package are equivalent to:
 - » 3.0 years of tax revenue (\$19 billion for Victoria) to fund some credit for all buyers over the last 10 years (almost half of all current owners);
 - » 2.3 years (\$14 billion) for a three-year land tax phase-in; and
 - » 0.1 years (\$0.4 billion) for a three-year opt-out option capped at 20 years tax-free.
- The total 5.4 year (\$33 billion) cost of concessions could be funded with a tax rate of around 0.75% over the first 10 years before reverting to around 0.5% beyond that.
- Tax deferral as default could generate net interest revenue worth \$3 billion (for Victoria) over the 10-year transitional period, sufficient to fund a 10% cut to payroll tax.
- If the transitional land tax rate were retained permanently instead of sunsetting, the additional revenue plus deferral interest could allow payroll tax to be halved at the 10-year mark.

“Adjustable policy and economic parameters mean the model is flexible enough to be used for a very wide range of costings.”

This section presents estimates of the budget impacts and overall policy costs of the proposed package and each of its elements.

The tax holiday and supplementary rate are by themselves straightforward to cost, but the opt-out and credit costings are inherently more complex. Note, for instance, that the cost of providing credit depends not only on past stamp duty paid but on past turnover – since some duty will have been paid by buyers who have subsequently disposed of their property.

There are also several interdependencies in the proposed package – e.g. the uptake of the opt-out option will be influenced by the concessionary LVT rates (tax holiday) and supplementary rate.

Further complexity arises when modelling year-by-year impacts to predict how the reform would appear in a state’s financial statements.

These issues have been addressed by building an integrated financial model capable of estimating budget impacts and policy costs over time with the inclusion of any (or all) elements of the proposed package. Adjustable policy and economic parameters mean the model is flexible enough to be used for a very wide range of costings.

The modelling of an opt-out option in particular is complex and novel, albeit constrained by data limitations.³² The tax deferral modelling also demonstrates, for the first time, the potential of such a scheme to fund further tax reform.

Specific predictions are provided here using Victorian revenue, tax rates, and property data.³³ Behavioural uncertainties, data limitations, and the inherent complexity involved in modelling new policies mean all results, however, should be treated as broadly indicative only.

This section provides a high-level overview of the model (section 6.1) and presents key results and sensitivities (section 6.2).

6.1. Model overview

The model comprises four interconnected calculations, one for each of the key policy elements:

- **RT:** Tax rate choices i.e. the impacts of the supplementary **R**ate and **T**ax holiday on revenue;
- **O:** Opt-out option for new buyers (residential only);
- **C:** Credit provided to existing owners (all property types); and
- **D:** Deferral of tax payments.

The baseline from which impacts are measured is a 'cold turkey' revenue-neutral transition. For modelling purposes the replacement tax is taken to be a non-progressive LVT applying at the same rate to all property types.

The revenue and debt impacts of a supplementary rate and tax holiday (absent any other policy concessions) are estimated first, to set a baseline for estimation of the incremental impacts of opt-out and credit policies.

Opt-out for new residential buyers is modelled by calculating a 'break-even' tenure length above which buyers would benefit in present value (PV) terms from paying a one-off stamp duty rather than the recurrent LVT. Break-even tenures are calculated for each of 80 LGAs and three property types (house, unit, and vacant block), based on the median residential sale price and with land-value-to-improved-value ratios set at the LGA average. A probability distribution of buyers' expected tenure lengths is then used to estimate the number of buyers with longer-than-breakeven tenure length.³⁴ Duty retained and LVT foregone by year is calculated by aggregating opt-outs from each of the 240 LGA/types with adjustment for those returning after subsequent re-sale.

Credit for existing owners is modelled using Prosper's backdated LVT approach, where the net credit provided equals duty paid less the hypothetical LVT payable since purchase date (see section 4.2). Past duty paid is adjusted by a year-by-year 'retention rate' to reflect duty paid on properties that were subsequently re-sold. ABS land value data is used to estimate the hypothetical LVT payable on 'retained' properties (using the base plus supplementary LVT rate in the table below). Duty paid less LVT payable (both indexed for inflation) determines the net credit and land value base of net creditors, and turnover rates then determine the rate of credit run-down and cash-out.

32 The model can however be easily updated with better data inputs to model opt-out take-up by location, property value, and buyer type more precisely.

33 Key data on property sales and biannual official valuations come from the Victorian Valuer-General, in *A Guide to Property Values 2017* (<https://www.propertyandlandtitles.vic.gov.au/property-information/property-prices>) and from 2016 Revaluation Outcomes (previously available online – available from author on request).

34 A truncated normal distribution of owners' tenure length was used, with mean and standard deviation chosen to produce results broadly consistent with the ABS 2013-14 Survey of Income and Housing (SIH) data. The SIH data relates to the question 'how long have you been in your current home?'. Neither the distribution of SIH responses, nor the distribution of buyers' expected tenures (which drives opt-out rates), are the same as the distribution of owners' tenures, but both can be derived from the latter. Repeat-sales data would allow for more accurate estimation of buyer distributions and hence opt-out rates.

Deferral can be modelled relatively straightforwardly. There is assumed to be full uptake of the scheme, i.e. that deferred-tax indexation rates are attractive enough for all LVT-payers to defer. The margin between indexation rates and state borrowing rates determines net interest revenue, and property turnover (which triggers repayment) determines the cashflow and debt profile. The budget impacts of deferral are measured last against the combined effect of the rest of the package.

The calculations thus follow a particular sequence that reflects the various interdependencies:

1. **RT** determines year-by-year LVT rates;
2. **O** uses the LVT rates from step 1 to determine which properties opt out;
3. **C** uses the LVT rates from step 1 to determine the amount of net credit provided and the time profile of credit run-down and cash-out;
4. The PV costs of the tax holiday, opt-out and credit estimated via steps 1-3 are used to calculate the necessary supplementary rate, with steps 1-4 iterated until a rate is found that makes the package revenue-neutral in PV terms;
5. **D** uses the LVT payable (less credit used in lieu of tax) calculated in steps 1-3 to estimate the net interest revenue, cashflow, and debt profile of a deferral scheme.³⁵

Key parameter inputs are detailed in Table 4.

35 That is, the proposed package is revenue-neutral without the inclusion of net interest on deferred tax.

Table 4: Key policy and economic parameters

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%
Economic parameters		
Land value growth	Assumption	0% per annum
Property value growth	Assumption	0% per annum
State borrowing rate	Sep-18 TCV 3-year bond yield	2.27% p.a.
Private discount rate	Approximately middle of residential mortgage rate range (RBA 2018, graph 4)	5%
Property turnover rate	Based on 2016 Valuer-General data	5.8% p.a.

Notes: *Opt-out and credit have revenue costs beyond the 10-year supplementary rate period. The supplementary rate is set to recover these, i.e. PV(10)>0 but PV(long-run)=0. **PPR=Principal Place of Residence, i.e. owner-occupied property.

6.2. Results

OVERALL IMPACTS

Table 5 summarises the estimated financial impacts from the proposed package.

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 (see Table 6).³⁶

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.

Figure 1 overleaf shows the time profile of the revenue and debt impacts of the proposed package, excluding tax deferral. Revenue and cashflow impacts are identical for this 'RTOC' package, and the debt impact peaks at \$9 billion (2% of GSP) in Year 3.³⁷

Table 5: Budget impacts of proposed transition package – Victoria – \$bn

	Year 1	Year 2	Year 3	Year 4	Years 1 to 4	Long-run PV	PV in years
Supplementary rate (R)	3.8	3.8	3.8	3.8	15.0	33.3	5.4
Tax holiday (T)	(7.4)	(4.9)	(2.5)	-	(14.8)	(14.3)	(2.3)
Opt-out (O)	0.7	1.2	1.1	(0.3)	2.6	(0.4)	(0.1)
Credit (C)	(2.1)	(2.8)	(3.2)	(2.9)	(11.0)	(18.6)	(3.0)
TOTAL – RTOC	(5.1)	(2.9)	(0.8)	0.5	(8.2)	0.0	0.0

36 The Year 1+2 total tax holiday stimulus of 2% of GSP is, by way of comparison, equivalent to what the Rudd government stimulus transferred directly to households in the single financial year 2008-09 (Li and Spencer 2014). The Rudd package also delivered another amount roughly equal to this in spending projects.

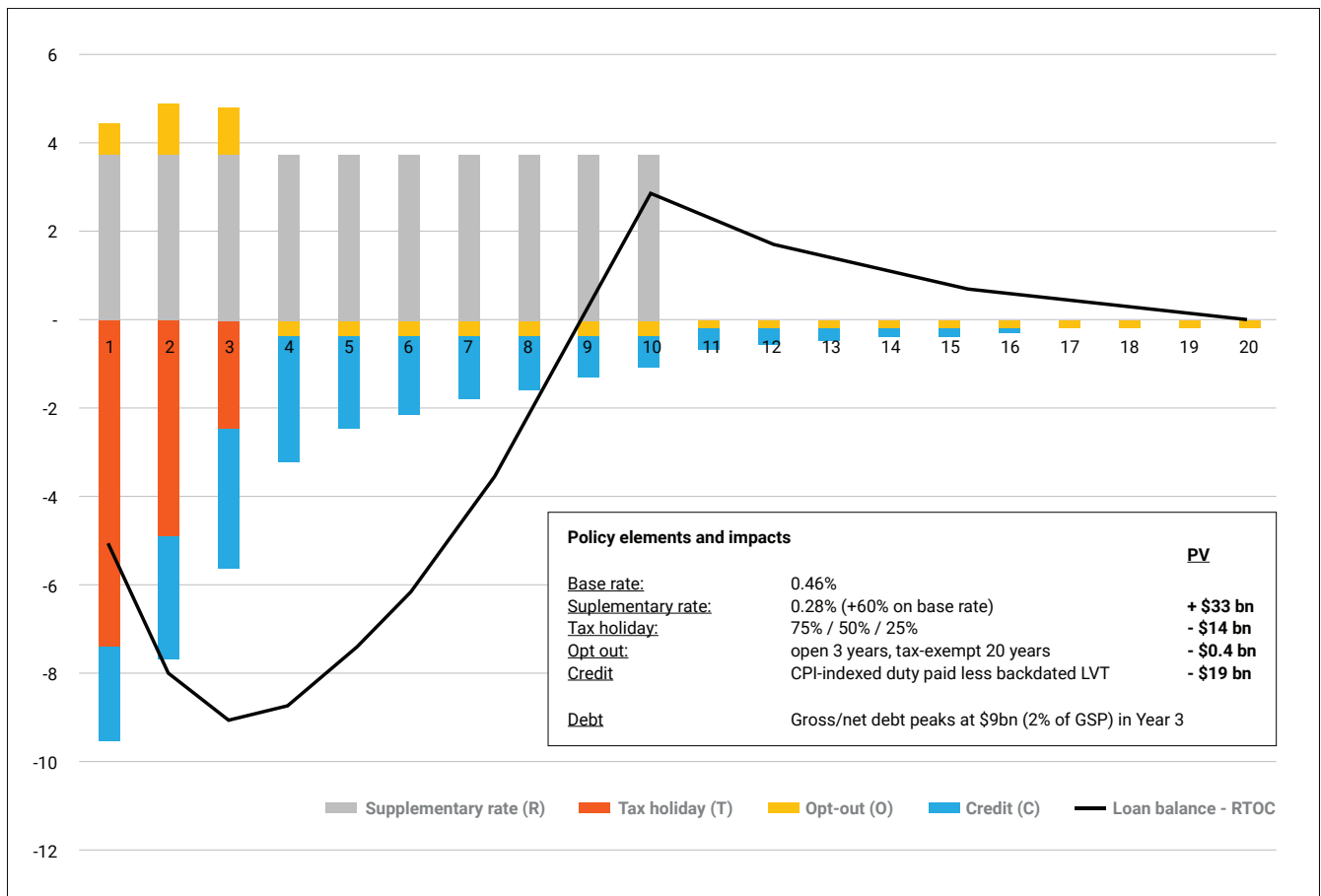
37 Victoria's net debt was 4.6% of GSP in June 2018, and is expected to increase to 6% by June 2021 (State of Victoria 2018).

Table 6: Baseline and impacts – Victoria – \$bn

	Year 1	Year 2	Year 3	Year 4	Years 1-4	Years 5-10	Years 11-20
Baseline LVT revenue	6.1	6.1	6.1	6.1	24.5	36.8	61.3
Impact of transition package	(5.1)	(2.9)	(0.8)	0.5	(8.2)	12.3	(3.2)
Impact relative to baseline (%)	-83%	-47%	-13%	9%	-34%	33%	-5%
Impact relative to GSP* (%)	-1.2%	-0.6%	-0.2%	0.1%	-0.4%	0.4%	0.0%

Notes: *Based on Year 1 GSP = 2017-18 figure of \$430bn (ABS 5220.0) and 4.5% p.a. growth.

Figure 1: Revenue and debt impact of recommended package (RTOC) – Victoria – \$ billion nominal



OPT-OUT

The summary figures in Table 7 below show that even if a time-limited opt-out option is taken up by a substantial portion of buyers – e.g. one in four as estimated here – it may nonetheless impose only minimal long-run cost.

This is for two reasons. First, the rate of turnover of the stock (i.e. buyers as a share of all owners) is only around 5-6%, so the loss from the LVT base is small. Second, the PV difference between duty paid and LVT foregone by opters-out – i.e. the adverse selection cost – is not large when the LVT exemption is limited to 20 years, with an estimated 88 cents in duty retained for each dollar of LVT lost (in PV terms). Even if the political utility of opt-out is low it may therefore be worth offering, albeit with careful design to balance political appeal and cost.

Table 7: Key policy outcomes – opt-out

Outcome	Value
Buyers opting-out (p.a.)	28% of residential sales (~40,000 p.a.) 22% of residential sales value (~\$20 billion p.a.)
Properties opted-out (total)	5% of residential properties (~120,000) 4% of residential land value (~\$44 billion)
<u>Retained duty (PV)</u>	<u>\$3.1bn</u> = 0.88
Foregone LVT (PV)	\$3.5bn

Opting-out makes financial sense for homes with a relatively high land value share (and for relatively cheaper homes, under the assumed flat rate LVT, due to progressivity in the duty scale). The option is therefore more likely to be taken up by buyers of units and vacant blocks rather than houses (see Table 8). The model predicts similar opt-out rates in Melbourne as in country Victoria, reflecting the fact that while house prices are much higher in Melbourne, so are land value shares.³⁸

Table 8: Opt-out by location and property type

Area	Type	Buyers opting out (p.a. avg)	Properties opted-out (max)	Share of all opters-out
		% sales	#	%
Melbourne	Houses	13%	22,231	19%
	Units	36%	36,329	31%
	Vacant block	76%	21,684	18%
Country Victoria	Houses	14%	11,383	10%
	Units	35%	4,775	4%
	Vacant block	81%	21,676	18%
Victoria	All	28%	118,079	100%

Opt-out also only makes sense where the buyer expects a long tenure. The effect of limiting the LVT exemption period (e.g. to 20 years) is to narrow this cohort only to buyers expecting a long tenure and breaking even before the exemption period ends. This limitation acts to reduce the rate of opt-out.

For example, in year 1 of the reform, the buyer of a median Melbourne house (\$720,000) with the

³⁸ Note that estimating opt-out rates by LGA and property type using only the median price involves both false-positive and false-negative errors for properties priced above and below the median in each LGA respectively. However since 50 per cent of sales are either side of the median, these errors will be roughly offsetting.

Melbourne average land value share (68%) would prefer to pay stamp duty only if they remained in their house and were LVT exempt for an estimated 24 years or more. But although some three in 10 buyers may anticipate such a long tenure, the closure of the tax-free period at 20 years means no rational buyer of a property at this price and land value would choose to opt out.

Sensitivity tests of how the total opt-out rate and policy cost depend on policy design and economic parameters are shown in Table 9 below. The exemption period is a key parameter, since extending it increases both the rate of opt-out and the average revenue loss per property. Differences in expected land value growth also influence opt-out rates significantly, as do high and low discount rates. The latter are included here as proxies for behavioural influences that might cause more or less opt-out than a comparison of PVs would indicate (see Box 5). Changing the open period affects the policy cost more or less proportionately to the number of years the option is available, and so is not shown in the table.

As the opt-out modelling method involves a number of assumptions and approximations, these scenarios are seen as important checks on the robustness of the basic finding that the cost of a temporary opt-out option is very small. Under most of these scenarios this conclusion continues to hold: no more than 1 in 12 properties is lost from the LVT base under any scenario, and the adverse selection cost for these properties is no more than around 20% of the LVT otherwise payable.

The main limitation remaining is that the influence of LVT structures other than a flat rate on opt-out has not been examined. As a general tendency, loading more of the tax burden on higher land value properties via a more progressive scale could be expected to increase the adverse selection cost, unless eligibility is restricted by value.

Table 9: Sensitivity tests – opt-out

Parameters	Buyers opting out (p.a. avg)	Properties opted-out (max)	Duty retained /LVT foregone	Policy cost (long-run PV)
	% sales value	% land value	Ratio	\$ billion
3 years open / 20 exempt	28%	4%	0.89	-0.4
Policy sensitivities				
No supplementary rate	9%	1%	0.82	-0.1
No tax holiday	42%	7%	0.86	-0.9
3 years open / 30 exempt	43%	7%	0.80	-1.4
3 years open / unlimited exempt	44%	7%	0.76	-1.8
Permanent option	44%	69%	0.67	-2.0 p.a.
Economic parameter sensitivities				
Land value growth -2% p.a.	14%	1%	0.85	-0.1
Land value growth +2% p.a.	48%	8%	0.82	-1.5
Discount rate 2.5%	52%	8%	0.97	-0.2
Discount rate 10%	10%	1%	0.65	-0.3

Box 5: Rational and behavioural drivers of opt-out

Several behavioural factors might play into opt-out decisions, and the assumption of rational choice driven by a comparison of PV tax amounts might conceivably either under- or over-estimate the likely rate of opt-out.

Credit constraints, myopia, and avoidance of future regret (should an earlier-than-expected sale be required) are reasons buyers might prefer a back-ended, less certain LVT option to a front-ended duty payment. A 'nudge' framing of opt-in as the default choice might also encourage this.

On the other hand, stamp duty offers certainty over the total tax liability. Buyers with a strong certainty preference, e.g. due to concern about policy (tax rate) risk or tenure length risk, or who generally misunderstand or do not trust the change, might therefore be more likely to opt-out.

These factors can be roughly modelled via the discount rate. A higher discount rate proxies for myopia or other factors driving buyers away from paying a large upfront duty, and a lower rate proxies for aversion to uncertainty over future tax payments.

“The credit calculation guarantees buyers in the last 10 years at least 10 years’ total tax free tenure – somewhat more generous to recent buyers than the transition in the ACT.”

CREDIT

Table 10 summarises the key outcomes from modelling credit for recent buyers using Prosper’s backdated LVT method, with hypothetical past LVT based on the full LVT rate of 0.74%.

Table 10: Key policy outcomes – credit

Outcome	Value
Landowners eligible for credit	43% of total SV =Buyers in last 10 years
Credit provided	\$4.3 bn cashed out \$14.3 bn in lieu of LVT
Credit exhausted	Year 16

The Prosper method would provide credit to some 4 in 10 landowners, or anyone who bought in the last 10 years. Property turnover of around 5-6% per annum means that around \$4 billion of the \$19 billion total credit could be expected to be cashed out upon sale rather than used in lieu of LVT.

All credit is expected to be used up by year 16. The modelling results show no clear relationship between the purchase year and the number of future years before a recent buyer’s credit is exhausted, due to the confounding factors of the temporary supplementary rate, the tax holiday, and uneven historical patterns of land value growth. As a broad rule of thumb, however, this credit calculation guarantees buyers in the last 10 years at least 10 years’ total tax free tenure. This is somewhat more generous to recent buyers than under a 20-year gradual transition as in the ACT.

Table 11 presents results from several alternative credit calculations. With a 10-year sliding scale calculation the eligibility and cost are practically the same as under the Prosper method. With a 5-year scale, the PV cost falls to \$11 billion (170% of annual revenue), with only around 20% of property owners eligible. Under all calculations the credit provided to the most recent buyers is exhausted between years 13 and 16.

Table 11: Sensitivity tests – credit

	Eligible properties		Credit cost (\$ billion)		
	% of SV	Years	Cashed out	In lieu of LVT	Total
Backdated LVT method / 0.74%	43%	10	4.3	14.3	18.6
Backdated LVT method / 0.46%	59%	14	6.1	20.5	26.6
Sliding scale - 5 years	21%	5	2.4	8.2	10.6
Sliding scale - 10 years	43%	10	4.4	15.1	19.5
Sliding scale - 15 years	62%	15	5.9	20.9	26.9

DEFERRAL

Table 12 summarises the deferral scheme financial impacts. As noted in section 5, the budget impact of tax deferral will be positive. There will be a significant increase in gross debt but a reduction in net debt as deferral assets (tax deferred and interest charged) exceed deferral liabilities (amounts borrowed including interest).

Interest revenue could fund further tax reform, e.g. by allowing steady reduction in payroll tax. Payroll tax could be reduced by 10% by Year 10 or, if no immediate cuts were made, a future government would inherit a \$3 billion (PV) asset to fund steeper cuts at that time. By Year 20, if deferral scheme proceeds were saved, the asset could be worth \$13 billion in PV terms.

Gross debt, i.e. the size of the loan on the deferral scheme PFC balance sheet, expands significantly in dollar terms. Even so, the peak gross debt to GSP impact never rises above 9%.

Figure 2 overleaf shows the transition package impacts over time with tax deferral allowed.

Table 12: Tax deferral budget impacts – Victoria – \$bn PV

	Year 4	Year 10	Year 20	Year 30
Net revenue (=interest margin)	0.1	0.7	1.3	1.7
Net revenue: % payroll tax	2%	11%	15%	16%
Net debt (= – value of deferral scheme)	-0.2	-3.2	-12.8	-24.5
Gross debt (=deferred tax and interest outstanding)	13.5	44.1	51.2	45.6
Gross debt: % GSP	3%	9%	8%	6%

Notes: Payroll tax revenue and GSP in Year 1 (FY18) = \$6.0bn and \$430bn respectively, and both are assumed to grow at 4.5% per annum. Note that all \$ figures are expressed in PV terms (discounted at the borrowing rate, which is roughly equal to inflation) to enable easier comparison with current figures.

VARIATIONS ON THE PACKAGE

Credit for existing buyers is at the centre of the proposed package. The other policies are supporting elements which could be included or excluded according to political preferences.

For instance, a government concerned with net debt impacts and headline tax rates, and willing to champion a tax deferral scheme as an adequate response to the political difficulties of a new tax on long-held properties, might exclude the tax holiday. The required 10-year supplementary rate would then be 0.16% rather than 0.28%, and the peak net debt impact \$2 billion instead of \$9 billion.

Table 13 shows the estimated costs for different variations on the transition package.

The policy elements interact in various ways that make the total cost sensitive to the package design (i.e. the PV costs in Table 5 are not simply additive). There are two materially significant interactions.

First is that providing credit costs \$6-8 billion less when the transitional package is internally funded. However this only occurs under the backdated LVT approach, not under a sliding scale approach, and only when the supplementary LVT rate is used to calculate backdated LVT (not the base rate alone).

Second and more significant is that internally funding the transition concessions raises the 20-year value of a deferral scheme by around \$3 billion. A decision to fund LVT concessions from the LVT base but allow deferral is therefore a combination that benefits future taxpayers twice over: they inherit not a \$33 billion debt from the transition, but a \$13 billion asset.³⁹

Table 13: Cost of variations on the proposed package – Victoria – \$bn PV

Policy package:	Unfunded concessions			Internally funded concessions		
	C	O+C	T+O+C	R+C	R+O+C	R+T+O+C
Supplementary rate (R)	-	-	-	21.0	21.3	33.3
Tax holiday (T)	-	-	(8.9)	-	-	(14.3)
Opt-out (O)	-	(0.1)	(0.1)	-	(0.4)	(0.4)
Credit (C)	(26.7)	(26.7)	(26.5)	(21.0)	(21.0)	(18.6)
<u>TOTAL – RTOC</u>	<u>(26.7)</u>	<u>(26.8)</u>	<u>(35.5)</u>	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>
Deferrals (D)*	10.4	10.3	8.9	13.4	13.1	12.8
Supplementary rate:	n/a	n/a	n/a	0.16%	0.16%	0.28%

Notes: *Deferral scheme net assets at Year 20, PV.

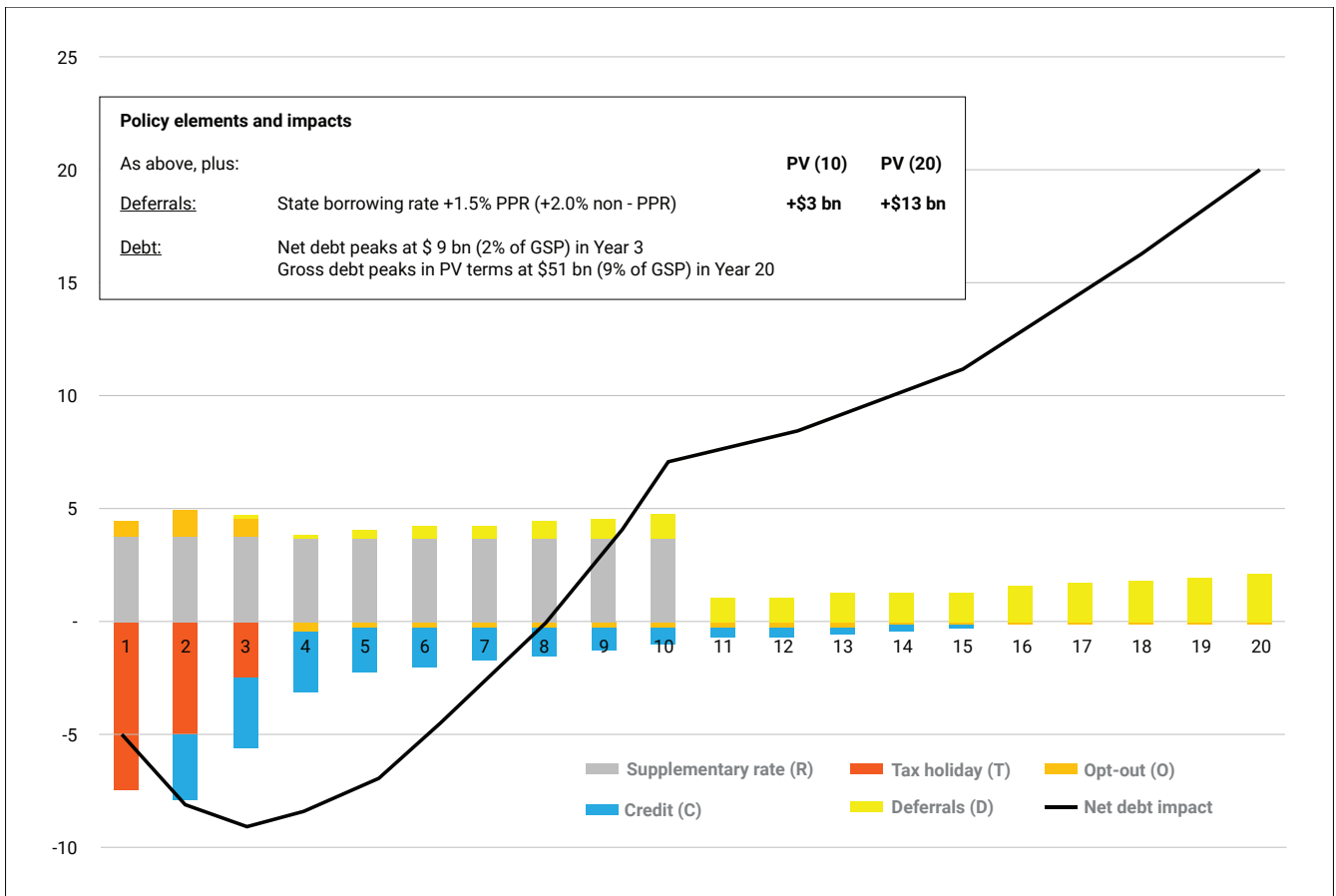
Another variation (not shown in the table above) would be to retain the supplementary LVT rate permanently, using the additional revenue to fund higher spending or reductions in other taxes.

Political acceptability may require a legislated sunset for the supplementary rate to make credible the claim that the package is revenue-neutral. But if not (or if the sunset is later reversed) then the additional LVT revenue plus expanded net interest from deferrals could be worth around \$4 billion PV from Year 11 onwards, adequate to fund an immediate 50% cut to payroll tax.

This could be a sensible revenue-positive variation on a tax switch reform package for any government bold enough to implement it. Over a limited transitional period, e.g. 10 years, the new tax would function as a direct replacement for stamp duty, but the rate would also be fixed high enough to credibly promise (or even commit to) an ongoing program of tax reform beyond that period. A government could even link the future LVT revenue explicitly to payroll tax cuts in the governing legislation in order to head off criticisms of tax increases by stealth, expanding the size of government, etc.

³⁹ A third interaction is that the incremental cost of offering opt-out rises with the tax rate, and also reduces deferral scheme revenue. Under the parameters proposed the magnitude of these effects is negligible, but to cost a more generous opt-out model under a similar package would require attention to these interactions.

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.

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