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BRIEFING NOTE: PROPERTY TAXES, RENTS AND HOUSE PRICES

KEY POINTS

- Property taxes, such as state land taxes and transfer duties, are not generally passed through to higher rents or house prices. Such taxes are borne by landowners and capitalised into lower land values.
- Property can therefore be taxed without affecting housing affordability. The burden of taxes falls on those who own land at the time of the policy change, not those who subsequently buy or use land.
- The underlying reason for this is that land, unlike other resources, has no 'cost of production' to ground its price. Land prices are determined entirely by demand. They are a 'residual' reflecting the value of land in use, less costs, so can fully absorb taxes without being withdrawn from supply.
- This is widely accepted by economists, but can appear counterintuitive since most other taxes are passed forward in part to end users.
- Another explanation for this result recognises that market rents reflect the fundamentals of housing demand and supply — population, income, preferences, and the stock of dwellings available — none of which are altered by property taxes.
- Even a selective tax on landlords (as per state land taxes) will not necessarily increase rents. If it causes landlords to sell property, reducing the supply of rentals, it will also reduce rental demand as some renters become homeowners.
- Calculations that imply the tax share of house prices is a cause of higher prices are misleading. Virtually all economic theory and evidence says that a higher tax share of house prices leads to a lower land price share (and vice versa).

Property can be taxed without affecting affordability…

This briefing note summarises the economics of how taxes affect housing costs — rents and house prices — and explains why some industry analysis of this question is misleading.

Housing affordability is a sensitive issue, and perceptions of how taxes affect housing costs can shape the political prospects for tax reform.

A common claim in response to higher property taxes — e.g. development contributions or land taxes — is that such taxes will be passed through to renters in the form of higher rents, or will increase the price of homes for homebuyers.[1]

[1] For instance, see AFR, 24 May 2023, *Victoria land tax rise to hit poorer renters, investors say*.

The simplest way to understand why this claim is unfounded is to ask the question: if landlords could increase the rent they charge, either unilaterally or in sync, without losing their tenants, why would they not have done so already? And if vendors could hike the price they demand without losing interest from buyers, why would they not do so regardless of taxes?

A long line of economic theory and empirical evidence supports the basic point that the price of housing services — rents and house prices — are set by the fundamentals of supply and demand, which are not directly affected by taxes.

Only if tax design distorts investment decisions, such that housing supply changes over time, might property taxes have indirect effects on housing prices.

… because property taxes are borne by landowners, not renters or homebuyers…

The economic ‘incidence’ of a tax describes who ends up bearing the economic cost.

This is not necessarily the party that legally submits the tax, since taxes can be passed on to other prices: they are passed ‘forward’ to consumers downstream of the taxed entity and/or passed ‘back’ to producers who supply to the taxed entity.

Employers submit payroll tax, for instance, but they do not necessarily bear the whole tax via lower profits: it is also partly borne by employees (suppliers of labour) via lower wages and by consumers via higher prices.

What determines the economic incidence of a tax?

Economists understand it to depend on the relative ‘elasticities’ of supply and demand in the taxed market, i.e. the relative responses of quantity supplied and demanded to price.

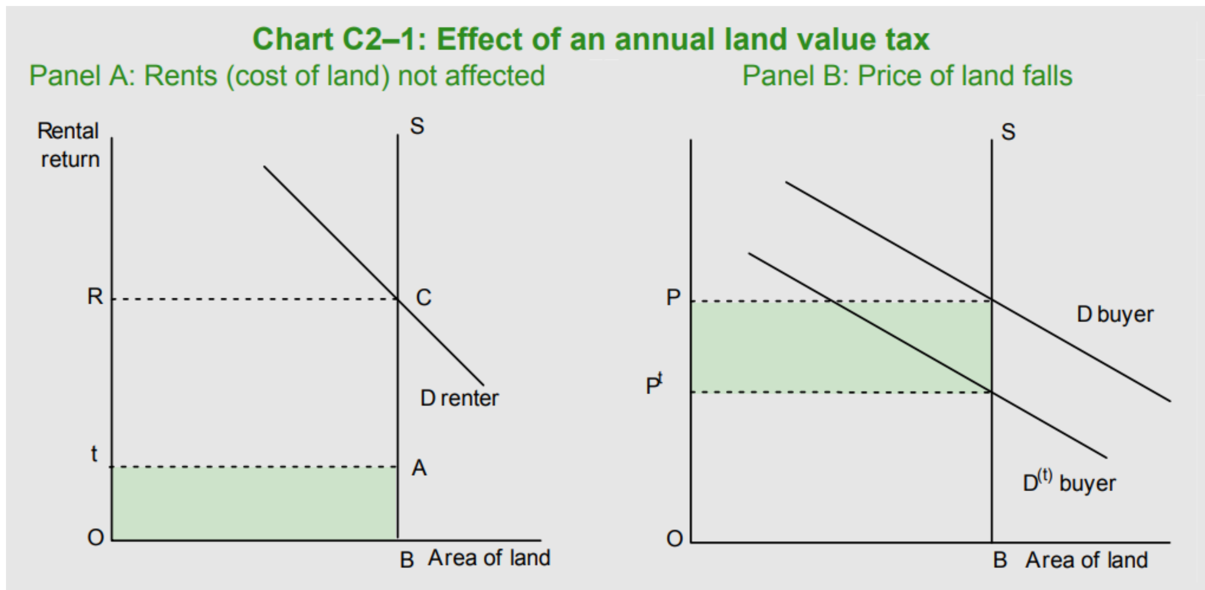
When supply is inelastic — i.e. suppliers do not readily scale up or down production in response to rising or falling demand for their product — changes in demand lead to small changes in output and large changes in the price suppliers receive. A new tax is like a change in demand: it drives a ‘wedge’ between the price buyers are willing to pay and the price suppliers receive. With inelastic supply, this wedge mostly reduces the supply price.

Taxes on property are a special instance of this. The largest component of property value is the value of land, and land is in fixed (‘perfectly inelastic’) supply.

That means prices of land (land rents or land values) are solely determined by demand, and property taxes are fully borne by landowners. The upshot is that higher property taxes are not stacked upon existing house prices, driving them higher, but instead are offset by lower land prices.[2]

The diagram below from the Henry Review illustrates this for the simplest property tax, a land value tax (like local government rates based on site value or state land tax).

[2] There is a wealth of empirical evidence on this point: see for instance Hoj et al. (2018), *Land tax changes and full capitalization*, Fiscal Studies 39(2); Borge and Rattsø (2014), *Capitalization of property taxes in Norway*, Public Finance Review 42(5).



Source: *Australia's future tax system review, Part 2 Volume 1, December 2009*

That property taxes are not passed forward is a long-established and uncontroversial result in economics. However to lay readers it can appear counterintuitive for several reasons.

First, the ordinary situation is of somewhat elastic demand and supply. For instance, in labour markets workers can respond to lower pay by reducing hours or exiting the labour force (elastic supply). This situation results in taxes being passed on to some extent in *both* directions.

Second, to developers and home builders or to landlords acquiring a rental property, land prices can seem like just another cost of business, equivalent to construction costs, maintenance expenses, or interest rates. Why are land prices different?

The difference is that land prices, unlike other business costs, are not rooted in a fundamental production cost. This is because land is not produced. Land prices are determined solely by what buyers are prepared to pay. By contrast, construction costs and other expenses reflect an equilibrium between the willingness of buyers to pay for the relevant goods and services (demand) and the willingness of suppliers to provide them (production costs).

Thus while taxes on other markets cannot be fully passed back to suppliers without reducing the quantity supplied, taxes on property are ultimately fully reflected in land prices.

Does the same hold for other property taxes besides a land value tax, such as stamp duties, development contributions, or rates based on capital improved value?

Yes — because the basic principle is the same: the price of housing (whether as a service or asset) is what determines the price of land, not the other way around.[3] Thus additional taxes are passed back to land, not forward to housing prices.

[3] It was expressed by classical economist David Ricardo as follows: "corn is not high because a rent is paid, but rent is paid because corn is high". Ricardo's theory of rent remains central to the economic understanding of land.

In relation to other property taxes this means that:

- **Stamp duties** on property are likely borne by the seller, despite being submitted by the buyer, since anything else implies systematic mispricing of housing assets by buyers above the value the property provides them;
- **Development contributions** submitted by developers are borne by the landowners that developers acquire land from, or by the developers themselves in their role as landowners, but do not increase the sales price of homes;[4]
- **Rates** based on capital value reduce the market value of property in accordance with the expected rates bill of the buyer (higher for more valuable improvements), and reduce the value of land in accordance with the rates expected on the most valuable development type for that land.

In none of these situations is there *direct* pass-through of property taxes to prices paid by home buyers or renters. Markets adjust to a new or higher property tax by passing the tax back into lower land values; the owner of land at the time of the change bears the burden.

The fixed supply of land gives landowners market power. Each has a monopoly over their own unique site, enabling them to charge rents in excess of the costs associated with bringing land into use (e.g. enforcing title). But this monopoly is a double-edged sword: the site cannot be moved to a lower-tax jurisdiction to escape higher taxes. Ultimately, all taxes come out of land values.

Depending on tax design, property taxes may have *indirect* effects on housing costs if they reduce the quantity of new housing supplied.

For instance:

- **Stamp duty** payable on the total sale value (not just the value of land transferred) discourages capital investment, since upon sale the investor will not recoup the full value of improvements made, since buyers will discount the purchase price by the duty they must pay;
- **Development contributions** levied on a per-dwelling or per-floorspace basis will, at the margin, discourage more capital-intensive development types, reducing the density of land use;
- **Capital value rating** discourages capital improvements: for instance, Murray and Hermans (2021) find that switching from capital to land value rating is associated with a 20% increase in the value of new residential construction.[5]

One tax design issue relates to property taxes with partial coverage. For instance, state land taxes are levied on landlords, second home owners, and commercial and industrial land, while exempting owner-occupied land.

This can cause reallocation of land from non-exempt to exempt uses. In the case of land tax, this could mean rental property is reallocated to owner occupied use.

However this reallocation need not result in higher user prices. If a higher land tax causes landlords to sell property, reducing the supply of rentals, it will also reduce rental demand, as some renters become homeowners. Thus far, no empirical evidence has been produced in support of the idea that Australia's state land taxes are passed through to rents.

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[4] Murray (2018), Developers pay developer charges", Cities 74, April.

[5] Murray and Hermans (2018), *Land value is a progressive and efficient property tax base: Evidence from Victoria*, Australian Tax Forum 243.

…meaning industry calculations of the tax proportion of prices are flawed.

Some industry submissions present property tax revenue as a proportion of the price of new housing.

One often cited claim is that 38% of the price of a new house and land package in Victoria is made up of taxes, passed on to or directly paid by buyers.[6]

The most widely cited figures come from the 2019 report *Taxation of the Housing Sector* commissioned by the Housing Industry Association of Australia (HIA).[7] The method involves summing all property taxes and comparing them to property values to calculate the 'tax share'.

The 2020 report *The Hidden Cost of Housing* by the Urban Development Institute of Australia (UDIA) uses a similar approach.[8]

This framing of property tax revenue as a proportion of house prices is misleading: it implies that taxes are passed on to buyers, and that removing them could reduce house prices. These claims are contradicted by the economic theory and evidence cited above.

Removing the 'tax share' would not reduce the price of housing; rather, it would increase the price of land, just as has happened with stamp duty concessions and grants for first home buyers, which are now widely acknowledged as having inflated house prices.

Policymakers should care about how taxes affect housing affordability, but the 'tax share' metrics put forward by the HIA and UDIA are meaningless in this regard.

FURTHER READING

Explainer: Do taxes on property cause high house prices? No.
Dr Cameron K. Murray, Henry Halloran Trust, The University of Sydney. September 2021.
https://osf.io/nv596/

Research Brief: Will a land value tax raise rents?
Robert Schalkenbach Foundation, May 2023
https://schalkenbach.org/research-briefs/

Australia's future tax system review, Part 2, Volume 1, Section C2 (p247).
Commonwealth of Australia, December 2009
https://treasury.gov.au/sites/default/files/2019-10/afts_final_report_part_2_vol_1_consolidated.pdf

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[6] HIA Media release: *Australia's highest stamp duty shatters Victorians' home ownership dreams* (24th Feb 2022)
[7] Centre of International Economics (2019) *Taxation of the Housing Sector*
[8] UDIA Victoria (2020) *The Hidden Cost of Housing*