

Buying better income taxes with better land taxes

How to cut taxes for Australia's highest-taxed workers.

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Key points

- Income tax and welfare withdrawal together penalise additional work effort by generating effective marginal tax rates (EMTRs) on extra income that are often as high as 75-80%.
- Flatter rate structures to provide fairer and more efficient returns to work require either lower top welfare payments, higher top tax rates, or reform of the tax mix.
- Levelling state taxes on land up to the benchmark set by the ACT could raise as much as \$27 billion more in revenue each year without reducing investment or growth.
- With changes to Commonwealth-state grants, this could fund a halving of all welfare withdrawal rates, producing an effective tax cut of 20-30 cents in the dollar for over one million workers and extra cash in the pocket for around two million more.

Introduction

Australia's 2024 tax reform debate has focused on fairness in the distribution of income tax and who wins and loses from changing tax rates. But meaningful reform to the tax and transfer system comes from replacing bad taxes with good ones – from changing the 'tax mix'.

This Prosper Australia Research Note shows that if Australian states were to meet a benchmark level of efficient taxation from the land value base, the additional revenue raised could fund removal of the most significant distortions in the tax and transfer system, leading to higher workforce participation, economic activity, and well-being.

Welfare withdrawal is a tax on working

Around 5 million Australians receive income support from welfare payments, which are aimed primarily at the aged, families, and the unemployed (Table 1). Around 1 million of these recipients are on part-payments due to means-testing, which reduces payments for people with higher incomes.

Withdrawing welfare payments as incomes rise is economically identical to taxing income. Withdrawal or 'taper' rates for many welfare payments are as high as 50% or 60%, and in combination with income taxation, these taper rates produce extraordinarily high effective marginal tax rates (EMTRs) for many workers.

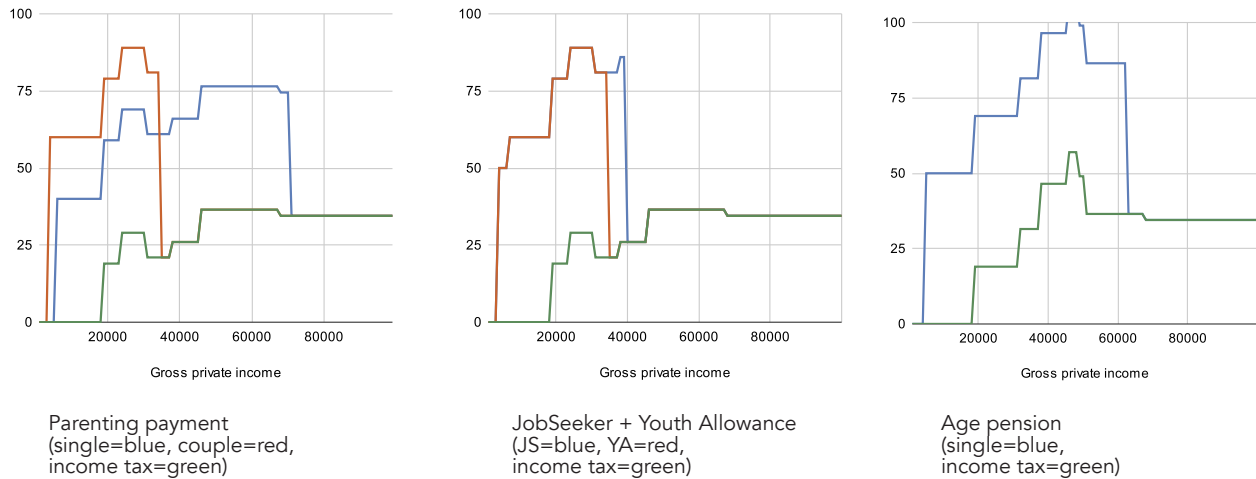
Table 1: Summary of major welfare programs¹

Welfare program	Total recipients FY23 (part)	Average duration	Total paid FY23	Type	Max payment	Taper rate
Age pension	2.6 million (800k)	12yrs	\$51 billion	Single Couple	\$30k \$45k	50% 50%
Parenting payment	350,000 (100k)	3 yrs	\$6 billion	Single (2 children) Partner (2 children)	\$26k \$18k	40% 60%
JobSeeker	750,000 (140k)	2.5 yrs	\$15 billion	Single	\$20k	60%
Youth Allowance	220,000 (60k)	1.5 yrs	\$3 billion	Single	\$17k	60%
Disability Support Pension	780,000 (90k)	17.5 yrs	\$19 billion	Single	\$30k	50%
Carer Payment	300,000 (60k)	11.5 yrs	\$7 billion	Single	\$30k	50%

¹ DSS (2023a), DSS (2023b), and Services Australia (2023). Not all couples rates shown. Not shown: ABstudy (9k), Austudy (28k), Special benefit (8k). 5.0 million recipients: AIHW (2023)

Figure 1 shows how EMTRs vary by income for recipients of the major payments. Over substantial income ranges, EMTRs exceed 50%, which is higher even than the top income tax rate. The shape of the curves illustrates how the system discourages workforce participation, and how regressive a tax-plus-clawback system is relative to the alternative of universal benefits funded by higher taxes.²

Figure 1: EMTRs for major welfare payment recipients³



High EMTRs mean we work, produce, and earn less

High EMTRs discourage people from taking on work or increasing hours. EMTRs of 75-80% mean a worker receives just a quarter or fifth of their value to the employer as take-home pay. This divorces pay from effort, discourages work, and increases labour costs, reducing GDP. High EMTRs can also create 'poverty traps' at low incomes.⁴

The issues are most acute for working parents and workers at retirement age. Childcare costs on top of income tax and welfare withdrawal can produce work disincentives twice as large as those imposed by the top income tax rate. The Productivity Commission (2014) and Grattan Institute (2020) have shown that in some circumstances parents can even be penalised for working at all, with some EMTRs exceeding 100%. The steep rate of pension withdrawal also discourages older workers: only 26% of Australians aged 65-69 participate in the workforce, compared to 40% in New Zealand where the pension is not means-tested.⁵

The problems of high EMTRs are well known, but solutions are limited by the so-called 'iron triangle' of tax and welfare design – the unavoidable trade-off between income adequacy, work incentives, and fiscal cost. Improving work incentives by lowering welfare taper rates necessarily requires either higher spending as eligibility is expanded to higher incomes, or lower top payment rates if the cost is to be held constant.

This tension applies to income taxation more generally: flattening any part of a rate scale either reduces revenue or requires higher rates elsewhere. It is an inherent problem with a system in which we fund adequate incomes for all by taxing the incomes of people who work and earn more. To escape this, we need revenue from elsewhere – i.e. from changing the tax mix.

² Examples of universal benefits include child benefits in Norway and Poland (Thoresen and Vattø 2023; Sussman 2019) and New Zealand's age pension (Ingles and Stewart 2015).

³ These simplified EMTRs comprise welfare phase-out and income tax (including Medicare phase-in and LITO/SAPTO phase-out). Full EMTR modelling including all taxes, offsets, allowances and childcare costs is complex, and in principle even payroll tax and GST can be included, though it is standard not to (Ingles and Plunkett 2016).

⁴ For example, minimum-wage sole parents in New Zealand face EMTRs of 49% after 6 hours of work, 80%+ from 12 hours to 20 hours of work, and 101% up to full-time (36 hours) work (Nolan 2018), providing them with little prospect of increasing income by working.

⁵ Ingles and Stewart (2015), p12.

We underuse our best tax base, and pay for it by overtaxing workers

Some taxes avoid trade-offs between revenue and efficiency entirely. A basic principle of tax design is to tax the things we want less of (e.g. speculation, pollution) rather than the things we want more of (e.g. investment, production). Taxes on land pass this test. They reduce land values without reducing the quantity of land available, and can even increase the amount of land put to productive use. They are efficient because they are paid out of economic rents (i.e. income in excess of effort) and because they can spur land into better use.

Land rents can be efficiently taxed by various means:

- Land value tax, e.g. state land taxes and municipal rates.
- Taxes on planning gains and land value growth, e.g. rezoning windfall gains tax and capital gains tax on land.
- Direct capture of land rent and rezoning value via public ownership.

States have access to the land base, but they underuse it and rely heavily on Commonwealth grants funded by less efficient taxes on work and investment instead. As a result, the tax mix in our federation is both 'back to front' and 'upside down': we use the wrong taxes, and we tax at the wrong level. This results in a complex and inefficient system, as well as a fiscal imbalance between the Commonwealth and states which dilutes accountability for spending.⁶ The problems are well known and have prompted numerous calls to more heavily tax land (e.g. the Henry Tax Review, 2010).

Some states tax land better than others – and levelling up would raise \$27 billion

Amongst states and territories, some tax land better than others. The Australian Capital Territory (ACT) in particular stands out for its unique system of rezoning value capture. The ACT prices rezoning via its Lease Variation Charge (LVC), which captures 75% of the windfall gains landowners would otherwise receive from permission to redevelop at higher density. Because it owns all rural land the ACT also captures 100% of the gains from rezoning for greenfield development.⁷

Taxes on planning gains are not passed to homebuyers or renters and do not affect development incentives – they just reduce the capital gains that developers or landowners selling to developers would otherwise receive.

The ACT also raises more revenue from regular taxes on land than the other states and territories. Figure 2 shows each state's "effective land tax rate", calculated as the revenue from all property taxes (including stamp duty) divided by the value of all land. Over the last 5 years, the ACT taxed land at an average of 1.0% of value per annum, with Western Australia (WA) close behind.⁸

⁶These simplified EMTRs comprise welfare phase-out and income tax (including Medicare phase-in and LITO/SAPTO phase-out). Full EMTR modelling including all taxes, offsets, allowances and childcare costs is complex, and in principle even payroll tax and GST can be included, though it is standard not to (Ingles and Plunkett 2016).

⁷Victoria's new Rezoning Windfall Gains Tax is a step in the same direction.

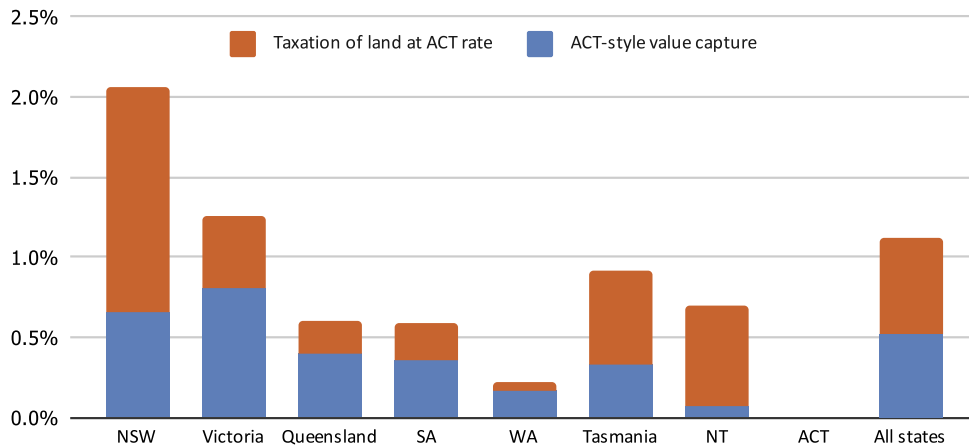
⁸Stamp duty is included on the basis that while not all property taxes are equally efficient, all suppress land values, so these effective land tax rates could be preserved via a revenue-neutral switch to efficient land taxes that does not reduce property values. See Appendix for details.

Figure 2: Effective land tax rate, 5-year average to 2021-22



Adjusting for property values and transaction volumes, we estimate that if other states were to capture value uplift by pricing rezoning as the ACT does they could raise a collective \$12 billion each year. If they were to use efficient land taxes to meet the ACT benchmark for regular taxes on land they could raise a further \$15 billion. In total, if all states achieved best-in-class taxation of land they would raise an additional \$27 billion in revenue each year, without reducing investment or growth. For under-performing states the revenue impact would be significant: with better land taxes New South Wales (NSW) could raise another \$15 billion per annum, equivalent to 2.1% of GSP (Figure 3).

Figure 3: Additional revenue as of percent of GSP from ACT-style taxation of land⁹



\$27 billion could fund a halving of welfare taper rates – reducing EMTRs by 20-30 cents for one million workers

What could \$27 billion fund if Commonwealth-state transfers were adjusted to bring revenue and expenses for each level of government closer to balance?

One option is a universal income of over \$1,000 per Australian. Another is a 10% reduction in the personal income tax take. But more economically significant would be a targeted reduction in the high EMTRs and work disincentives created by strict welfare means-testing.

⁹5-year average to 2021-22 of ACT value capture revenue scaled for inter-state construction and prices, plus additional revenue from increasing effective land tax rate to 1.0%. See Appendix for details.

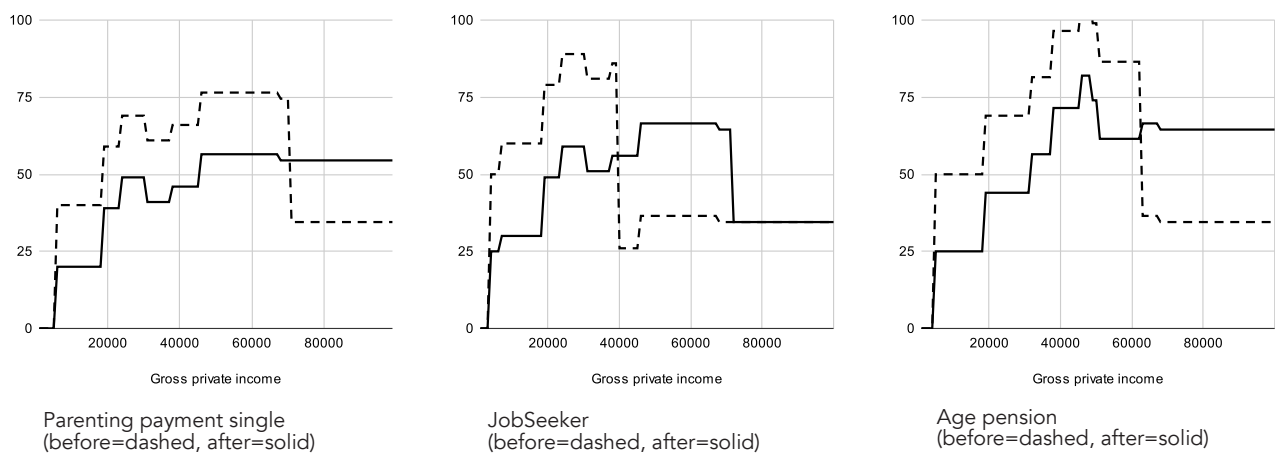
We model the approximate cost of reducing taper rates on all major welfare payments, as well as Family Tax Benefit (FTB), and estimate that the additional \$27 billion raised from best-in-class land taxation and value capture could fund a halving of welfare taper rates with no reduction in maximum payments. The cost of this would be roughly \$17-22 billion, leaving \$5-10 billion to pay for incentive payments to states, or to fund other reforms.¹⁰

For the one million Australians currently on welfare part-payments this would deliver an effective tax cut of 20 to 30 cents per additional dollar earned. Figure 4 illustrates this for several payments.

For most recipients, this would more than double their net-of-tax return to working more hours. For these people, primarily in the low-to-middle income range up to \$70,000, this change would boost incomes by roughly \$4,000 to \$7,000 p.a. even before accounting for additional work effort.

For another 800,000 or so FTB part-recipients a halving of taper rates would reduce EMTRs by 6-12 cents per dollar earned. With the addition of these taxpayers and others on higher incomes who now qualify for welfare payments or FTB, it is likely that 3 million or more Australian workers would benefit from this change.

Figure 4: EMTRs for selected welfare payments before and after halving taper rates



The economic impact could be in the order of billions

Estimating the effect on work effort and GDP is challenging since the response of workers to taxation varies significantly by circumstance.¹¹

For a ballpark estimate, we first apply an 'elasticity of taxable income' to the change in after-tax returns to work for existing and new part-payment recipients. This suggests a net gain in total wages and GDP of around \$2 billion. Applying instead the estimated economic welfare impact of income taxation from Treasury modelling to the \$17-22 billion effective tax cut suggests the impact could be \$5-7 billion, establishing a range of around \$2-7 billion for economic impact.¹²

Implementation

This indicative proposal demonstrates what could be delivered with modest tax mix reform that goes no further than lifting all states up to an existing benchmark. For the same cost, alternative designs to better target the highest EMTRs or workers most sensitive to taxation would also be possible. A larger budget would clearly allow for further flattening of EMTRs or even an end to means-testing for some payments.

Since states receive Commonwealth grants, rebalancing revenue between levels of government is an administrative matter which the Commonwealth can initiate. This could involve (for instance) shrinking the

¹⁰See Appendix for details.

¹¹See Dandie and Mercante (2007) for a review of Australian labour supply elasticities.

¹²See Appendix for details.

GST pool distributed to states over some fixed timeframe, or reducing other payments as funding agreements expire.

A new funding agreement could provide incentives for states via top-up payments provided in proportion to additional revenue raised by states from land tax rate and design changes (but not tax base growth). Re-zoning windfall capture could also be made a condition of infrastructure funding. With incentivised, co-ordinated action driven by the Commonwealth the political barriers to better land taxation that each state faces alone would be markedly lower. At state level, appropriate transition and tax deferral mechanisms would remain important.

Conclusion

The biggest economic gains from tax reform come from changing the tax mix to expand the best taxes and reduce or replace, not just rearrange, the worse ones. The effects of high EMTRs and the merits of better taxing land, both well known issues, are challenging to address in isolation – EMTRs for the cost, and land taxes for the politics. This makes reform driven by the Commonwealth an attractive option. As shown, even modest changes in land taxation could pay for substantial reform.

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Appendix

State taxation of land

"Effective land tax rates" are calculated by dividing recurrent taxes on property (land tax, municipal rates, other property levies) plus stamp duties on conveyances (ABS 5506.0) by total land value (ABS 5204.0, Table 61). Additional revenue by state equals the ACT rate (1.0%) times land value, minus actual revenue, indexed by CPI to 2022-23 dollars (Table A1).

ACT rezoning value capture revenue is calculated as LVC revenue (from ACT Budget papers) plus Suburban Land Authority (SLA) operating results before tax (from SLA annual reports). Equivalent revenue for other states equals ACT revenue scaled by new dwelling completions (ABS 8752.0, Table 38) and mean dwelling prices (ABS 6432.0, Table 1). Revenue is indexed by CPI to 2022-23 dollars.

Table A1: Additional revenue from ACT-benchmark taxation of land, 5-year average to 2021-22

State/territory	Taxation of land at ACT rate (\$m)	ACT-style rezoning value capture (\$m)	Total (\$m)
NSW	10,243	4,844	15,087
Victoria	2,414	4,346	6,760
Queensland	984	1,821	2,805
SA	308	478	786
WA	207	709	916
Tasmania	229	126	355
NT	187	22	208
ACT	-	-	-
All States	14,566	12,371	26,937

Policy cost

Policy costing is on a no-behavioural change basis, so is likely conservative (i.e. overstates cost), due to lower average EMTRs boosting aggregate labour supply and income tax revenue.

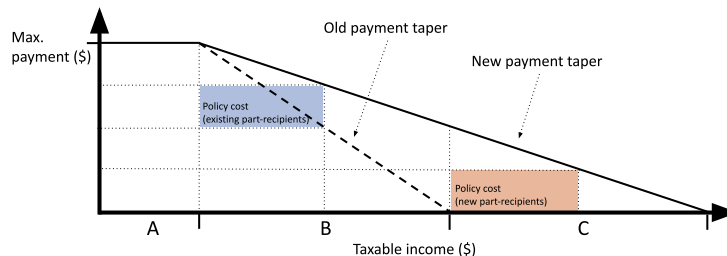
For each welfare payment the cost is calculated from three datapoints:

- The current number of part-recipients;
- The current maximum payment; and
- The proportional change in taper rate (i.e. one half).

In lieu of data on the distribution by income of potentially eligible taxpayers we assume uniform distributions within each of the old taper range (range B in Figure A1) and extended portion (C) of the new range (B+C), so that the average increase in payment in each range is the increase at the range midpoint (i.e. 1/4 the max payment). Total cost is multiplied by recipient numbers.

The high-end costing assumes identical recipient numbers in range B and C (the shaded boxes). This overstates costs if the true distribution is downward sloping (as per the entire population; see Figure 2 from Johnson et al (2023)). The low-end costing assumes half as many recipients in C as in B, but a uniform distribution within each range (i.e. the red box is halved).

Figure A1: Stylised approach to policy costing and economic impact estimation



Behavioural change

The low-end estimate is based on an 'elasticity of taxable income' (ETI), i.e. percentage change in taxable income for a 1 percent change in the net-of-tax rate (=1-EMTR). From Figure 9 in Johnson et al (2023) we select a ballpark ETI of 0.05 for all taxpayers, i.e. doubling the return to work increases taxable income by 5%.

For each payment we use the average EMTRs over ranges B and C before and after reform to determine the change in net-of-tax rate for each range, assuming uniform distributions within B and C but only half as many recipients in C. We ignore the labour supply impact of lower EMTRs for lumpy increases in working hours for full recipients (range A), making our low-end estimate of a \$2 billion wage and GDP impact conservative (Table A2).

The high-end estimate multiplies the 0.32 marginal excess burden (MEB) of labour income tax from Table 3 in Cao et al (2019) by the policy cost range (\$17-22 billion) to get a GDP impact of \$5-7 billion. Since this MEB is based on an average tax rate of 0.25, which is much lower than the average EMTRs of around 0.75 for welfare recipients, our estimate is likely conservative.

Table A2: Taper ranges, EMTRs, and change in taxable income (low-end estimate)

Welfare payment ¹³	Taper range: old (new)	Avg. EMTR (B): old(new)	Avg. EMTR (C): old(new)	Net change in income: B(+ve)+C(-ve)
Age Pension: single	\$6k-\$65k (\$124k)	0.76 (0.51)	0.35 (0.60)	\$1.00 bn
Parenting: single	\$6k-\$71k (\$135k)	0.64 (0.44)	0.36 (0.56)	\$0.03 bn
Parenting: partnered	\$4k-\$34k (\$65k)	0.72 (0.43)	0.32 (0.62)	\$0.00 bn
JobSeeker	\$4k-\$39k (\$73k)	0.73 (0.44)	0.34 (0.64)	\$0.10 bn
Youth Allowance	\$4k-\$39k (\$73k)	0.71 (0.43)	0.32 (0.60)	\$0.03 bn
Disability Support	\$6k-\$65k (\$124k)	0.76 (0.51)	0.35 (0.60)	\$0.11 bn
Carer Payment	\$6k-\$65k (\$124k)	0.76 (0.51)	0.35 (0.60)	\$0.07 bn
FTB(A)*	\$63k-\$125k (\$187k)	0.75 (0.65)	0.55 (0.65)	\$0.84 bn
FTB(B)*	\$6k-\$32k (\$58k)	0.75 (0.65)	0.55 (0.65)	\$0.04 bn
Total				\$2.25 bn

¹³DSS (2023a) only disaggregates single/partnered data for Parenting Payment, so we base cost and GDP calculations on the singles phase-out range but using combined single/couple numbers. *FTB ranges are for partnered, two children. Due to the complexity of overlapping payments and childcare costs, FTB EMTRs are 0.75 by assumption.