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Submission into the NSW Treasury's consultation process for proposals to reform property taxation and stamp duty.

15 March 2021

Dear NSW Treasury,

The McKell Institute thanks the NSW Treasury for the opportunity to share its perspectives and findings on "'Buying in NSW, Building a Future', NSW Treasury Consultation Paper into changing NSW property taxes" (hereafter **Consultation Paper**).[1]

Since 2012, the McKell Institute has expressed its commitment to the principle of transitioning away from stamp duties towards land taxes. So long as such a shift is equitably undertaken, it is a reform that is vital to ensuring, as the Consultation Paper notes, a modern tax system.

The McKell Institute is therefore is committed to making this reform process successful. Success will be undermined, if the reform process fails to adequately consider issues such as fairness or equity, or if it fails to take advantage of the financial opportunities that reform brings.

The NSW Treasury should also work to ensure this important reform is implemented in such a way that it controls fluctuations in property prices following the reform. Stability and confidence are required to ensure public buy-in of the policy.

The NSW Treasury and NSW Treasurer should be congratulated for pursuing reforms that will provide a more stable state tax base and allow more people to own a home that is right for them and their family.

Your consideration of this submission is appreciated.

[redacted]

About The McKell Institute

The McKell Institute is an independent not-for-profit research organisation dedicated to advancing practical policy solutions to contemporary challenges.

The Institute also regularly convenes a bipartisan roster of policymakers, business leaders, trade union leaders, and leading voices from across civil society in regular roundtable discussions and public events.

About This Submission

The Consultation Paper poses broad questions for consideration. Given the scope of feedback requested this submission is focused on a few key aspects of the reform we believe are most vital to its success.

The McKell Institute has published extensively on the need to reform stamp duty, and how to improve housing affordability generally. Stamp duty discourages homeowners from moving thereby locking in the inadequate allocation of housing stock. It also represents a significant up-front cost when moving between residences, which is a particular barrier for first home buyers. The McKell Institute is in favour of the principal of sensibly substituting stamp duty to property taxes.

This submission highlights the Institute's previous work on this topic and identifies aspects of the reform that should be carefully considered as the NSW Treasury considers how to implement the proposed policy.

We strongly commend the NSW Treasurer and NSW Treasury for their collaborative and thoughtful approach to this important reform.

About The Author

[redacted]

Key Findings

1. The McKell Institute supports the replacement of Stamp Duty with some form of land or property tax and has argued for such a policy in the past.

2. The introduction of a property tax may place upward pressure on house prices in the short term, but the reduction in stamp duty costs will still result in a net positive effect on housing affordability.

3. There must be clearly articulated proposals that would protect tenants and renters, so they are not adversely affected by a decision they did not make.

4. House prices and rental prices must be continually monitored following the introduction of the scheme, so as to manage any fluctuations and analyse the effects of the reform.

5. Renters must be protected by some kind of enforcement agency that keeps track of rental prices and vacancies.

6. Landowners should be protected by a rent deferral scheme, modelled off the one available in the ACT or the recent NSW option to defer land tax due to COVID-19.

7. Protections are essential in order to ensure high uptake of the property tax.

8. Grants and concessions for First Home Buyers should be reconsidered, or potentially abolished. Reduced expenditure on these schemes may allow the NSW Government to abolish other inefficient taxes, such as the Emergency Services Levy.

9. The uptake of the scheme requires trust from the community. This could be established by guarantees related to the rates of taxation, whereby the per cent amount should be fixed and gross amounts should not vary significantly.

10. The NSW Government should try, where possible, to emulate the ACT Government scheme, as well as creating a system that can be replicated in other states.

11. Further detail is needed as to how the reform will relate to commercial properties. This includes consideration of the transition process between the existing land tax and the future property tax.

The proposal

Key Points

1. The McKell Institute welcomes the Consultation Paper's support of replacing stamp duty with a property tax but cautions that in the short term it is unlikely to place downward pressure on house prices to improve housing affordability.

2. Even if there were to be short term increases in house prices, such increases would be offset by the lower upfront cost to housing due to the removal of stamp duty.

The Proposal

The policy will allow new property purchasers the option of paying stamp duty or paying a property tax. This tax will take the following key features:

1. The rate will be calculated via a fixed amount plus a rate applied to the unimproved land value of an individual property.
2. Buyers can choose between paying stamp duty or the property tax, but once a property is subject to the property tax, it will remain as such.
3. There are no changes to existing properties.

McKell Institute's previous work on stamp duty

The McKell Institute supports the replacement of Stamp Duty with some form of land or property tax and has argued for such a policy in previous works including in *Homes for All: The 40 things we can do to improve supply and affordability* (2012),[2] *A Plan to End Stamp Duty* (2016)[3] and *Choosing Opportunity: A Policy Blueprint for a Fairer Australia* (2016).[4]

In these reports, we noted that stamp duties are not only highly inefficient but also inequitable, as the tax falls on those who regularly move to a new house, rather than those who stay in individual properties.[5] Additionally, stamp duties are a major barrier to first home buyers, as it adds to the upfront cost of purchasing a new home (and cannot be included in a mortgage).

These points were raised in the Consultation Paper, which noted the increasing approximate number of years to save for the cost of a deposit plus stamp duty. The Consultation Paper also noted that the way that stamp duty disincentivises moving from property to property acts as a handbrake on economic activity and therefore replacing it will stimulate the NSW economy.

In addition, The McKell Institute's 2016 report endorsed the transition arrangements of the 2011 Financial Audit (The Lambert Report).[6] These transition arrangements called for land taxes to be only applied on new homes (which would no longer be subject to stamp duty), which was followed and expanded upon in the Consultation Paper, with a proposal to allow purchasers the choice of which tax would apply.

Further The McKell Institute's 2016 report endorses a rate deferral system, as applied by the ACT Government. Such a proposal is discussed below.

Effect on house prices

Short Run

In the short run, it is likely that the policy will have a mixed effect on housing affordability. It is useful here to separate housing *affordability* and house *prices*. The McKell Institute predicts that due to an increase in demand for housing, house prices will increase in value in the short run. This aligns with earlier research that predicts that the lower transitional costs will cause an influx of demand, and lead to short-term growth in the average house price. [7]

In 2021, housing demand is reduced in some capital cities because of decreased migration but is increased because of low interest rates. Overall, house prices increased by approximately 5.8% in capital cities over 2020.[8]

In giving people a choice between stamp duty or an ongoing land tax, buyers are likely to choose whichever will maximise their buying power. Those who opt for land tax will have increased equity to support a larger loan than they may otherwise have entered into. The effect will be upward pressure on house prices in the short term.

Finally, given the public is unfamiliar with a land tax regime, it is likely some purchasers will not price it effectively into their bid.

Despite these pressures, removing stamp duty reflects a substantial reduction in the up-front cost of housing. The overall effect of the policy proposed in the Consultation Paper is to substantially reduce the upfront cost of housing, regardless of any short-term change in the house prices.

However, these movements in prices depend on the uptake of the new property tax scheme, i.e. how many new purchasers elect to pay the new property tax. This point was noted in the Consultation Paper.

Table 1: *Case study: Impact on affordability for a $900,000 home ($600,000 land value)*

In this example, various one-year short-term spike in house prices are modelled. The upfront cost of the house under a property tax scheme regime is calculated, and this is compared with the cost of the property under the existing stamp duty scheme assuming a short-term spike doesn't exist.

% increase in short-term house prices	Upfront cost (property tax)	Difference (under stamp duty and no change in property prices)
1	911300 + 2300 yearly	-24535
2	920336 + 2336 yearly	-15499
3	929354 + 2354 yearly	-6481
4	938372 + 2372 yearly	**2537**

Source: Author's calculations, based on suggested property tax rates from the Consultation Paper.

As such, even in the event of some minor short-term increase in the upfront cost of housing, the total cost of buying a new home will fall as a result of the reform. This holds so long as the short-term increase remains low, in our model this equates to approximately 3 per cent or lower.

Long run

The Consultation Paper argues that "[t]he proposed changes would also place downward pressure on home prices over the longer term, making housing more affordable for all".

However, the Consultation Paper doesn't make out a clear explanation for this long-term downward pressure.

In the Grattan Institute submission,[9] it is argued that as the reform will result in a better allocation of housing stock, property prices will reduce in the long run. While it may be correct that housing stock will see an increase in the long term due to this reform, the effects on demand may counterbalance this. McKell Institute's previous research has found that the combined effect of abolishing stamp duty and extending taxes on land will most likely have a neutral effect on house prices in the long term.[10]

As such, more economic analysis is needed to evaluate the effect of house prices in the long run. Further, price monitoring through a Government agency may be helpful in order to see the real-world effect of the reform.

Protections

This section addresses two questions posed in the report.

> *9. What arrangements should be made for residential and commercial tenants if their landlord chooses to pay the property tax?*
>
> *10. What should happen for people who have chosen the property tax, but then can't afford it?*

Downfalls for tenants

The Consultation Paper correctly notes that in the short-term, the reform may induce an increase in rents.

These concerns for tenants are important to note when one considers the fairness of the scheme. The current proposal is based on the choice of the property owner – to opt-in to the new property tax system or to pay stamp duty. However, the levying of property taxes will likely lead to disruptions to the market, and potential movements in house prices (as noted above). As the levels of house prices change and experience distortion, owners may wish to pass on such charges to tenants.

As such, tenants may be punished for choices they did not elect to make. The owner is free to make the choice that they see fit for their own personal financial circumstances, but the renters may have to accept the forces of the market.

Solutions for tenants

The McKell Institute submits that the next stages of the proposal must include clear provisions to protect tenants from increases in rents that are merely levied to meet property owners' property tax liability.

As it stands, the Consultation Paper suggests 'proactive monitoring'. The McKell Institute welcomes the suggestion of a monitoring body. This would also monitor the effect on dwelling prices generally, as identified above. This monitoring body must have the authority to gauge what the real-world effect of the tax reform. Specifically, it must monitor whether those who are 'stuck' renting in stamp-duty properties or those who have moved on to renting in property-tax properties are paying higher rents. It must be able to discern which factors, exogenous or endogenous resulted in any change in rents.

However, monitoring alone is not enough. The Government must be equipped with the power to challenge landlords passing-on the cost of the property tax. The consultation calls for 'legislation governing the pass-through of the property tax'. While this is welcomed, this legislation must have its ambit defined.

Ideally, the legislation creates a mechanism whereby the landlord can't engage in practices that would allow them to pay lower overall tax, but still allow an increase in rents. In this sense, it could monitor changes in rents and determine the source. It should have investigative powers, and the power to order back payments of overcharged rents. For instance, an 'overcharged' rent could mean that rent has been increased by a per cent change greater than the increase in cost to the landlord, or an increase greater than a difference in the dwelling's previous listing price.

Downfalls for landowners

Similar to above, the Consultation Paper gave a passing thought to another fairness question – what happens when someone who elects to pay the yearly property tax finds that they are no longer able to do so?

This scenario is most likely to arise in relation to disadvantaged groups, those receiving government support as well as the elderly. Circumstances in people's life may change, and it may be the case that a homeowner who previously envisioned paying property tax into the future finds that they are no longer able to.

Potential solutions for landowners

The McKell Institute proposes a property tax deferral scheme, also known as a rates deferral scheme. As noted in our 2016 report, the ACT Government currently enacts such a scheme to complement their land tax regime. Under the *ACT Rates Act 2004,* pensioners have a statutory right to defer their land tax payment. Eligible households may also defer their payment if they meet certain criteria. This is managed by the ACT Revenue Office.[11]

Alternatively, potential hardship provisions could be modelled on recent land tax relief options introduced by the NSW Government in the wake of the COVID-19 pandemic.[12] Such relief options allow for a homeowner to reduce their liability when changed circumstances can be proven, which is analogous to the situation of a pensioner who finds that they may no longer be able to pay the property tax or a homeowner finds themselves unexpectedly unemployed.

Such a scheme could involve eligible homeowners, such as the elderly, deferring their payments to then be collected upon the next sale of their home. Provided that the deferred payments accrued a discounted interest rate equal to the rate of Government borrowing costs and any defaults, the Government could allow this scheme with no net budget impact.

Allowing for hardship provisions will encourage the adoption of the property tax

Fundamental to the Consultation Paper's approach to the tax is choice – allowing any property purchaser to elect the choice of tax that will best suit their needs. Without any kind of property tax deferral option to act as a backstop, risk-averse purchasers who would have otherwise partaken in the new scheme may defer it. As such, not specifying clear hardship provisions and deferral schemes risks low uptake of the reform.

Changes for First Home Buyers

The Consultation Paper's proposal

The Consultation Paper correctly identifies that under a shift to a property tax scheme, that concessions currently offered on stamp duty become irrelevant. The concessions on stamp duty are an admission that stamp duty is one of the most significant barriers for first home buyers and has been identified by The McKell Institute in the past.

The Consultation Paper proposes the continuation of subsidies and schemes for first home buyers. These take the form of:

1. Short term financial support via cash grants of up to $25,000
2. Continuation of the First Homeowner Grant (New Home) scheme of up to $10,000

These two measures would complement the option to opt-in to paying property tax in lieu of stamp duty. While the Consultation Paper argues that these measures could further assist first home buyers, we think that this assertion requires analysis and discussion.

The FHBG is an ineffective scheme

The First Home Buyers Grant (FHBG), and concessions on stamp duty generally, are flawed policy fundamentally because they don't address the fundamental forces affecting the price of the homes, and any benefits are absorbed into the price.

While up to $35,000 for first home buyers sounds effective in reducing barriers, all it will ultimately do in effect is drive up the prices of the homes.[13] Sellers will factor in this $35,000 into their market appraisals and sell the properties for that higher price. Ultimately the only beneficiary from the policies is the seller themselves, contrary to the intent of policymakers, and at a considerable cost to government.

Previous studies of First Home Buyers Grants have found that the FHBG increased house prices by approximately $57,321 due to the ability to borrow more and an inelastic supply.[14]

Fundamentally, the cost of housing is driven by market forces such as the supply of homes, planning laws, and the general state of the market economy. Therefore, more analysis is needed on the actual efficacy of the existing FHBG, and grants in general, and whether they should continue under a shift to a property-tax system.

If policymakers wanted to incentive first home buyers, they could provide a discount to first home buyers on their annual property tax. Given first homeowners are likely to have less equity and larger mortgages, this ongoing relief will provide a greater benefit. Note that this scheme would also place upward pressure on house prices.

Reduced spending on the FHBG could be put to use

First Home Buyer concession and exemptions are costing the budget approximately half a billion dollars each year. This is a significant budget impost which, we argue, is not effective at assisting with housing affordability.

Table 2: Costs of First Home Buyer concessions and exemptions

Year	2018-19 $m	2019-20 $m	2020-21 $m
First Home Buyer concessions and exemptions	447	523	592

Source: NSW Budget Statement 2020-21 Table A2.3[15]

The replacement of stamp duty with a general property tax will be a larger break for a first home buyer than the first home buyer grants and concessions ever had the potential to be.

As such, we recommend that analysis be undertaken into the option of gradually removing first home buyer grants and using the budget expenditure on the grants and concessions elsewhere. The hundreds of millions of dollars being used on these concessions can be eliminated and reallocated in order to work on other budget priorities.

In the short term, the funds could help offset the substantial budget impact of transitioning to property tax. In the longer run, the funds could be used to maximise the efficiency of the reform by targeting other inefficient state taxes.

For instance, the Consultation Paper itself notes that along with stamp duty and vehicle duty, the marginal excess burden of the Emergency Services Levy is among the highest out of all state taxes.[16] Given earlier attempts to scrap the Levy,[17] as well as recent calls for its removal,[18] it's worth considering whether the money currently being sent on first home buyer grants can potentially be redirected towards the gradual removal of this levy.

Table 3: Cost of Emergency services Levy Contributions over the forward estimates

	2018-19 Actual $m	2019-20 Actual $m	2020-21 Budget $m	2022-23 Fwd Est $m	2023-24 Fwd Est $m	2024-25 Fwd Est $m
Emergency Services Levy contributions (excluding council contributions)	785	907	1,080	1,040	1,040	1,029

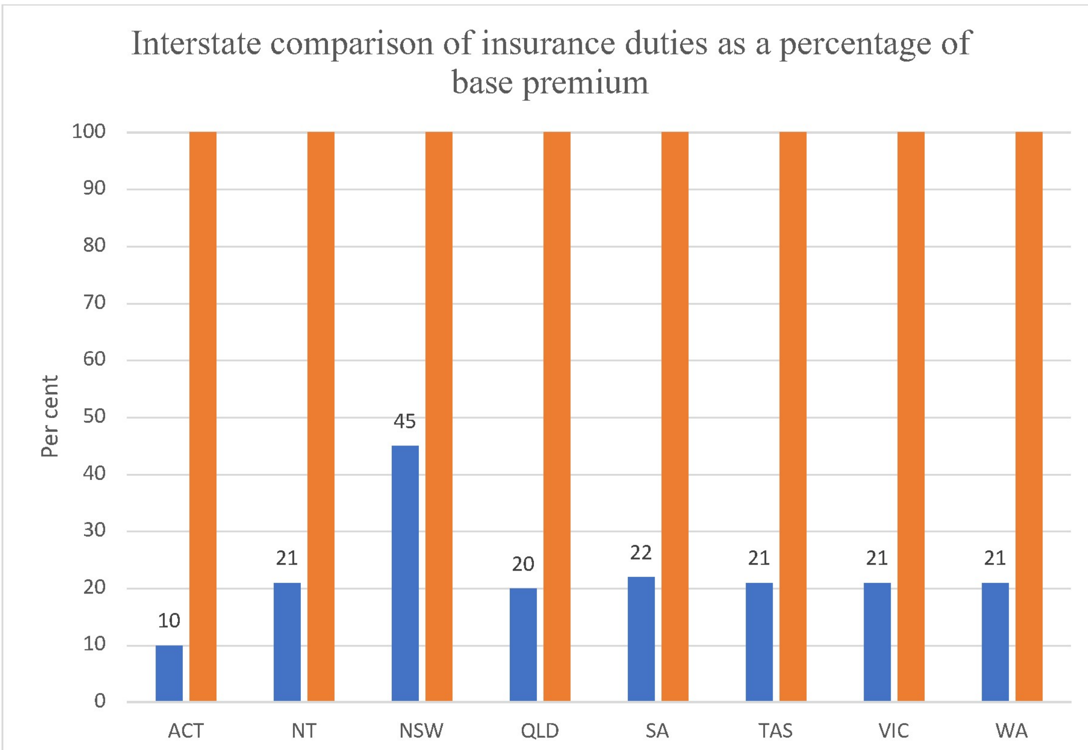
Source: NSW Budget Statement 2020-21 Table 4.3[19]

This gradual removal of the Emergency Services Levy would align with the NSW Government's goals in the Consultation Paper, such as creating a modern tax system and stimulating economic recovery.

As the ICA noted in 2019, 'NSW is the only state to retain an additional ESL' increasing the cost of insurance duties in the state relative to other jurisdictions.[20]

Reducing the Emergency Services Levy will reduce the cost of insurance, and therefore increase insurance coverage. Ultimately this will support communities to recover after natural disasters. This small change to the property tax proposal could greatly increase its benefits.

Chart 1: Interstate comparison of insurance duties as a percentage of base premium[21]



Other points

Proposal uptake requires trust

The uptake of land tax requires trust that the scheme will continue to be operated fairly into the future.

While paying stamp duty upfront may not be in a buyer's interest, fear of future property tax increases and the uncertainty around the future value of their land (which determines the property tax), may lead some to mistrust the scheme and therefore reduces uptake.

We propose:

1. A guarantee in the legislation that there will be no increase in the rate of property tax.
2. Land values are calculated every year by the office of the valuer general. We suggest that in any given year the value of land tax payable cannot increase more than 5 per cent. This will make for more gradual increases in tax payable during times of rapid value increases.

Alignment with other states

The release of the Consultation Paper by the NSW Government coincided with speculation that the Victorian Government may also embark on a process of reforming stamp duty. Regrettably, reform was dropped by Victoria in announcing their 2020-21 budget.[22]

However, alignment with other state jurisdictions should still be a goal of the NSW Government in the design and implantation of the new scheme. Where possible, the NSW Government should align the new model with the ACT's ongoing transition away from stamp duty. Starting in 2012, the ACT Government has embarked upon a 20-year long process of moving away from stamp duty and other inefficient taxes.[23]

Further, the Government should table reform proposals to the National Cabinet and aim to consult other State governments. While this should not impede the progress of reform, the creation of a model system that can easily be adopted by other states would encourage efficiency across the Australian states.

Alignment with other States will also reduce the risks for when, eventually, stamp duty will need to be phased out completely. Uniformity across the States means that no individual state or territory will individually benefit from the tax model that they currently have.

Commercial properties

Both the Consultation Paper and this submission deal mostly with the adoption of property taxes as it relates to residential properties. However, much consideration should be given to the transition from the current NSW land tax system, to the broader property tax system.

Specifically, more analysis and consultation surrounding the existing exceptions, as well as the rates and transition arrangements are needed. There is a need for broader industry consultation on how this will affect commercial industries, specifically those industries that regularly acquire new commercial property.

Conclusion

Owing to its previous work in this area, The McKell Institute welcomes this once-in-a-generation opportunity to create substantial reform to a flawed taxation system. This opportunity is therefore rare, and not to be squandered.

As such, fairness and equity measures must play a central role in the design of the scheme, or the reform journey risks being undermined.

In addition, the reform brings to bear questions about the broader taxation and spending system, such as first home buyer grants, and the emergency services levy. Reform planning without consideration of these elements will therefore be incomplete.

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