STAMP DUTY TO LAND TAX: REVENUE IMPACTS OF 'GRANDFATHERING' AND 'OPT-IN'

This brief summarises new modelling on the revenue impacts of the model floated by the NSW Treasurer, and explains the key trade-offs involved to inform public policy debate.

SUMMARY

Replacing stamp duty with land tax has the potential, if enacted sensibly, to support budget recovery without impeding economic growth.

The NSW and Victorian Treasurers are to be commended for taking on the challenge of reform.

How this switch is implemented is critically important.

The NSW Treasurer appears to favour a two-part transition model for stamp duty to land tax: switch-on-sale (full grandfathering) for existing property owners and voluntary 'opt-in' for new buyers.

This transition model is unviable, and inconsistent with the aims of the reform.

In NSW, this transition model will take more than 50 years and cost over $120 billion in foregone revenue – some 20% of GSP.

The equivalent impacts in Victoria are even more significant with net debt expanding 25% of GSP within 50 years – a giveaway of more than $100 billion from future taxpayers primarily to current landowners.

In its final report The NSW Review of Federal Financial Relations (Thodey Review) must properly address the limitations of certain transition models in order to avoid inadvertently derailing land tax reform.

The NSW Government cannot be allowed to to rush into commitments it neither can nor should deliver on.

BACKGROUND

Numerous tax reviews have argued for state duties on real estate transfers ('stamp duty') to be abolished and replaced by a new broad-based land tax.

The NSW Review of Federal Financial Relations (The Thodey Review) has reiterated these calls in its draft report of July 2020. The draft report has also endorsed the views of Prosper and others that a tax on land, not an expansion of the GST, is the right replacement for stamp duty (while also exploring GST expansion as a means of increasing overall state revenue).

Both NSW and Victorian Treasurers have expressed their willingness to undertake this reform.

The transition from one tax to another is a critical and difficult part of the overall policy design task.

The Thodey Review has put it that "the transition should be managed with the support of detailed distributional and financial modelling and public communication and consultation, so that the transition is fair, efficient and minimises the amount of revenue foregone".

A range of factors make this challenging: the concentration of stamp duty on a small proportion of property owners, the importance of land in household net wealth, the size of stamp duty in state budgets and more.

The NSW Treasurer has foreshadowed a two-part transition model:

- Full grandfathering of land tax-free status for existing property owners who previously paid stamp duty (a 'switch on sale' model); and
- A voluntary 'opt in' approach for new buyers that would offer the choice of either paying an upfront stamp duty (opting out) or the recurrent land tax (opting in).

Prosper examined transition issues in depth in its 2019 report Stamp duty to land tax: designing the transition, by Dr Tim Helm. Below is an analysis of the costs and trade offs associated with the approach mooted by Treasurer Perrottet.

GRANDFATHERING ('SWITCH ON SALE')

Grandfathering tax-free status for existing owners feels intuitively fair, since it preserves the tax bargain understood upon purchase. Why should those who have 'pre-paid' their quotient of tax via stamp duty also now 'pay as you go' via land tax, just like newer buyers not subject to duty? From the perspective of the property owner this appears to be double taxation.

The problem with exempting current owners from land tax until the property is next sold is that it entails a massive and unavoidable loss of tax revenue over a transition period lasting for generations.

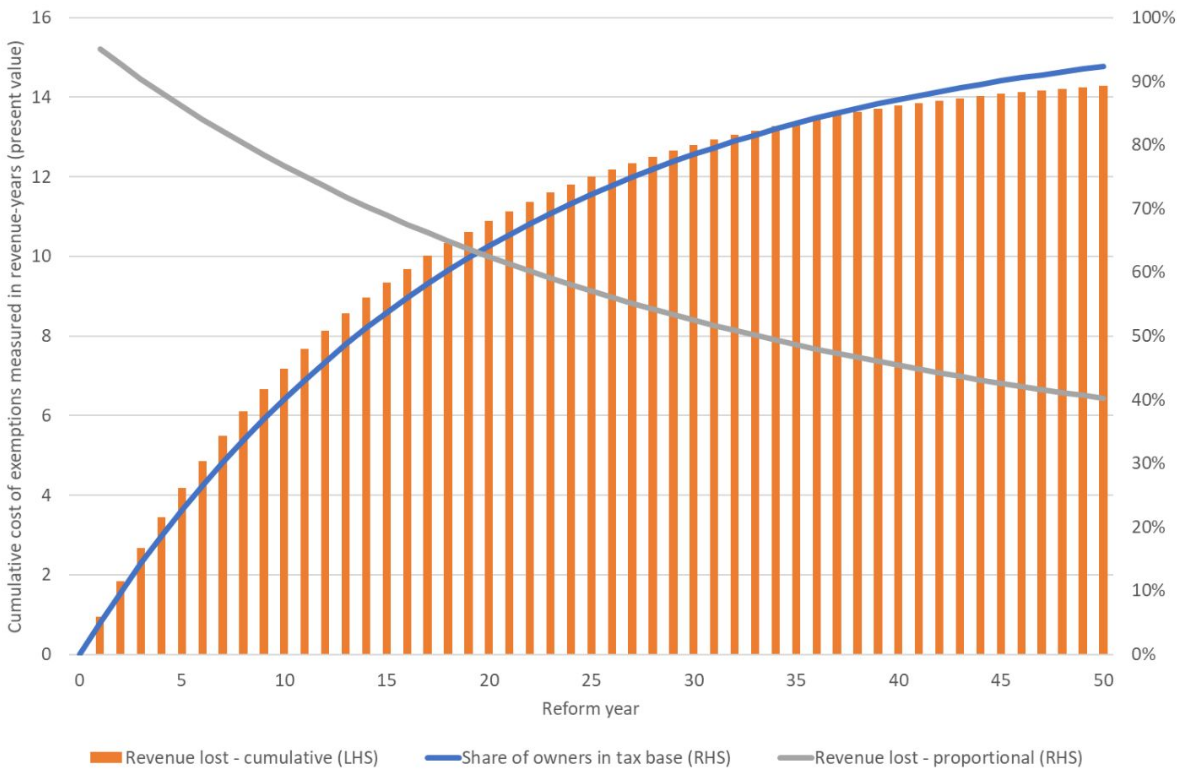
As ABS data shows, some 30% of homeowners have owned their homes for more than 20 years and some 20% for more than 30 years.[1] For many properties the time to next sale will be considerable.

Typically around 5% of properties are transacted each year. This means additions to the land tax base will be slow. In the first year of the reform, states can expect to receive land tax from only 5% of properties, in the second year from around 10%, etc.

Chart 1 shows the percentage of landowners paying land tax per year and the cumulative loss of tax revenue due to grandfathering, assuming 5% of untaxed properties join the land tax base each year.

The chart also shows the loss of land tax revenue due to grandfathering exemptions, as a proportion of revenue before exemptions, over various horizons (the downward sloping line). Over the first 20 years, for instance, full grandfathering means sacrificing 62% of potential land tax revenue.

Chart 1: Land tax payers as share of all owners (RHS) and revenue loss due to grandfathering (cumulative=LHS, proportional=RHS)



Source: Prosper Australia calculations based on 5% of untaxed properties joining the base p.a.

Over the course of transitioning all properties to land tax (a period proxied here by 50 years) full grandfathering costs a state 14 years' worth of annual tax revenue out of a total 36 years' worth of potential tax revenue (expressed in present value terms). This is 40% of potential revenue.

[1] ABS 4130.0, Housing Mobility, from Survey of Income and Housing.

Table 1: Tax expenditures due to full grandfathering transition policy, by state

	Stamp duty	Cost of exemptions for existing owners			
	2018-19	20 year horizon*		50 year horizon**	
	$m	$m PV	% GSP	$m PV	% GSP
NSW	6,875	74,842	12%	98,260	16%
Victoria	6,292	68,496	15%	89,928	20%
Queensland	3,195	34,781	9%	45,664	12%
SA	750	8,165	7%	10,719	10%
WA	1,097	11,942	4%	15,679	5%
Tasmania	249	2,711	8%	3,559	11%
NT	79	860	3%	1,129	4%
All (excl. ACT)	18,537	201,797	11%	264,939	14%

*Source: Prosper Australia calculations based on ABS 5506.0 and 5220.0. Notes:*10.9 revenue-years (62% of revenue).**14.3 revenue-years (40% of revenue)*

Table 1 shows these costs (or 'tax expenditures') state-by-state in dollar terms and relative to annual GSP over 20 year and 50 year horizons. These estimates assume the reform is long-run revenue-neutral, i.e. land tax revenue before exemptions is equal to the current level of stamp duty.

Chart 1 and Table 1 effectively demonstrate that unless land tax rates are set well above the past stamp duty equivalents, grandfathering will generate a massive revenue gap persisting for decades, and to maintain current spending will require a large and permanent increase in debt.

For NSW, the long-run revenue loss from grandfathering will be close to $100 billion in present value terms, requiring the state to ultimately take on additional debt worth 16% of GSP. For Victoria the cost is even more significant: the $90 billion in lost revenue from these exemptions will mean taking on additional debt of 20% of GSP.

A negative balance sheet impact will occur even if the tax switch is revenue-neutral from the perspective of each buyer, that is, does not involve any reduction in the total tax paid over the course of the buyer's tenure but only a shift in the timing of payments (from upfront or 'pre-payment' taxation to recurrent or 'pay as you go' taxation).

Several commentators have confused this point, concluding incorrectly that since buyers on average would pay no less tax "government balance sheets won't change in the longer run" and "the state would need to increase its gross debt by borrowing to plug the revenue hole, but its net debt would be roughly steady".[2] [3]

The long run debt impact occurs because while the present value of tax paid over the course of the average buyer's tenure might well be unchanged, government accounting does not recognise future land tax receipts as current revenue, unlike annual stamp duty revenue. Nor are future land tax receipts recognised as a current asset. This means that while the switch might be neutral from the perspective of the average buyer, from the perspective of the operating statement and balance sheet it is not.

[2] Richard Holden, "Vital Signs: Stamp duty is an economic drag. Here's how to move to a better system", The Conversation, 3 July 2020

[3] John Kehoe, "How states can axe housing stamp duty", AFR, 2 Jun 2020

These are not accounting quirks but are reflections of economic reality and are quite appropriate – future cashflows are not current revenue.

Tax revenue securitisation (selling rights to future tax in exchange for upfront payment) cannot alter this long-run debt impact. It can provide positive upfront cashflow in exchange for negative cashflow later, so is a financing instrument, not a funding solution. There are no obvious advantages of this proposal over ordinary debt.

To avoid a permanent increase in debt under full grandfathering requires higher land tax rates. For the net debt impact of the reform to return to zero within 50 years would require land tax rates high enough to recoup the average 40% of revenue foregone over this period from the average 60% of properties paying land tax over this period.

This would require tax rates two-thirds higher than the long-run revenue-neutral levels, e.g. approximately 1.0% of land value per annum instead of 0.6% of land value per annum. Debt-neutrality over 20 years would require land tax rates more than 2.5 times higher (e.g. around 1.6% per annum).

This level of revenue-negativity means that full grandfathering is implausible as a reform model, or if plausible is counter to the purposes of reform and is clearly undesirable – a point that has been lost in public debate but becomes apparent in light of quantification.

OPT IN/ OPT OUT

The transition will be even slower if combined with an 'opt in' approach for new buyers. Stamp duty received from buyers 'opting out' will somewhat reduce the front-end revenue loss, but only at the price of slowing the transition and thus maintaining the inequity and inefficiency of stamp duty for long-tenure properties.

Opt in will have enduring revenue costs arising due to 'adverse selection'. Buyers expecting to hold their property for relatively short periods will opt in to land tax to reduce their overall tax bill. But buyers expecting longer-than-average tenure will opt out, and so pay no more tax than at present.

This will generate a net loss of revenue, as those who opt out will pay less tax overall than if stamp duty were fully abolished and land tax were compulsory. It also means opted-out properties will pay less tax on average per annum than opted-in properties, and will face a disincentive to sell and lose their tax-free status (i.e. both the inequity and inefficiency of stamp duty remain unresolved).

Modelling for Prosper's 2019 transition report suggests that for every $1 lost in land tax from buyers opting out an average $0.67 will be recovered in stamp duty.

Buyers expecting longer tenure are more likely to opt out. But opt out rates will also depend on the relative progressivity of stamp duty and land tax scales, biases in the value and land value share of properties being bought for short-term versus long-term tenure, and other factors.

Absent specific tax design details, it is reasonable to expect the 50% of buyers anticipating longer-than-median tenure to opt out, and at least 50% of land value to ultimately be exempted from the land tax base as a result.[4]

The long-run revenue impact of the opt-in / out-out model is therefore a loss of at least $1 in every $6 of tax revenue each year: $1 in $3 of tax foregone, from at least 50% of properties.

The transition will also be twice as slow as in Chart 1; **states will effectively be operating dual tax systems in perpetuity,** since it is unlikely a politically critical mass of properties will ever be opted in.

Table 2 shows the opt in policy costs state-by-state both in annual terms as well as over 20 and 50 year horizons.

For NSW and Victoria, the long-run cost of opt-in is around $1 billion per annum (in present value terms). Over the first 20 years of the reform, some $7 billion in each of these states would be lost due to stamp duty payments not being adequate to recoup the land tax foregone. Over a 50 year horizon the total cost rises to over $20 billion present value, or 4-5% of a single year's GSP.

Table 2: Tax expenditures due to opt in / opt out policy, by state

	Cost of opt in policy (adverse selection cost)				
	Per annum*	20 year horizon**		50 year horizon***	
	$m	$m PV	% GSP	$m PV	% GSP
NSW	1,146	7,494	1.2%	24,329	3.9%
Victoria	1,049	6,858	1.5%	22,266	4.9%
Queensland	533	3,483	0.9%	11,306	3.1%
SA	125	818	0.7%	2,654	2.4%
WA	183	1,196	0.4%	3,882	1.4%
Tasmania	42	271	0.8%	881	2.7%
NT	13	86	0.3%	280	1.0%
All (excl. ACT)	3,090	20,205	1.1%	65,597	3.4%

*Source: Prosper Australia calculations. Notes:*1/3 of revenue from 50% of properties.**1.1 revenue-years (6% of revenue).***3.5 revenue-years (10% of revenue).*

Obviously these costs cannot be recovered via higher land tax rates without driving more buyers to opt out, and further slowing the transition

Table 3 summarises the total cost of the transition model floated by the NSW Treasurer over 20-year and 50-year reform horizons (summing the figures in Tables 1 and 2).

For NSW the proposed transition policies are expected to sacrifice $82 billion or close to 70% of revenue over the first 20 years of the reform, increasing net debt by 13% of GSP. This is far from

[4] Since short-tenure property types and buyers may transact disproportionately often relative to their share of total land value, this 50% ballpark likely overstates the rate of opt-out but understates the long-run share of the land value base exempted from tax. Prosper's 2019 modelling, based on the Victorian stamp duty scale and a hypothetical flat rate land tax, suggested that 44% of buyers would opt out but this would ultimately lead to 69% of the land tax base being exempted. 50% is therefore a conservative figure for the adverse selection cost.

revenue-neutral reform. **In the long-run this transition approach will cost NSW over $120 billion in foregone revenue – some 20% of GSP.**

Table 3: Policy costs – NSW Treasurer's proposed transition model

	Stamp duty	Total cost of grandfathering and opt-in policies			
	2018-19	20 year horizon*		50 year horizon**	
	$m	$m PV	% GSP	$m PV	% GSP
NSW	6,875	82,336	13%	122,589	20%
Victoria	6,292	75,354	17%	112,193	25%
Queensland	3,195	38,264	10%	56,970	15%
SA	750	8,982	8%	13,373	12%
WA	1,097	13,138	5%	19,561	7%
Tasmania	249	2,982	9%	4,440	14%
NT	79	946	3%	1,409	5%
All (excl. ACT)	18,537	222,002	12%	330,536	17%

*Source: Prosper Australia calculations. Notes:*17.8 revenue-years (69% of revenue).**12.0 revenue-years (50% of revenue).*

The equivalent impacts in Victoria are even more significant. This transition model would lead to net debt expanding by 17% of GSP within 20 years, and 25% of GSP within 50 years – a giveaway of more than $100 billion from future taxpayers primarily to current landowners.

To put these figures in context, the Thodey Review's discussion paper cited the 2016 NSW Intergenerational Report's projected fiscal gap by 2056 of 3.4% of GSP per annum as motivation for why "business as usual is not an option" on funding. As the fiscal gap grows over that 40-year interval, the cumulative debt impact could be expected to total roughly 68% of GSP.

The proposed land tax transition approach would not only fail to help close the fiscal gap, but would add further debt worth about one-third as much again.

This transition approach, which at first appears attractive on political and equitable grounds, is on closer reflection clearly infeasible as a means of achieving the stated purposes. The price paid to remove stamp duty from a self-selected minority of properties is obviously far too high.

RECOMMENDATIONS

The only principled yet realistic transition options involve limiting exemptions to the most recent buyers, and for a limited period.

These could be enacted by means such as **a partial refund of stamp duty**, which is a more targeted approach than the ACT's gradual transition, with **concessions paid for via a sunsetting temporary rate** (the Prosper model). A **time-limited** opt-out option could also be offered for a limited window with a limited exemption period (e.g. 20 years).

Prosper has covered all this and more in our 2019 transition report.

A **PATHWAY** TO REFORM

The following policy points are excerpts from Prosper's Stamp Duty to Land Tax transition design model which can be accessed here.

Immediate abolition of stamp duty to realise the efficiency benefits without delay.

Credit for recent buyers, to avoid the inequity of double taxation. This credit would be equivalent (in economic terms) to refunding the duty paid by current owners, then retrospectively applying the new LVT.

Tax deferral should be used to alleviate liquidity issues for all taxpayers. 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.

A short phase-in of land tax (e.g. over three years) would give current owners (not eligible for a stamp duty credit) time to get used to the idea as land tax is phased in at 25% increments. A tax holiday might encourage prospective buyers to bring their home purchase forward: stimulating turnover, and protecting house prices from the effects of uncertainty.

A time-limited 'opt-out' option to allow prospective buyers to be no worse off under the new scheme. (open for three years). Opt-out makes the transition voluntary for people considering a purchase in the near future. Opt-outs would be exempt from land tax for 20 years.

'Internally funded.' The revenue costs of these policies are funded via a higher land tax rate over a defined transition period, so the overall reform package is budget-neutral. The 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.

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