17th October 2008

LAND TAX: INEFFICIENT, DISTORTIVE, DISCRIMINATORY

A submission to the Federal Government's Inquiry into Australia's future tax system

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Executive Summary

- Land tax revenues harvested by the States and the ACT have risen by 132% between 2001-02 and 2008-09. Total land tax revenue collected around Australia will top $5 billion this financial year for the first time.

- Perhaps the most important social consequence of spiralling land tax charges has been its prominent role in discouraging investment in residential rental accommodation. Investors hit by ever-increasing land tax bills have sold out of residential properties and diverted the funds into other investment forms. These properties have normally been sold to owner-occupiers and therefore removed from the rental pool. The result has been a chronic shortage of rental accommodation in many capital cities and, as a consequence, rents have risen sharply.

- Its role in creating a chronic shortage of private rental accommodation is only one of a number of distortive effects that land tax has had on investment patterns around Australia. The tax can have a significant impact on cash flow and return on investment. The effect on owners of non-income-producing properties – which are exempt from land tax in the ACT but nowhere else – can be devastating.

- Land tax is a national problem and needs to be dealt with nationally. Structurally, the tax is too narrowly based and the rates are unaffordably high.

- The Victorian Land Tax Coalition (VLTC) recommends that the tax be abolished and replaced by more broadly based taxes. Alternatively, the VLTC has proposed two national land tax tables, one for residential property, the other for commercial and industrial land. The principal place of residence, non-income-producing properties and bona fide farming properties should be exempted.

1: The Inexorable Rise of Land Tax Charges

1.1 Land tax revenue has escalated sharply in all States and the ACT over the past 10 years and has now become a major source of State revenue. Between them, the six States and the ACT are now harvesting more than $5 billion a year from land tax. The increase in annual land tax revenue since 2001-02 has been 132%.

1.2 Land tax is a national problem. Further, it is a problem that has arisen only since about 2002. Until then, land tax charges were an irritation, but nothing more than that. Since then, land tax has become a significant investment disincentive and a cause of a wide range of economic distortions, all of which are dealt with later in this paper.

1.3 As Table 1 demonstrates, between 2001-02 (actuals) and 2008-09 (budget estimates), land tax revenues have escalated sharply. The States' land tax receipts increased by between 98% and 245%. In three States – Queensland, South Australia and Tasmania – annual revenue for the period increased by comfortably more than 200%.

Table 1

Land Tax Revenue

	2001-02 Actual $ million	2002-03 Actual $ million	2003-04 Actual $ million	2004-05 Actual $ million	2005-06 Actual $ million	2006-07 Actual $ million	2007-08 Estimated actual $ million	2008-09 Projection $ million	% Increase 2001-02 to 2008-09
Victoria	515	655	768	917	772	989.1	865.4	1049.8	104
Queensland	230.8	279	313	419	404	485	622	797	245
New South Wales	1,001	1,136	1,355	1,646	1,717	2,036	1,968	1,983	98
South Australia	141	159.2	199.8	274.5	251.7	332.2	369.6	476.5	238
Western Australia	226.5	260	280	315	313	394	426	563	149
Tasmania	26.4	25.5	27.4	43.5	49.2	61.2	73.7	83.9	218
Australian Capital Territory	31	38	47	53	56	67	73	83	168
	2171.7	2552.7	2990.2	3668	3562.9	4364.5	4397.7	5036.2	132
% increase in land tax revenue (year-on-year)		17.5	17.1	22.7	(2.9)	22.5	0.8	14.5	

1.4 As Table 2 shows, the Victorian Government's land tax revenue has quadrupled over the past decade from $264 million in 1997-98 to an expected $1050 million in 2008-09. Land tax revenue has doubled in the past seven financial years from $515 million in 2001-02 to the current year estimate of $1050 million.

Table 2: Victorian Land Tax Revenue

1997-98	$264m
1998-99	$369m
1999-00	$411m
2000-01	$525m
2001-02	$515m
2002-03	$655m
2003-04	$768m
2004-05	$917m
2005-06	$772m
2006-07	$989m
2007-08	$865m
2008-09	$1050m*
*Victorian 2008 budget estimate	

1.5 There are now clear signs that the State Governments are treating land tax as a cash cow. As an example, during its budget update on December 12, 2007, the Victorian Government released an estimate showing that land tax revenue was expected to rise from the 2007-08 total of $871 million to $1167.4 million in 2008-09. This would have been an increase of 34%.

In its May 2008 budget, the Victorian Government announced a number of so-called reductions in land tax and adjusted its estimate of 2008-09 revenue to $1049.8 million, representing a year-on-year increase of 20.5%.

In other words, the Victorian Government – faced with a prospective windfall – did not reduce land tax revenue at all: it merely reduced the expected rate of increase from 34% to 20.5%.

2: Causes and Consequences

2.1 The rapid escalation in land tax charges and revenue has been caused by the interaction of three factors:

- A sharp and continuing escalation in land values
- Progressive land tax rate scales
- The impact of aggregation.

2.2 For the benefit of the Inquiry, aggregation is a practice pursued by all State Governments except NSW. It involves adding together the land holdings of each land owner and taxing them as a single amount. Where a progressive rate scale applies, this obviously means that the average rate of land tax on a portfolio of land can be much higher than if each property were taxed separately.

It should be noted that in NSW, a flat rate of land tax applies (now 1.6%). Where there is a flat tax, aggregation obviously has no impact. In Queensland, once taxable land value exceeds a certain level, a flat rate applies on the whole value.

2.3 The interaction of the three factors identified has had in many instances a devastating impact on land owners. Using Victoria as an example, the best estimate the VLTC can find suggests that land values across the State have risen by about 130% since the Bracks/Brumby Government came to power. In 1999-2000 – the last budget year of the Kennett Government – land tax revenue was $411 million. Budgeted land tax revenue for 2008-09 is $1049.8 million. This means land tax revenue has risen by more than 155% in Victoria during the Bracks/Brumby Government's term of office against an increase in land values of only 130%. If one assumes that the stock of land is constant, it is quite clear that land tax charges have easily outpaced the rise in land values.

2.4 The Inquiry will be interested to note that, between June 2000 and June 2008, the Consumer Price Index increased by only about 30%. This compares to an increase in Victoria's land tax revenue of 111% during the same period ($411 million in 1999-2000 and $865.4 million in 2007-08). Similar trends have appeared in other States.

2.5 Spiralling land tax charges have had a number of serious consequences including:

- It has eroded return on investment for property holders.
- It has distorted investment patterns in several ways.
- It has been a major causal factor in the current shortage of private rental accommodation.
- It has had a serious impact on cash flow in many sectors – particularly for owners of non-income-producing properties and proprietors of small businesses.

2.6 It is perhaps useful to compare and contrast the impact of stamp duty with the effect of land tax on investment returns. Both stamp duty and land tax are disincentives to investment and the VLTC is aware of many cases where institutional investors with large property portfolios have diverted investible funds from Victoria because of the hostile stamp duty and land tax rates. It is important to differentiate between the two taxes. Stamp duty is a one-off charge and can be amortised over the period for which a property is held. Clearly, it affects return on investment but the effect diminishes the longer the property is owned.

In contrast, land tax is an annual charge and if history is repeated, the trend is for the annual cost to rise.

It should also be noted that, for large property owners such as listed property trusts and superannuation funds, the top rate of land tax effectively becomes their average rate across a property portfolio. (As previously mentioned the exceptions are NSW where a flat rate is used and in Queensland where a flat rate applies above a certain level.) This is because of the impact of aggregation, where properties owned in a single name are combined and taxed accordingly. This magnifies the impact of progressive land tax rate scales.

2.7 The impact of land tax on ROI in the residential sector has been particularly severe. Over many years, investors in residential property have come to expect a gross yield of about 5%. In Victoria in recent years, for a number of reasons the gross yield has slipped to about 3% and the net yield, partially due to land tax, has fallen to less than 2%. Rapidly increasing annual charges like land tax are most unwelcome in this sort of environment. And it has been a major reason for many residential investors moving their money into other property and/or asset classes or into property in other states with more favourable land tax rates.

The inevitable consequence of this has been a shortage of rental accommodation. Spiralling rents have been the knock-on effect of this trend and the worst casualties are low-income families who cannot afford home ownership.

It is worth remembering that, for people and organisations who own investment properties, rents have not risen by anything like the same amount as land tax over the past decade and it is the rental income on investment properties from which land tax payments must be funded.

2.8 The shortage of private rental accommodation had its origins in the period 2005-2007. During that time, many residential property investors – disaffected by rapid increases in land tax – decided to sell properties. Many of these properties were blocks of flats which traditionally had been held as long-term investments. Typically, blocks of flats were strata-titled and sold off to owner-occupiers which effectively removed them from the rental pool. This information was made freely available during interviews that the VLTC had with Melbourne real estate agents who collectively accounted for a material share of Melbourne's property market.

2.9 There is clear evidence that rising land tax charges have created a number of distortions in investment patterns around Australia. These are fully explored later in the paper.

2.10 The unpredictable and sharp increases in land tax charges have had a significant impact on cash flow, particularly for owners of non-income-producing properties and for small and medium-sized businesses.

In the case of non-income-producing properties, by definition, they generate little or no cash flow. The inevitable result is that owners are forced to find the tax payments out of other income streams (this is not always possible with retirees) or are forced to sell their asset (hardly the hallmark of a good tax).

Many small businesses have been forced to close because of excessive land tax bills. Smaller businesses typically operate on slim profit margins and simply cannot accommodate spiralling annual charges like land tax. In Victoria, many businesses that have closed largely or entirely because of excessive land tax bills have received media publicity over the past few years, but there are a substantial number of businesses in the same situation who have received no publicity. In an exercise about 18 months ago, the VLTC identified 14 businesses which had closed either largely or entirely due to excessive land tax charges. None of the proprietors were prepared to be quoted publicly for fear of reprisals.

2.11 Land tax causes considerable inequity between asset classes. There are no holding charges associated with fixed interest and equity investments. In contrast, property investors are taxed when they buy (stamp duty) and are taxed every year they hold the property (land tax). If they are fortunate enough to make a profit when they sell, they are then subject to capital gains tax.

2.12 Land tax also creates difficulties between different classes of property. At least with commercial and industrial property there is rental income from which land tax payments can be funded. In the residential sector, investment properties certainly generate rental income but the yields are typically much lower than for commercial and industrial property and residential investors therefore have great difficulty accommodating the significant impact of land tax.

It is worth noting that the ACT has a separate land tax scale for residential land, with lower rates. Most important, non-income-producing residential land is exempt from land tax.

3: Land Tax Inefficiency -- Theory v Practice

3.1 The VLTC is aware that many economists regard land tax as an attractive and efficient tax form. To test this contention, the VLTC commissioned economic consultancy ACIL Tasman to evaluate the Victorian land tax system against the four widely accepted criteria for good tax design:

- Economic efficiency
- Equity
- Simplicity
- Transparency

The study was part of a previous VLTC submission to the Victorian Government seeking wholesale restructuring of Victoria's land tax system.

ACIL Tasman concluded that the Victorian land tax system, as presently constituted, failed on all four criteria.

The same conclusions can be applied to land tax in all other States.

3.2 Three important reasons that land tax is not a desirable tax form are:

- There are too many exemption categories.
- The rates are too high.
- The tax is too narrowly based.

At the time, the VLTC argued that the exemptions should be removed with two exceptions (bona fide farms and the first $540,000 of the principal place of residence). The Victorian Government rejected this proposal for political reasons.

Significantly, if the Government had adopted these recommendations, ACIL Tasman calculated that the revenue-neutral land tax rate at the time would have been 0.25%.

3.3 Land tax as a form of taxation differs significantly from most other types of taxation. It taxes a static asset. Most other major forms of taxation in Australia, such as income tax and capital gains tax are transaction-based. The benefit of a transaction-based tax from a taxpayer's perspective is that cash flow is generated by the transaction from which the tax payments can be funded.

It could be said that stamp duty on property transactions also taxes a static asset. But stamp duty is a one-off charge, it is triggered by a transaction and, in many property transactions, the amount of stamp duty is built into the borrowings that fund the purchase.

4: The Distortive Effects of Land Tax

4.1 Land tax, in its present form, creates a range of distortions in investment markets. The most evident of these is that sharply rising land tax charges have induced residential property investors to divert capital from residential rental accommodation comprising both the sell-down of existing stock and the reluctance to build new stock for that purpose. This was most evident between 2005 and 2007. This distortion has led to a shortage of private rental accommodation which is now being felt in Melbourne, Sydney and Brisbane in particular. A consequence of this distortion has been that rents have escalated in cities that have low vacancy rates.

4.2 The continuing rise in land tax charges has also continued to erode return on investment to the point where many large institutional investors have been underweight in Victorian property for several years. These institutions – such as listed property trusts and large superannuation funds – have taken a dim view of hostile stamp duty and land tax regimes and have chosen to divert funds that had been earmarked for property investment into States such as NSW which have lower land tax rates.

4.3 The problems associated with land tax have not been confined to property investment. Any industrial ventures that are property-intensive have also been affected. One high-profile example of this was a leading provider of storage facilities which chose to stop investing in Victoria because of land tax rates and instead diverted its investible funds elsewhere.

4.4 Land tax and stamp duty have combined to create a major disincentive to property investment. Of the three major asset classes – equities, property and fixed interest – property is the only asset class that attracts such substantial transaction and holding charges. This represents a clear distortion in the market and should be remedied.

5: Land Tax and the GST Agreement

5.1 Land tax is not covered by the GST agreement between the Federal Government and the States. This is understandable. When the GST agreement was first negotiated, land tax was not the significant problem it is today. When GST was introduced, land tax represented nuisance value only. It was certainly not the major cost impediment that it now represents.

5.2 If the GST agreement were negotiated today, there is no doubt that land tax would be at the top of the list of State taxes and charges to be abolished.

The VLTC understands that the State Governments previously all approached the Federal Government privately to seek approval by the Federal Government to have land tax substituted for other duties that were slated for abolition. Unfortunately, the Federal Government refused.

This was a lost opportunity. The current Inquiry has an opportunity to remedy this disappointing outcome.

6: Conclusion -- An Unsatisfactory Tax Form

6.1 Former NSW Auditor-General Mr Tony Harris once said: "*One criterion for a good tax is that it does not stop people from doing what they want to do.*"

Unfortunately, Australia's land tax system falls well short of meeting this criterion. As they are presently structured, Australia's land tax systems are inefficient, aggressively discriminatory and distortive.

6.2 The present Federal Tax Inquiry is a welcome opportunity to review this unsatisfactory situation and develop a more rational tax system that does not stop people doing what they want to do. As long as land tax is so aggressive that it forces people to sell their assets, it will be seen as an escalating national problem.

7: Recommendations

7.1 The VLTC believes the best way to deal with land tax is to abolish it and replace it with more broadly-based, fairer forms of taxation.

7.2 If the Inquiry does not believe a suitable revenue replacement is available to it, we recommend a radical restructuring of land tax which should contain the following features:

- It should be a single national system.
- The structure should comprise two progressive tax tables, one for commercial and industrial land, the other for residential land.
- Both tables should have a top rate of 1% which would cut in at $5 million land value for commercial and industrial property and at $10 million for residential property.
- There should be no aggregation. All properties should be assessed separately.
- The present system of biennial valuations in Victoria should be adopted nationally.
- Exemption categories should be kept to a minimum. Bona fide working farmland, non-income-producing properties and the principal place of residence should be exempted and there could be a tax-free threshold for taxable residential property. This threshold could be indexed annually to movements in land prices. (This is similar to the system that has applied in NSW.)
- Bracket thresholds in the two tax tables should be indexed to movements in land values every two years, subsequent to the biennial valuations.

The VLTC has provided two suggested rate tables in appendix 1.

Appendix 1

Residential	
Land Value	**Land Tax Rates**
Not more than $349,999	Nil
$350,000 to $599,999	$500 plus 0.25% of the value in excess of $350,000
$600,000 to $9,999,999	$1,125 plus 0.5% of the value in excess of $600,000
$10 million and over	$48,125 plus 1% of the value in excess of $10 million

Commercial and Industrial	
Land Value	**Land Tax Rates**
0-$599,999	0.25% of the value
$600,000 to $1,999,999	$1500 plus 0.5% of the value in excess of $600,000
$2,000,000 to $4,999,999	$8,500 plus 0.75% of the value in excess of $2 million
$5 million and over	$31,000 plus 1% of the value in excess of $5 million