Federal Pre-Budget Submission 2018-19

Prosper Australia | (03) 9328 4792 |Level 1, 64 Harcourt St. North Melbourne VIC 3051|
office@prosper.org.au

Contents

About Prosper:

Prosper Australia is an independent, not-for-profit organisation campaigning for economic justice. Our reform agenda derives from the work of nineteenth century philosopher, Henry George. Prosper's mission is to influence revenue policy by educating policymakers and the public in the economics of locational advantage.

Preamble

Australia has sustained over 25 years of uninterrupted economic growth, but our economy faces great challenges. Wages growth is flat. Labour underutilisation is an emerging problem with rising underemployment and fewer secure, full-time jobs created. Private non-mining investment is lethargic. Households are servicing record levels of debt with precarious balance sheets, relying on unsustainable, debt-financed consumption. Land prices are out of control, resulting in deteriorating housing affordability. Infrastructure is under enormous strain from sustained mass immigration. The Federal Government's reform agenda has stalled, and now more than ever, bold budget policy is needed to help rebalance the economy.

Prosper Australia invites the Federal Government to consider five key policy priorities to ensure Australia's economy can remain strong into the future.

1. Stamp Duty to Land Tax
2. Land Value Capture
3. Capital Gains Tax Discount and Negative Gearing for real estate and land
4. Company Tax shift to a more comprehensive Resource Rents Tax Regime
5. Adequate resourcing of the ABS and open public data

These measures aim to shift the tax burden off the productive sectors of Australia's economy and onto unproductive monopoly rents. These reforms will support employers, help sustain our economic diversity and vibrancy, and enhance financial stability. The result is a more equitable and sustainable distribution of wealth and incomes.

Key Priorities

1. Facilitate the shift from Stamp Duty to Land Tax

Adopt the Productivity Commission's recommendation[1] *of facilitating state transition from Stamp Duties to a broad based Land Value Tax.*

The Federal Government should establish a grants fund (of similar nature to the defunct Asset Recycling fund) to provide financial support and incentives to State Governments' transitioning from stamp duties to broad-based land value tax. This builds upon the Government's City Deals policy framework.

The Federal Government has the capacity to facilitate the immediate abolition of land transfer duties (stamp duties) and associated deadweight losses they impose on the Australian economy. With sufficient bridging finance and grant incentives, State Governments could immediately abolish stamp duties and impose a Stamp Duty Replacement Tax (SDRT) on all future purchases of property.

Features of an effective Stamp Duty Replacement Tax:

- A flat levy on the value of unimproved land per square metre
- Rate of SDRT should be at least sufficient to replace stamp duties revenues over the long run.
- SDRT rate should also be phased in for existing landowners over a transition period e.g. up to 20 years as done in the ACT.
- Existing landowners would still receive a transitory grandfathering arrangement to facilitate restructuring.
- Properties that did not transact within the transition period eventually end up on the SDRT rate, as to ensure landowners are not deterred from transferring property due to tax exemptions.
- Further incentives should be offered to State Governments intending to abolish or reduce other distortionary taxes as well e.g. insurance duties, payroll tax etc.
- Investigate use of tax escrow methods such as incorporation into mortgage repayments, or added into council rates notices (e.g. Fire Services Levy), to reduce salience.[2]

The grants fund should supply grants for states that undertake such an initiative. Federal bridging finance is necessary to staunch temporary shortfalls of state government revenue. Increases in federal net debt would be minimised under this scheme, as the loans to the states would constitute an asset to match the corresponding issuance of Australian Government Securities. In turn, state governments could securitise part of future SDRT payments and sell these to the federal government (or even private investors), if they wanted to keep federal transition loans off balance sheet.

The economic benefits of such a tax shift are estimated by the Productivity Commission to be approximately $8.5 billion per annum in the long run. This is similar to the estimated benefit of the Government's proposed company tax cut.

---

[1] Productivity Commission 2017, *Realising the Productive Potential of Land*, Shifting the Dial: 5 year Productivity Review, Supporting Paper No. 10, Canberra https://www.pc.gov.au/inquiries/completed/productivity-review/report/productivity-review-supporting10.pdf

[2] Cabral, M., & Hoxby, C. (2012). The hated property tax: salience, tax rates, and tax revolts (No. w18514). *National Bureau of Economic Research*. http://www.nber.org/papers/w18514

The Federal Government should utilise the Council of Australian Governments and the GST distribution to ensure states are heavily penalised for levying inefficient taxes compared to efficient taxes, to ensure states are not incentivised to reintroduce stamp duties once stamp duties have been abolished in favour of land taxes.

2. Land Value Capture

The Federal Government should expand its use of land value capture (LVC) for infrastructure financing.

The Federal Government can incentivise sub-national governments to adopt LVC, within a City Deals policy framework. This accords with the desire to use City Deals to leverage government investment toward broader economic reform[3]. A suite of appropriate mechanisms have been outlined in Infrastructure Victoria's Value Capture Report.[4]

Land Value Capture (LVC) taps increases in locational value resulting from public investment and service provision. It is well established that sites proximate to public investment (especially fixed-line transport such as heavy and light rail) experience an uplift in locational value due to increased accessibility and amenity. The largest uplifts occur when infrastructure delivery is integrated with planning changes that enable intensification and diversification of land-use[5]. Increases in value may also occur on distant sites that benefit from increased accessibility and/or productivity as a result of public investment. Taxing locational uplift accords with the 'beneficiary pays principle' and is an equitable and economically efficient approach to financing public infrastructure.

- LVC can occur passively through an expansion of existing land taxes. This opportunity strengthens the case for a state level transition to broad-based land value taxes via a Stamp Duty Replacement Tax, for example.
- New development opportunities and asset leases are also worth considering. Leases are a more sustainable option than asset sales in the long term, in absence of broader land tax reform. Through government leases, the public continues to capture the reoccurring (and growing) annual land rents.
- Once-off asset sales should be avoided. Once sold, the ongoing land rent revenue is lost to private owners (in absence of a broad based land value tax). This is worth noting in the context of housing affordability issues. Housing (or any commercial/industrial land use) could be developed on government land through value capture lease initiatives. Leases would provide sustainable efficient government revenue, without the need to directly impose land taxes on owners to capture value.
- Direct LVC may be used where benefits can be isolated to specific areas, however in general these are inferior to broad based market mechanisms.
- Betterment taxes should be encouraged to capture windfall gains due to rezoning and other land-use changes that result in uplift. The ACT's "Lease Variation Charge" (previously known as a "Change of Use Charge") offers a compelling model.

---

[3] Australian Government Department of Prime Minister and Cabinet (2017) *Delivering City Deals* https://cities.dpmc.gov.au/19047/documents/64949

[4] Infrastructure Victoria (2016) *Value Capture: Options, Challenges and Opportunities for Victoria*. http://www.infrastructurevictoria.com.au/sites/default/files/images/IV18%20Value%20Capture%20Options_Final%20web_v2.pdf

[5] LUTI Consulting (2016) Transit And Urban Renewal Value Creation Report http://www.luticonsulting.com.au/wp-content/uploads/2013/12/Sydney-Transit-and-Urban-Renewal-Value-Creation-Report.pdf

The Federal Government should ensure that Value Capture mechanisms are incorporated into its infrastructure projects, and incentivise states to adopt such mechanisms through City Deals and a grants fund.

3. Capital Gains Tax Discount and Negative Gearing for real estate and land

The Federal Government should curtail tax expenditures for real estate.

The Capital Gains Tax (CGT) discount and negative gearing tax expenditures have a distortionary impact in Australia's economy.

- The CGT discount incentivises land speculation by encouraging speculative investment in dwelling stock for capital gain (left vacant), rather than producing rental income from rental stock demanded by tenants (occupied).
- Negative gearing for real estate incentivises debt leveraged land speculation.
- Negative gearing encourages landholders to gamble on future capital gains, and to marginalise rental yields and income in their investments decisions.
- Negative gearing enables investors to bid up the price of land.
- Negative gearing is only useful for housing policy insofar as it facilitates new construction, thus increasing the supply of rental stock. Negative gearing for established real estate does not contribute to the dwelling stock.

These tax incentives are facilitating unsustainable increases in land price inflation and subsequently household debt. As shown in figure 1 below, land price inflation has accelerated dramatically since the introduction of GGT discounting in 1999

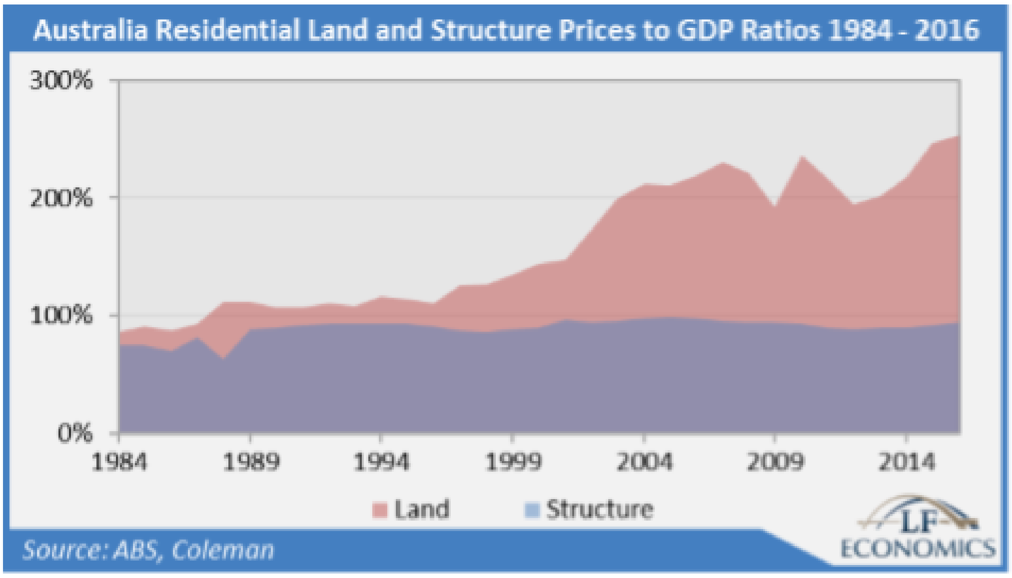

Figure 1

The rapid acceleration in land prices in recent years has been due to speculative investor demand. Investor demand relies upon future capital gains to justify investment decisions.

As shown in figures 2, 3, and 4 below. Rental price inflation is low, indicating that dwelling supply shortages in general are not the issue. These charts indicate changes in rental price growth across Sydney, Melbourne, and Brisbane between 1973 and 2017.

Speculative vacancy data indicates that a significant portion of the dwelling stock is not being purchased for the purpose of rental income or demanded rental stock, but rather speculative capital gains.[6] These factors have contributed to a very large disconnect between prices and rents, which is apparent in deteriorating rental yields. Further, there is a potential dwelling oversupply and a structural mismatch of dwelling stock between units desired by tenants and units demanded by investors.

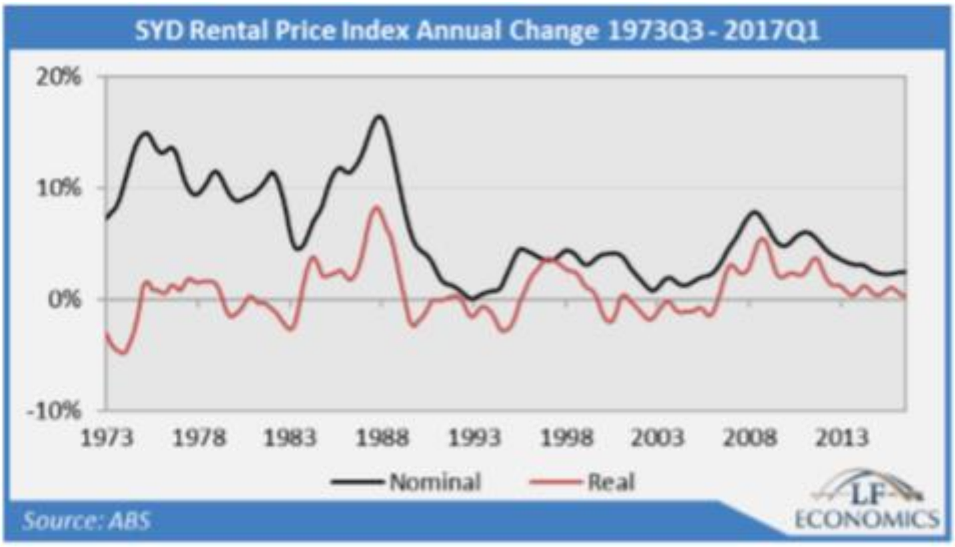

Figure 2

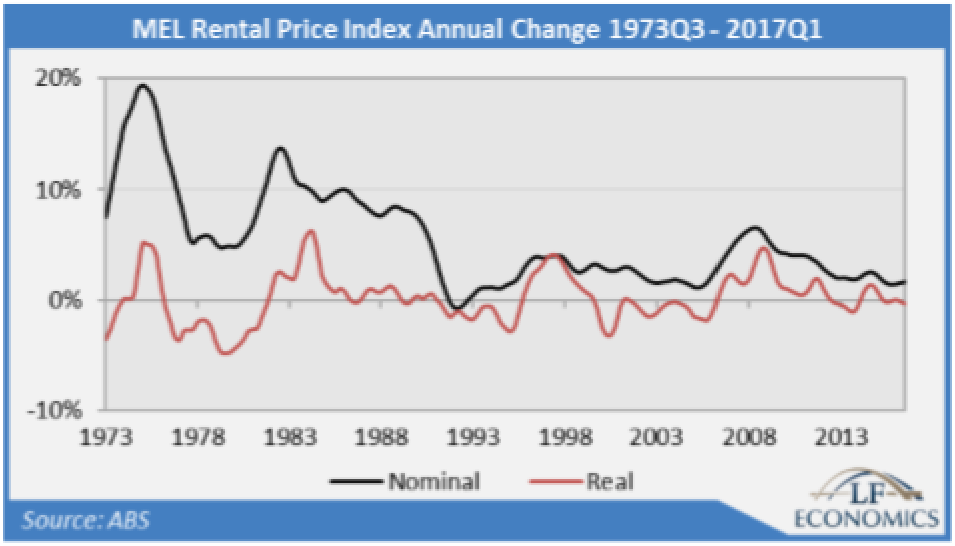

Figure 3

[6] Prosper Australia (2015) *Speculative Vacancies 8* https://www.prosper.org.au/wp-content/uploads/2015/12/11Final_Speculative-Vacancies-2015-1.pdf

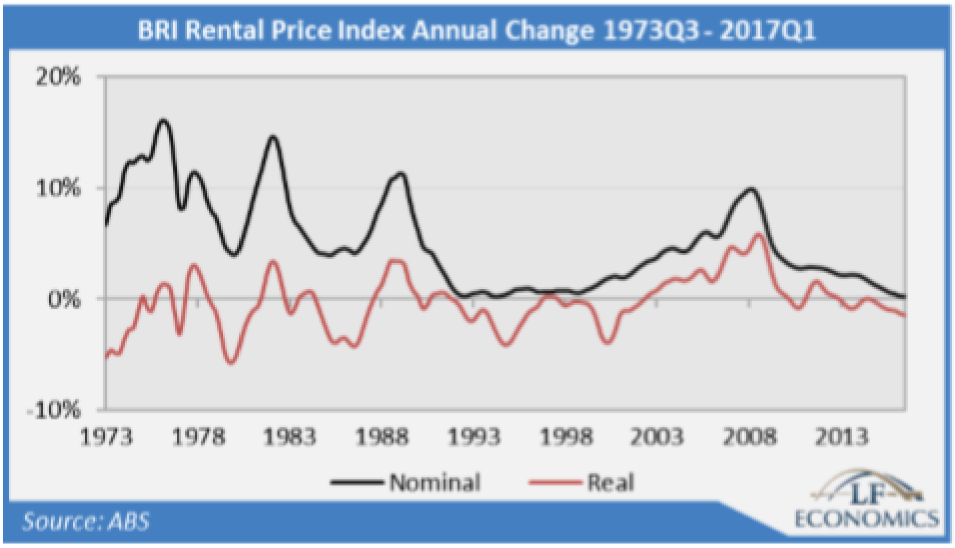

Figure 4

Strong land price inflation has the insidious effect of institutionalising land as a commodity and an investment vehicle. Commodification and financialisation of land and housing obscure the primacy of shelter as a human right. Affordable land and housing is necessary to ensure equality of opportunity and social participation.

Treating land as an investment vehicle is detrimental. Boosting land prices does not increase the productive capacity of the economy; it merely constitutes an inequitable transfer of wealth from landless to landowners. In the process, would-be owner-occupiers put upward pressure on rents.

Already the Reserve Bank of Australia is under pressure to raise interest rates due to the systemic risks posed by land price inflation and very high household debt. At this stage in the economic cycle, a rate increase would put unnecessary strain on the rest of the economy, which is suffering from lethargic non-mining investment and low wages. Monetary policy cannot do what fiscal policy must.

The best tool available to the Federal Government to decelerate land price inflation is the tax treatment of land.

The Federal Government should restore the previous regime of taxing inflation-adjusted capital gains at full marginal tax rates for real estate. Abolishing the CGT discount is a fair and economically efficient reform. Land price growth is *not* the consequence of an individual investor's actions, but rather reflects an increase in available economic rent due exogenous factors.

Restoring the full marginal rate of CGT would:

- Deter debt-leveraged speculation in land prices.
- Ensure that housing capital is not grossly misallocated in unproductive dwelling investments for the purpose of land price speculation, but rather allocated to producing rental income from tenants.
- Direct capital investment away from land price speculation toward productive enterprises that grow the capital base, increasing output and wages.

Further, we urge the Government to adopt the 2014 Financial System Inquiry recommendation and reinstate the ban on Self-Managed Super Fund (SMSF) borrowing[7]. SMSF borrowing has mostly gone into property which is no surprise given the very generous CGT discounts available for SMSFs. It is clear that CGT tax concessions are fuelling land speculation and exposing Australia's retirement system to unnecessary risks, with little to no demonstrated benefit. These expenditures would be more effectively redirected to the aged pension, low-income super contributions or even general income tax cuts.

4. Company Tax shift to a more comprehensive Resource Rents Tax Regime

Fund a shift in company tax with a stronger and more comprehensive Resource Rents Taxation Regime.

Cutting the rate of company tax is inherently sensible tax policy. However, there are a number of issues with the Government's current proposal to cut company tax.

It is unclear how the Government intends to fund the cut to company tax. The cut could be funded by increasing net spending, however the Government has repeatedly stressed a desire to *reduce* net spending. Spending cuts are unlikely given the extensive reductions in Federal spending imposed by previous Governments. This leads us to speculate that proposed company tax cuts will be funded ultimately out of increased income tax, perhaps through income tax bracket creep. The economic gains from shifting company tax to income tax are estimated to be mediocre compared to the available alternatives (such as shifting stamp duties to land tax).

Increasing the tax burden on labour is economically and socially unwarranted.

Under current arrangements, the largest company tax receipts come from businesses that profit by capturing economic rents. That is to say, a significant proportion of their company profits are derived from economic rents, rather than returns to productive capital investment[8]. Companies within the resource extraction sector, such as miners, are particularly representative of businesses whose profits are largely economic rent. Their activities are capital intensive, they predominantly foreign owned and their production is export orientated.

Shifting the current company tax burden off economic rents and onto wage earners amounts to giving away Australia's resource rents.

Company tax cuts should be offset by shifting to a much more stringent and comprehensive Resource Rent Taxation Regime. This should be based on international best practice, as in Norway's scheme.

- A reformed and comprehensive Resource Rent Tax (RRT) should be applied to all resource extraction industries (including mining).
- Deductions for state royalties paid would encourage states to make the most out of this tax base, reduce vertical fiscal imbalance and avoid double taxation.
- Reform the Petroleum Resource Rent Tax (PRRT) as recommended by Prosper's submission to the Review of the PRRT.
- Follow Norway in utilising State Direct Financial Interests as part of its Resource Rent collection and enforcement strategy.

[7] Murray, D. *et al* (2014) *Financial System Inquiry Final Report* http://fsi.gov.au/publications/final-report/

[8] Dixon, J (2016) "Big business doesn't want to talk about it, but SMEs lose from a company tax cut" *The Conversation* https://theconversation.com/big-business-doesnt-want-to-talk-about-it-but-smes-lose-from-a-company-tax-cut-57965

- Investigate setting up a publicly owned enterprise for participating in resource extraction activities. The revenues from capturing a larger share of Australia's resource rents provide far better efficiency gains compared to shifting company taxes to income taxes, given the negligible deadweight loss associated with RRTs. Additionally, there would likely be better equity outcomes and greater public support for such an initiative.
- Economic benefits of a cut to company taxes will not primarily flow to wages as is often presumed. As the Grattan Institute noted earlier this year[9], under a sustained policy of high immigration, it is likely increases in wages will be competed away in higher land rents and thus land prices. In effect, cutting the company tax rate will exacerbate land and housing affordability issues, and increase inequality between landowners (via imputed rents) and wage earners.

After accounting for an increase in income taxes, or a reduction in services, cuts to company taxes *as currently proposed* will likely leave wage earners worse off. Recipients of economic rent (resource extractors and landowners) will likely be better off. This outcome is in direct conflict with the Government's objectives of innovation, jobs and growth, and instead rewards those who derive passive income from extracting (non-renewable) natural assets.

5. Adequate resourcing of the ABS and open public data

Easy and open access to accurate and precise information is fundamental to a functioning market economy. Prosper Australia supports a well-funded and resourced Australian Bureau of Statistics (ABS).

Over the course of the last decade, governments have repeatedly cut funding to the ABS. These cuts are having a significant impact on the delivery, integrity, and breadth of the ABS data. Business, policy makers and research organisations such as Prosper Australia are inherently reliant on high quality, trustworthy, and open public data. Without it, we cannot make accurate assessments and decisions.

Private and public sectors alike rely on accessible, high quality information to make strategic decisions. Data availability gives our economy a competitive edge and ensures it can run efficiently. There is nothing "efficient" about undermining the capabilities of the ABS through continuous "efficiency dividends". These are myopic cuts to a core government function, and if not reversed will pose a significant risk to our economy.

Prosper Australia is disturbed by proposed changes to ABS reporting on housing finance, international trade data, and vehicle sales. We do not support a reduction in the Bureau's human resources.

Conclusion

Prosper Australia thanks the Federal Government for an opportunity to be a part of the budget consultation process. We hope the Government will undertake bold policy reforms to drive Australia's prosperity in the 21st century.

[9] Grattan Institute (2017) *Myth busting claims on the impact of the company tax cut* https://grattan.edu.au/news/myth-busting-claims-on-the-impact-of-the-company-tax-cut/