

WESTERN AUSTRALIAN DECEMBER 2009 SUBMISSION

LAND TAX

Key Points

- Western Australia does not support either of the two approaches proposed by the Commission.
 - They give materially different results for a number of States.
 - There are questions around the reliability of the data underpinning both approaches.
 - We do not believe that land values provide the best indication of the land tax base.
- Land tax is very unpopular, and as a consequence, State governments are very conscious of capacity to pay and regularly adjust effective tax rates to offset increases in property values. This is 'what States do'.
 - This is seen in evidence that States with higher land values tend to have lower land tax rates, and in land tax growth being 'capped' at well below growth in land values.
- Land values do not necessarily provide a good indicator of capacity to pay, as they are heavily influenced by short term and speculative factors rather than just the income generation capacity of the land.
- The relationship between land tax and economic activity is strong and stable, indicating that an economic activity indicator would provide a reasonable guide to the land tax base.
 - This would have the added virtues of being simple and transparent, avoiding the reliability and comparability concerns associated with the other approaches, and abstracting from policy influences on land values.
 - We propose using Household Income as the land tax capacity indicator, with adjustments for special circumstances such as the size of the government sector in the ACT.
 - An alternative indicator could be Gross State Product, adjusted to exclude the gross operating surplus of industries where there are substantial impacts from cross-border income flows (e.g. mining).
- If the Commission persists with a land value approach, Western Australia supports whichever approach yields less extreme variations in revenue raising capacity across States, as we believe capacity to pay differences are less extreme than land value differences.
 - This would also seem to be a case where discounting the assessments is likely to improve equalisation.

ASSESSMENTS BASED ON STATE REVENUE OFFICE (SRO) DATA OR VALUER GENERAL (VG) DATA

The Commission staff paper on Data Options for the Land Tax Assessment, circulated on 22 December 2009, states that “The two data sources do not agree well with each other.”

This would appear to be confirmed by our calculations of estimated needs and value distribution adjustment factors based on these two approaches for 2007-08, using data provided in the staff paper (see Tables 1 and 2).

We conclude that the question of data reliability is very important in determining the merits of the two approaches.

Table 1: Needs ^(a) based on SRO and VG data, 2007-08, \$million

	SRO Data	VG Data
NSW	-67	-335
Vic	138	344
Qld	-157	-38
WA	-228	-305
SA	204	223
Tas	81	95
ACT	30	16

Source: WA DTF estimates based on data in the Grants Commission staff paper.

(a) Excluding the Northern Territory from the calculations.

Table 2: Value distribution factors ^(a) based on SRO and VG data, 2007-08

	SRO Data	VG Data
NSW	1.025	1.138
Vic	0.824	0.714
Qld	1.407	1.095
WA	1.005	1.181
SA	0.577	0.585
Tas	0.505	0.329
ACT	0.803	1.075

Source: WA DTF estimates based on data in the Grants Commission staff paper.

(a) Excluding the Northern Territory from the calculations.

A higher factor indicates a greater proportion of higher value properties.

Using the VG data has well-known problems:

- non-principal residential land values are not known and must be estimated (including by value range, under the staff paper proposal); and
- SRO tax data by value range are applied to VG land values in each value range, despite the inconsistent apportionment of land by value range in the VG and SRO data (e.g. due to the 'aggregation' issue).

These problems are in principle overcome by using the SRO data. However, there has been much difficulty in obtaining SRO data that is comparable across States. This approach is reliant on extensive 'back room' effort in each State and by the Grants Commission, as a consequence of which the transparency of the approach is low. The degree of comparability achieved remains unclear.

- The staff paper indicates that "it appears that some problems still exist", mainly in below threshold land value holdings.
- In Western Australia's case, revenue data by land value range is based on lagged property values (reflecting our legislation).¹ We were not able to match revenue data to more recent property values. We understand that some other States have been able to do what we have not been able to do. There is no way for outside observers like us to comment on the reliability of this work.
- Table 2 in the staff paper indicates a potential problem with the Queensland SRO data, as the data implies an effective tax rate in the \$3 million plus range that is well below Queensland's legislated rates.

As there are data issues around both approaches, and the two approaches yield significantly different outcomes, we suggest that a different approach should be considered, that is simpler and more transparent.

As discussed below, the conceptual problems around using land value as a tax base measure also suggest that a different approach is needed.

LAND TAX BASE

The debate on land tax has generally assumed that land values give the best indication of the States' capacity to generate revenue.

- Accordingly, most of the discussion on land tax has focussed on the various sources and reliability of State land value data as applied for land tax purposes.

We contest the view that land values provide the best indication of the land tax base.

¹ For example, 2008-09 revenue collections are based on August 2007 property values.

- Using the data in Table 1 of the staff paper, Western Australia's land tax base (not adjusting for progressivity impacts) has risen by 91% over the two year period 2006-07 to 2008-09, compared with 28% nationally. Western Australia's 2008-09 land tax base exceeds Queensland's land tax base by 13%, despite the fact that Queensland has nearly twice the population and is also a high growth State.
- While Western Australia has performed well, we do not accept that this is a true reflection of our capacity to pay land tax relative to other States (our land tax collections actually grew 44% over this period).

Land tax is a deeply unpopular tax.

- Land tax is highly visible, with around 104,000 taxpayers in Western Australia directly receiving a lump-sum assessment on an annual basis.
- In Western Australia's experience, land tax typically generates more taxpayer discontent than any other State tax (as measured by the volume of Ministerial correspondence).
 - The level of discontent relative to revenue raised vastly exceeds any other State tax.
 - Since it is a (narrowly-based) wealth tax, there is no direct connection between land tax and a specific economic transaction. This contrasts with conveyance duty, where it could be argued that taxpayers implicitly consent to paying tax when choosing to proceed with the purchase of a new home.

Reflecting taxpayer discontent with land tax, State governments across Australia frequently adjust tax rates and/or thresholds to offset (at least in part) growth in land values to better reflect capacity to pay.

Political economy and capacity to pay considerations dictate that the downward adjustment of effective land tax rates is an almost inevitable outcome in strongly rising property markets. In short, this is 'what States do.'

Land values do not provide a good indicator of capacity to pay, as they are heavily influenced by short term and speculative factors. The market at any one time may be a poor indicator of the underlying value of real estate in terms of its future income generating capacity.

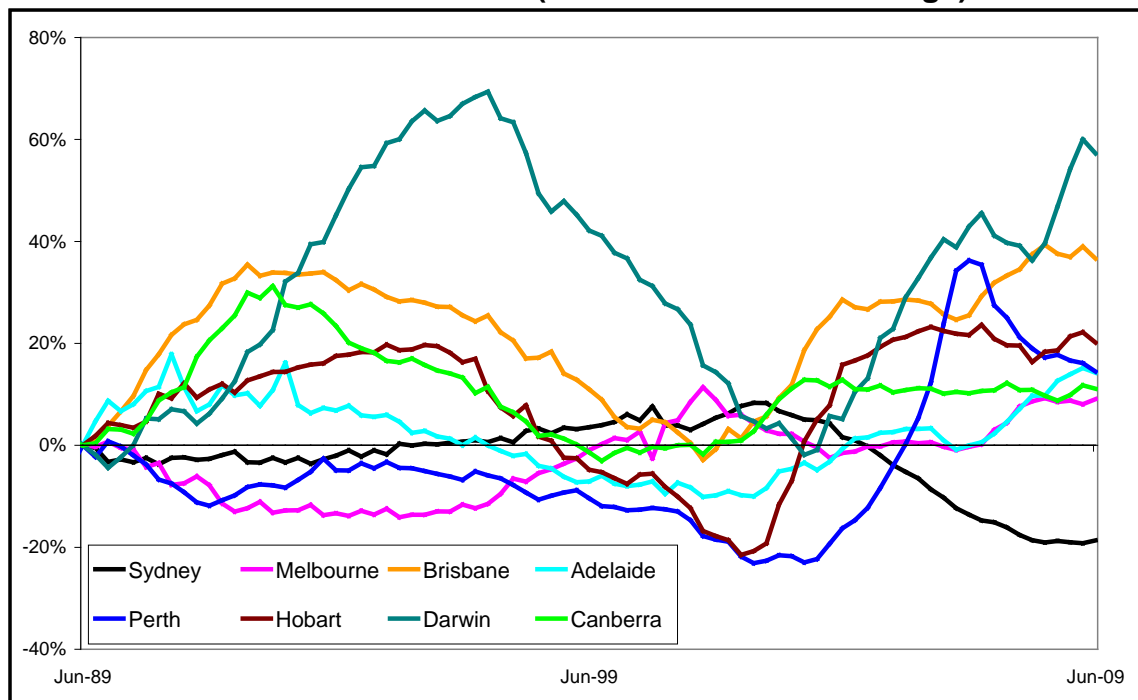
- Commentators have noted significant over-valuation in the Australian market.

- Akerlof and Shiller² provide some observations on the United States experience of market pricing (albeit in relation to homes as opposed to the income generating properties that comprise most of the land tax base in Australia), which have general applicability:

*It appears that people had acquired a strong intuitive feeling that home prices everywhere can only go up. They seemed really sure of this, so much so that they were ready to dismiss any economist who said otherwise. If pressed for an explanation, they typically said that, because there is only so much land, real estate prices have always gone up. **Population pressures and economic growth should inevitably push real estate prices strongly upward. Those arguments are demonstrably false. But no matter.*** (page 150, emphasis added).

- Chart 1 below, reproduced from our September capital submission, illustrates the impact of short-period cycles on relative house prices across States. Over the short term, property values can move sharply without there being a corresponding shift in permanent income. Notably, over the long term, relative annual house price movements have been small (see Table 3).

Chart 1: Cumulative growth in State established house price since June 1989 (relative to national average)



Source: Calculated from ABS data

² George A. Akerlof and Robert J. Shiller, *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism*, Princeton University Press, 2009

Table 3: Annual average relative growth in house prices, June 1989 to June 2009

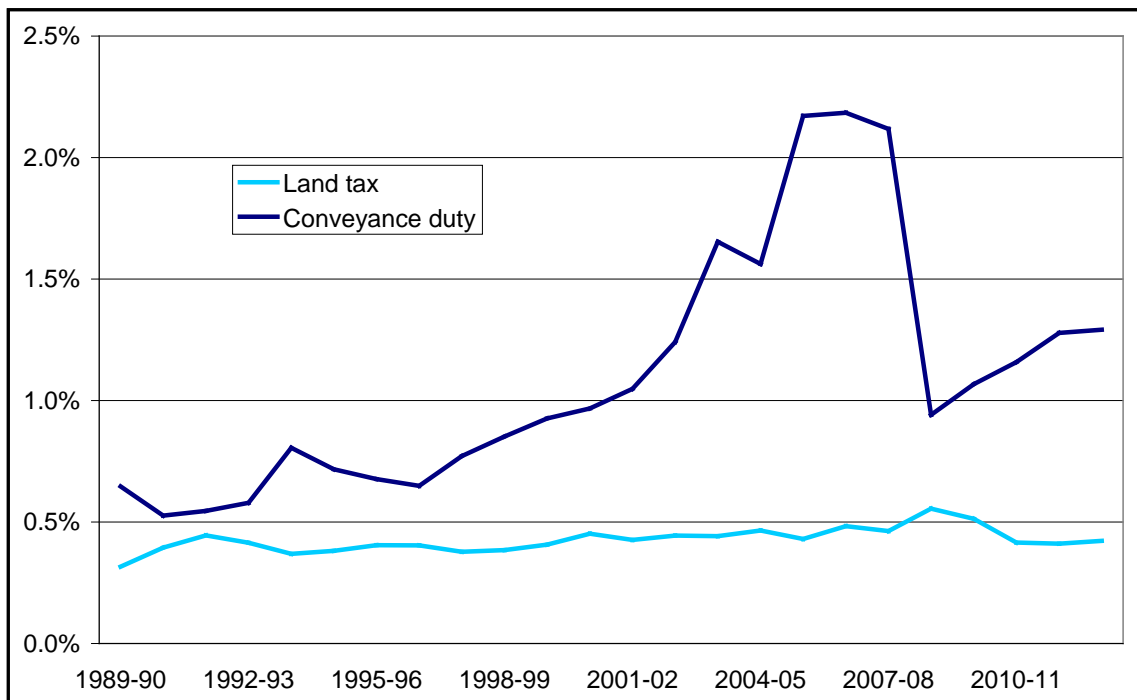
	% growth relative to weighted 8 State average
Sydney	-1.0
Melbourne	0.4
Brisbane	1.6
Perth	0.7
Adelaide	0.7
Hobart	0.9
Canberra	0.5
Darwin	2.3

Source: Calculated from ABS data

In Western Australia, successive policy changes have effectively capped growth in land tax to rates similar to growth in economic activity. Indeed, the ratio of land tax to Household Income is very stable over the period 1989-90 to 2012-13 (projected).

- This contrasts with conveyance duty, which has been allowed to increase substantially (see Chart 2 below).

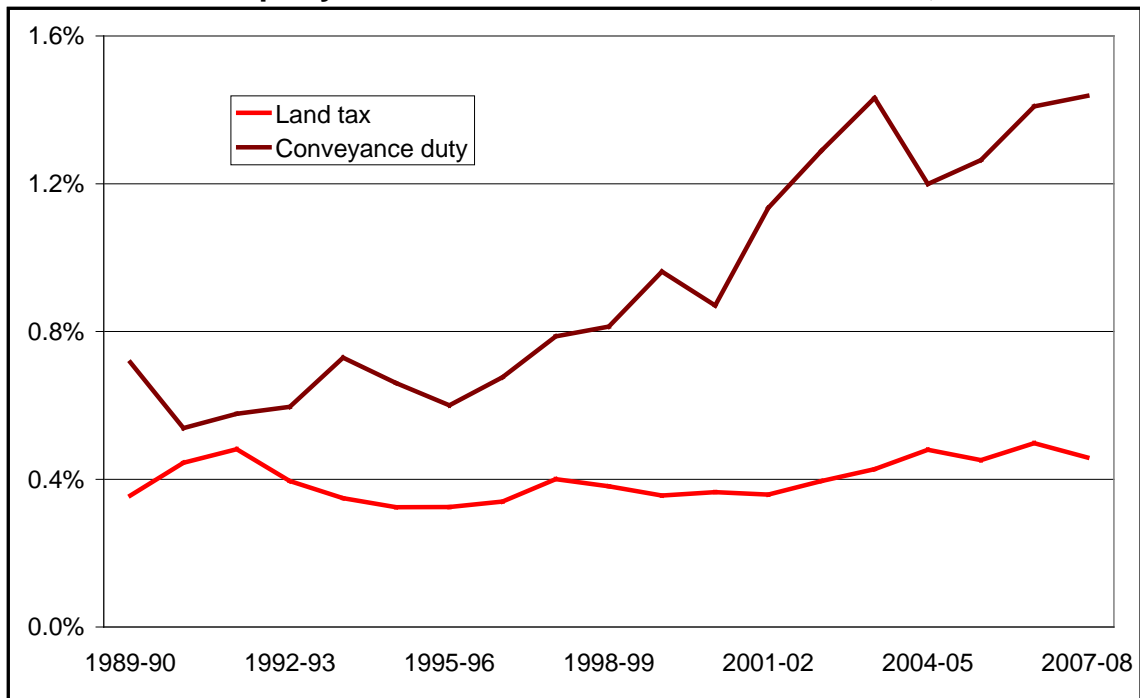
Chart 2: Property taxes as a share of Household Income, Western Australia



Source: WA DTF estimates based on ABS and Grants Commission data and WA's 2009-10 Mid-Year Review.

Other States have shared a similar experience (see Chart 3 below).

Chart 3: Property taxes as a share of Household Income, Australia



Source: WA DTF estimates based on ABS and Grants Commission data.

It is also instructive to compare Western Australia's relative land tax effort (i.e. relative to the average of all States) as assessed by the Grants Commission against what it would have been using Household Income as the revenue base.

- As shown in Chart 4 below, Western Australia's land tax effort is much smoother over time using the Household Income measure, and does not exhibit the precipitous decline over 18 years implied by the Grants Commission's land value measure.

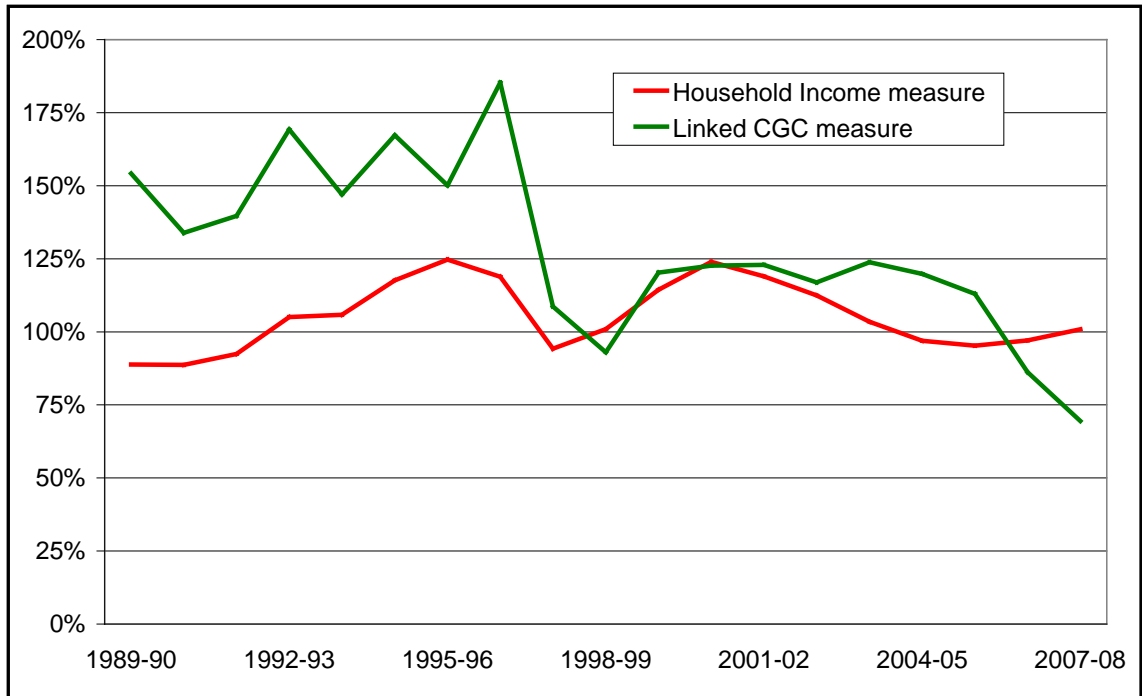
The conclusion to be drawn from these charts is that a general measure of economic activity is a much more plausible measure of land tax capacity than land values.

Notably, the general look of the charts does not depend on the specifics of the indicator of economic activity. However, we consider Household Income to be a better indicator of taxable capacity than, say Gross State Product, as the latter includes income that is paid out of the State through dividends.

- This is an important issue in the mining sector, which generates relatively little land tax directly (compared to the size of mining factor income), and instead generates most land tax indirectly through the impact on the economy of mining income retained in the State.

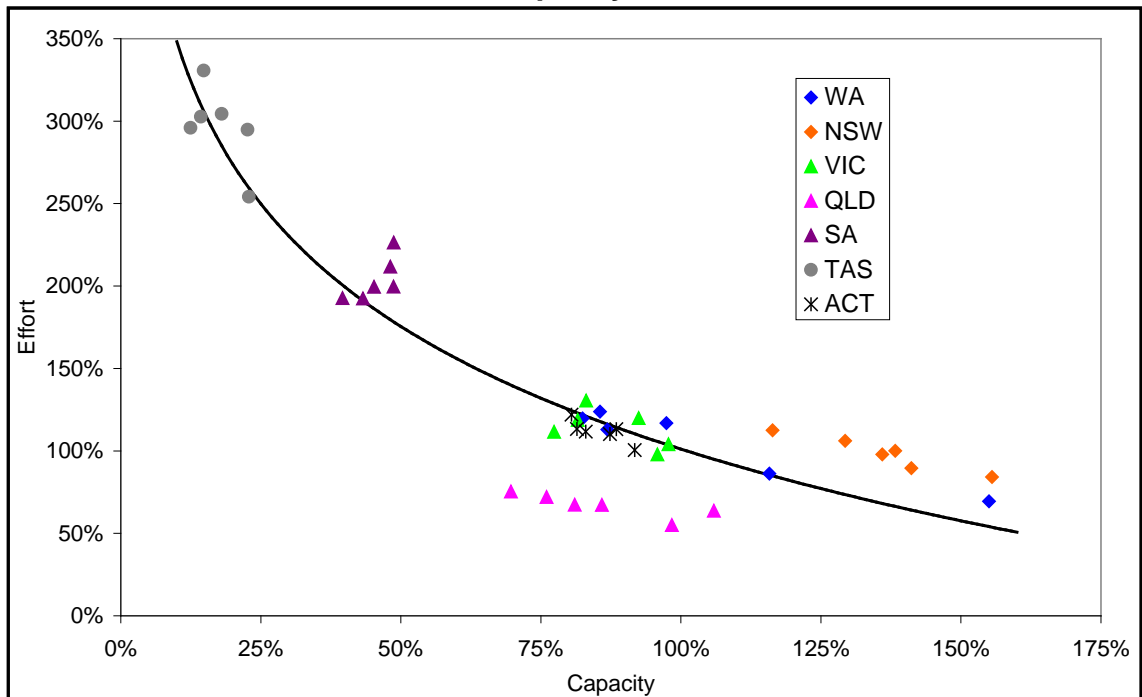
The stable relationship between economic activity and land tax is consistent with the view that States with rising land values are effectively compelled to reduce tax rates. Conversely, jurisdictions with relatively low land values have relatively high land tax rates. The strong inverse relationship between land tax effort and capacity is illustrated in Chart 5 below.

Chart 4: Western Australia's land tax effort, relative to the national average



Source: WA DTF estimates based on ABS and Grants Commission data. The Grants Commission's data series of land tax effort shows reasonable consistency over the time period, but there are some small to moderate 'jumps' caused by data/method revisions. A linked series has been derived to eliminate these discontinuities. The raw series is about ten per cent lower in the earliest years.

Chart 5: Each State's land tax capacity and effort, 2002-03 to 2007-08 (a)



Source: Grants Commission 2009 Update results, with WA DTF fitted line.

(a) Relative to the national average. Each data point for a given State represents a different assessment year. Excludes the Northern Territory, which does not levy land tax.

Some parties might argue that a uniform national land tax scale would raise more revenue in States with higher land values. However, the above analysis suggests that a uniform national scale would not reflect average policy. Furthermore, some States have policies such as capping arrangements on the growth in land tax assessments. If capping were applied under a uniform national tax scale, the relationship between revenue and land values would be weakened.

In summary, we believe there is a strong case for the Commission to use an appropriate general indicator of economic activity as the land tax base measure.

- Household Income is considered an appropriate indicator. An alternative could be Gross State Product excluding the gross operating surplus of industries where there are substantial impacts from cross-border income flows, such as mining.
- Unlike the two proposed approaches, a general economic indicator also has the advantage of being simple and transparent – consistent with one of the key objectives of the 2010 Review.

The general indicator can be modified for special circumstances, such as the dominance of the government sector in the ACT (which reduces the ACT's land tax capacity), or any material variations in private renter proportions (if this is not the result of policy, such as differences in the provision of public housing or policies to encourage home ownership).

Using Household Income results in much less extreme variations in revenue capacity across States. For example, for 2007-08, the Commission's 2009 Update assessed Western Australia's per capita revenue capacity as 6.8 times that of Tasmania. Based on household income, Western Australia's per capita revenue capacity is 26% higher than Tasmania's in 2007-08.

WHAT IF THE COMMISSION RETAINS LAND VALUE?

If the Commission persists with a land value approach, Western Australia supports whichever approach yields less extreme variations in revenue raising capacity across States, as we believe capacity to pay differences are less extreme than land value differences (see above).

The staff paper has suggested discounting the land tax assessments on data reliability grounds.

- If the Commission uses land values, we consider that discounting would improve the assessments, by reducing the variations in revenue capacity between the States, consistent with the results of using a general economic indicator.