South Australian Centre for Economic Studies

The Broad Context for Changes to Aggregation Measures in the SA Land Tax and Their Impacts on the Development Sector

Final Report

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Executive Summary

This report considers potential impacts of the South Australian Government's recently announced changes to aggregation measures in the land tax and considers a broader land tax reform agenda that surrounds them.

In the 2019 Budget the Government announced its intention to reduce the top marginal land tax rate and to change the rules around aggregation of land holdings for land tax purposes (alongside surcharges on ownerships that cannot have aggregation measures applied to them).

The aggregation measures are forecast to raise $40 million per year in additional revenue. This is larger than the revenue sacrificed by reducing the top rate. In addition, the Valuer-General is in a process of 'catching-up' valuations on undervalued land holdings. The combination of all these factors suggests that land tax collections will rise.

The degree of exposure to the aggregation changes varies quite substantially from land holder to land holder. Those land holders who are affected by the aggregation changes will have the impacts of the changed taxation regime compounded by increases in the Valuer-General's valuations. The beneficiaries of the reduction in the top marginal rate (taking into account 2018-19 and 2019-20 announcements) will be those with holdings in excess of $1.302 million. Many of those affected by the aggregation measures will not have been on that top marginal rate, and as such they will see increases in their tax liabilities.

Increases in land tax liability are likely to be particularly substantial for landholders who own multiple parcels which currently are assessed as separate ownerships but which will now be aggregated. For instance, a landholder who has four parcels of land valued at $500,000 each which are treated as separate ownerships now would have a land tax liability of around $2,000 per year. If those holdings are aggregated, the liability would rise to around $40,000 per year.

While disaggregated ownership structures have the potential to reduce land tax, not all disaggregated land holding arrangements are motivated by avoiding tax. Some small to medium size land, business and property developers set up an investment vehicle to bring together multiple investors and thus to share capital contributions and risk. These structures are important enablers of development activity given the reluctance of banks to lend to small and medium sized property developers/business generally.

In this context various industry groups are opposing the aggregation reforms. SACES has been retained by one of those groups, the Urban Development Institute of South Australia (UDISA), to compare South Australia's land tax system with those operating in other States, to consider whether and how the structure of land tax in South Australia could be improved, to consider impacts on the development sector including its competitiveness and to identify possible areas for reform of the land tax system. Our analysis is primarily qualitative. SACES preliminary view was that reforms to aggregation are desirable and that remains the case, but there is also a strong case for broader reforms to land tax. Bundling other land tax reforms with the aggregation reforms might help to allay some of the current concerns.

Compared with the other States, South Australia's land tax rates are in the middle of the pack for land holdings worth up to $1 million. But South Australia's land tax rates are the highest in the country, by a considerable margin, for holdings worth $2 million and more. Related to this, South Australia has the most steeply rising scale of land tax rates in the country—see Figure E.1. An overall perspective can be had from the work of the Commonwealth Grants Commission, which shows that South Australia has a weaker than average land tax base but makes an above average level of effort on it—on average land taxes here are about 27 per cent higher than the land taxes that would be levied on comparable pieces of land interstate.

South Australia's marginal tax rate of 3.7 per cent on holdings in excess of $1.302 million is higher than in any State, and this would be true even if the planned reduction in the top rate to 2.9 per cent were implemented today. Although the Government's proposal will bring South Australia's aggregation measures into line with New South Wales and Victoria, the average tax rates in application here will be considerably higher on holdings worth $2 million or more.

Government's choices about the design of land tax, and the fiscal and legal system more broadly, raise complex ethical issues. In this report we consider the land tax design against the ethical objectives of efficiency and equity, and economics has substantial insights in respect of these objectives. More general concerns about the fairness of the tax system and reform processes will also be important to Government; we offer some general comments about aspects of fairness economics has less to say on these matters. Governments will also need to weigh up and sometimes trade-off competing ethical objectives.

Figure E.1   Average rate of land tax payable by holding value by State, 2019-20
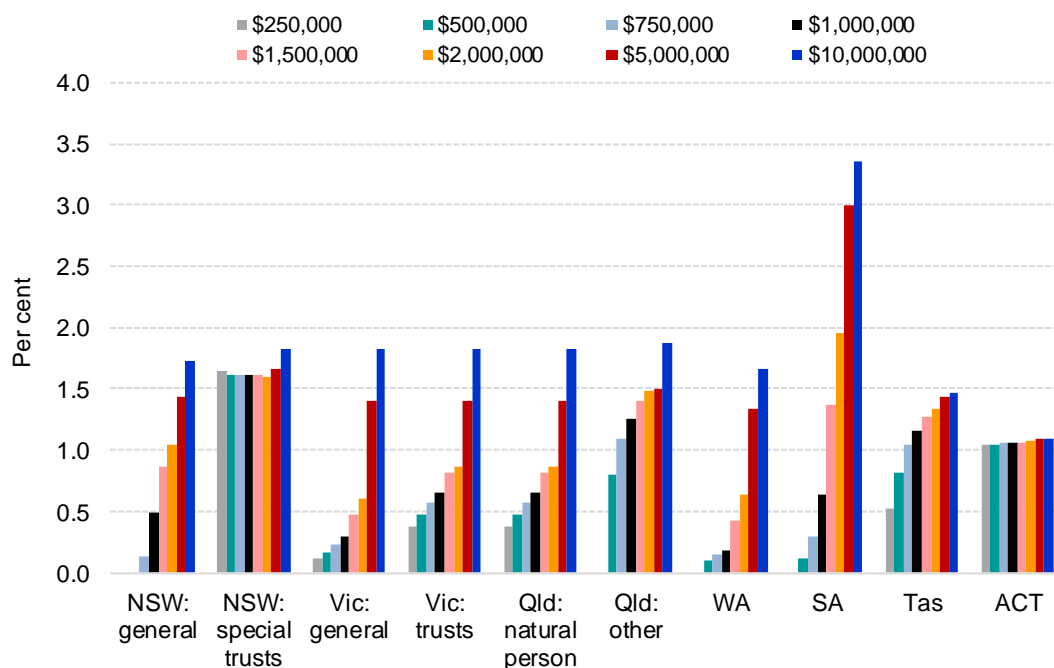
Source: State Treasury websites, SACES calculations.

A broad-based flat-rate land tax is a highly efficient way for a Government to raise the revenue that it needs to deliver infrastructure and public services. It is not likely to be deleterious to a Government's equity objectives, although it will not make any significant contribution to a Government's efforts to actively redistribute the fruits of prosperity according to individual households specific capacities and needs. The pursuit of distributive goals is probably best left to the income tax-transfer system rather than pursued through a land tax that is poorly suited to the task.

It is a failing of the design of the South Australian land tax (and the land taxes in most other States) that the land tax base is narrow, the efficiency of the tax is compromised by exemptions and exclusions, and there are administrative and compliance cost impacts that follow from this. Taxes on owners of rental residential property will in the main be passed on to tenants with adverse equity consequences. The idiosyncrasies of the tax design distort land use, land ownership and the timing of land development and transactions in land.

All the forgoing would suggest the need and the potential benefit of comprehensive reform to land tax including broadening the base of land tax and flattening the rate scale. This could be done in a revenue neutral way. Or it could be done in a revenue-positive way with the proceeds use to remove inefficient taxes such as stamp duty on conveyances.

It has been suggested in the public debate that the aggregation reforms will undermine property prices, but we think there is not much to this argument. The situation is that South Australia's budgetary outlook deteriorated, in part because of a large write-down in prospective GST revenues, and the adjustment to the changed budgetary circumstances is likely to impact one way or another on net rents accruing to property owners in South Australia. Those reductions in net rents will tend to flow into lower property prices. Thus the change in the GST outlook can be seen as undermining of property prices in South Australia. The GST reduction requires a budgetary adjustment, and the Government has proposed that part of that adjustment is a $40 million increase in land tax revenues arising from aggregation measures, which diminishes future net rents on land holdings. But if the budgetary adjustment were delivered differently, say via an increase in other taxes or a decrease in government service levels, those changes could be expected to impact negatively on the budgets of South Australians (firms and households), therefore to decrease their demand for goods and services that use land in their production, and thus to reduce gross rents and then net rents on land. The point is that, in the face of reduced GST revenues, the choice facing South Australia is not between aggregation and lower net rents and a fiscal structure which preserves net rents. Rather, the choice is between aggregation and some other fiscal adjustment that pushes down net rents.

It should also be noted that the increase in land tax associated with aggregation reforms is small in the context of the South Australian land market, even if it is not small for the small group of land owners who have high exposure to it. We suspect that the $40 million revenue impact of the aggregation reforms will flow through

fairly much dollar-for-dollar to lower net rents to land owners. For the purposes of illustration we will temporarily ignore the argument of the previous paragraph, and imagine that somehow the Government could abandon the aggregation measures without making any other budgetary adjustments that were adverse for net rents. Then, in a scenario where all of the burden of the aggregation measures fell on the net rents of residential property investors, we estimate that there would be a downward impact on land values of less than half a per cent.

Our view is that changes to aggregation measures will have quite substantial impacts on future land tax bills for a small group of land owners who are highly exposed to the aggregation reforms. However, we do not anticipate that those land owners will suffer a 'double whammy' in the form of a large adverse movement in their land values.

Developers will commonly have a number of projects in progress at any one time. For a variety of reasons, including risk management, the need to bring together consortia with the right contributions for the project, access to capital and tax treatment, these projects will often be structured as standalone entities. Reforms to aggregation will group together some projects that have hitherto not been grouped for the purpose of calculating the value of aggregate land holdings. For projects affected in this way, average land tax rates will increase, potentially from rates below 1 per cent to rates above 2 per cent.

The aggregation reforms are likely to prompt some rearrangement of the structure of activity in the development sector. We can expect to see increased activity from entities that are eligible for lower average tax rates at the expense of entities whose tax rates are increased by the new aggregation measures. Thus aggregation reforms will disadvantage medium-sized developers with several projects relative to small developers with one or two projects. The reforms will tend to increase the difference between the average tax rates faced by medium and small developers. The expansion of the tax wedge will tend to shift activity to smaller developers who have higher costs as a result of their lack of economies of scale, access to capital, risk management, etc. This is an inefficient outcome, but we do not know how large the induced distortion will be.

While restructuring of ownerships within the sector will attenuate the impacts of the new arrangements on average tax rates, it is implicit in the estimated $40 million revenue impact that there will be an increase in average land tax rates. The impact on developer cost structures will vary widely depending on the circumstances of the project and the developer. But if the average land tax went from 0.5 per cent to 2.5 per cent on a project to develop residential sites, with the sites being held by the developer for one year at an average site value of $150,000, there would be an extra $3,000 of land tax payable per allotment.

When average tax rates go up, developers will need to pass them on. The development sector is competitive and as such operates only on 'normal' profit margins which leave no room to absorb extra costs. Any extra costs will therefore need to be passed forward to purchasers of developed land or back to the suppliers of undeveloped land for development. The question of where the economic incidence of such a tax change would fall is complicated and a meaningful empirical estimate would require use of a well-specified computable general equilibrium model.

While the cost impacts of aggregation changes on the development sector will need to be passed in to the community, the overall impacts on competitiveness of the State are likely to be small if indeed there are any. The use of less efficient taxes to adjust to the GST-related budget shortfall, such as increases in payroll taxes or stamp duties, would be likely to have worse effects. It is probable the complexion of activity related to land use will vary under aggregation, however the overall activity in South Australia will not. For every seller who liquidates their South Australian land holdings, there must be a buyer. Whoever is left holding the land has a commercial interest in allocating the land to its most valuable use, and this is true both before and after any aggregation changes.

The aggregation reforms support the principle of horizontal equity in the tax system. At present individuals who have essentially the same circumstances potentially face different tax bills purely as a result of differences in the structure of their land holdings. The principle of horizontal equity—the idea that like individuals should receive like treatment before the tax system—is best served by a tax system that looks beyond legal ownership to beneficial ownership, which is what the aggregation reforms seek to do.

We note however that the need for aggregation measures would not arise with a broad-based flat rate land tax. The inequities that the Government seeks to address through amended aggregation measures would not arise if the sliding rate scale were replaced with a flat rate. In our view there are no convincing reasons for having a sliding rate scale, especially when one takes into account its costs in terms of introduced administrative complexity, distortions to activity and horizontal inequities that arise in its presence.

Efficiency objectives provide no support for a sliding rate land tax. We also struggle to find a sensible equity rationale for it. Is it intended, in some say, to compensate for deficiencies in the structure of the income tax? Is it a surrogate for a wealth tax? We find it hard to find any solid rationale along these lines. When one takes into account the availability of a land tax exemption for owner-occupiers while housing landlords are subject to land tax and will effectively pass it on to renters, the deficiencies of South Australia's land tax from an equity perspective look even worse.

It is a failing of the design of the South Australian land tax (and the land taxes in most other States) that the land tax base is narrow, the efficiency of the tax is compromised by exemptions and exclusions, and there are administrative and compliance cost impacts that follow from this. Taxes on owners of rental residential property will in the main be passed on to tenants with adverse equity consequences. The idiosyncrasies of the tax design distort land use, land ownership and the timing of land development and transactions in land.

We suggest for further consideration by the Government a range of possible reforms to land tax, with these reforms chosen on the basis that they:

• take South Australia closer to a broad-based flat-rate land tax; or

• redress inefficiencies or inequities that are imposed in the absence of moving to a broad-based system—such as the current situation whereby households occupy dwellings under a rental tenure are effectively subject to land tax while those who owner-occupy are not, and the inclusion of improvements to sites in the land tax base; or

• support desirable tax reform more broadly.

The measures include narrowing the scope of exemptions, flattening the rate scale by lowering the marginal land tax rates applying for larger land holdings, introducing real time assessments rather than whole of year assessments based on circumstances on June 30 and increasing land tax to fund the abolition of stamp duties on conveyances of land. Table E.1 lists the specific initiatives, which in some cases might sensibly be bundled together, and gives a preliminary assessment of their impact against various high-level tax design criteria. We have ignored constraints of political feasibility but have highlighted the impacts on efficiency and equity of the possible reforms.

As part of articulating a holistic reform agenda, the Government should also think carefully about appropriate transition arrangements. Transitional arrangements allow market participants to adjust their activities to new tax arrangements without being negatively affected by surprise changes in the rules. A balance needs to be struck: overly long transitions are undesirable but this does not mean that no transition should be allowed. In the report we have set out three possible transitional arrangements that would allow graduated increases in land tax bills for those taxpayers hit particularly hard by the combination of aggregation measures and the Revaluation Initiative. We believe that they would bring about a transition to the new arrangements within three years in most cases, thus ensuring that the transition process does not drag on excessively.

Table E.1   Possible land tax reforms and preliminary assessment of impact

Measure	Government revenue	Administrative and compliance costs	Costly distortions	Vertical equity	Horizontal equity
A) End PPR exemption	positive	unclear	decrease	strongly progressive	enhance
B) Extend PPR exemption to renters	negative	increase	decrease	strongly progressive	enhance
C) End exemption for PPL	positive	unclear	decrease	neutral	minimal
D) End exemption for community service with supplementation	neutral	increase	decrease	neutral	minimal
E) Review/reform community service exemptions	unclear	unclear	unclear	progressive	minimal
F) Introduce uniform flat rate	possibly neutral	reduced	reduced	neutral or slightly regressive	enhance
G) Introduce flat rate within land use classes	possibly neutral	reduced	reduced	neutral or slightly regressive	enhance
H) Introduce geographically differentiated tax rates	possibly neutral	neutral	neutral	neutral	neutral
I) Introduce a fixed charge for every non-exempt land holding	positive	increase	Possible increase	neutral	neutral
J) Introduce aggregation reforms	positive	increase	decrease	neutral	enhance
K) Reduce top rate faster	negative	nil	reduced	unclear	enhance
L) Reduce top rate below 2.9%	negative	nil	reduced	unclear	enhance
M) Increase threshold for top rate	negative	nil	minimal	neutral	neutral
N) Real time application of exemptions	unclear	increase	reduced	neutral	Neutral
O) Quarterly assessment	unclear	increase	reduced	neutral	neutral
P) Abolish stamp duty on conveyances of land	negative	moderate decrease	large reduction	neutral	enhance
Q) Land tax exemption for developers	negative	unclear	unclear	neutral	neutral
R) Exclude developer improvements from land valuations	negative	decrease	reduced	neutral	enhance
S) Delay inclusion of developer improvements in land valuations	negative	decrease	reduced	neutral	enhance

1. Introduction

This paper considers the role of land tax in the South Australian revenue mix, with particular attention to the decision in the recent South Australian Budget to implement more comprehensive aggregation rules for assessments of land holdings.

The paper considers what criteria of efficiency, equity and fairness might mean for design of the land tax system. It lays out the following:

- political commitments given in 2018, recent changes and announcements in respect of property taxation, and impacts of revaluation;
- a comparison of land tax regimes in the Australian States and the intensity of land tax effort;
- a discussion of the role of land tax within the broader fiscal system—for both a "pure" tax and as practiced in South Australia;
- a discussion of the impact on developers of the aggregation measures and land tax reform more broadly; and
- discussion of a range of options that might be considered as part of a broad land tax reform agenda including transitional arrangements.

The Urban Development Institute of South Australia has retained SACES to advise it on these issues. UDISA has spoken out against the proposed changes. We see some advantages to reforms to aggregation along the lines proposed by the Government, but we also see considerable flaws in South Australia's land tax regime as it stands. Given that the aggregation measures will boost SA Government revenues, albeit by an uncertain amount, this raises the question of whether some of the extra revenues could be allocated to make improvements to the land tax regime. Our primary aim herein is to identify what those desirable reforms might be. We also discuss possible transition arrangements to allow land holders to adjust to the new arrangements.

We have not sought to model the revenue cost of possible reforms. This would be a time-intensive task and in addition it would require access to Treasury datasets – grouping issues such as payroll tax data, land title office data, the scope of land tax and the use of trusts, and how many individuals, households and businesses are grouped under the sliding scale of taxable site values and the ultimate ownership structure of total taxable site values. Nor have we sought to quantitatively model the whole of economy impacts of land tax reforms. This could be done with a computable general equilibrium model, but that is a more substantial task.

2.   Recent and Announced Changes to Land Tax in South Australia

2.1   Recent and announced changes

Prior to the last election (March 2018) the then Leader of the Opposition in a press release (18/3/2018) stated the following:

> *"South Australia's land tax regime … is the most uncompetitive in Australia.*
>
> *We now have the highest top marginal rate in Australia at 3.7% – the national average is 2.17%.*
>
> *If elected we …will increase the tax-free threshold to $450,000 from the current $353,000. We will decrease the top marginal tax rate from 3.7% to 2.9% for holdings valued at just over $1 million up to $5 million benefitting approximately 3,200 land tax payers. These changes will be implemented from 1 July 2020.*
>
> *These changes to land tax will complement our existing tax-related commitments which include scrapping payroll tax for small business with payrolls under $1.5 million, slashing the ESL …".*

The Opposition also committed to reduce Emergency Services Levy bills.

In its first Budget (2018-19) the new Government confirmed these commitments and made allowance in the forward estimates for their phased introduction. Table 2.1 shows the revenue impacts.

In the 2019-20 Budget the Government announced its intention to reduce the top marginal land tax rate and to change the rules around aggregation of land holdings for land tax purposes (alongside surcharges on ownerships that cannot have aggregation measures applied to them). The revenue impact from the taxation measures announced in the 2019-20 Budget is also shown in Table 2.1.

The reduction in the top marginal land tax rate extends the rate reductions announced in 2018-19 to land holdings worth more than $5 million. The revenue sacrifice from the phased reduction in the top rate begins at $2.7 million in 2020-21 (when the rate will have been reduced by 0.1 percentage point) and it increases as the rate reductions proceed. The completion of that phase-in is in 2027-28, which is beyond the forward estimates, but the fact that a 0.1 percentage point rate reduction costs $2.7 million in 2020-21 suggests that the full 0.8 percentage point reduction would cost something of the order of $20 million at today's land values.

The aggregation measures are estimated to bring in an extra $40 million in revenue in 2020-21 and thereafter. However, there is uncertainty as to the exact impact of the announced aggregation measures, not least because their specifics have not yet been finalised. Some industry sources believe that the revenue impact will be greater than $40 million per year.

It is clear from Table 2.1 that the revenue impact of the aggregation changes will outweigh the revenue impact of the reductions in the top marginal rate announced in the 2019-20 Budget. This means that the combination of these two measures will increase average effective land tax rates.

Table 2.1   Property-related taxation measures ($ million)

	2019-20	2020-21	2021-22	2022-23
2018-19 Budget				
Emergency Services Levy remissions	-90.0	-90.0	-90.0	n.a.
Tax-free threshold and marginal rate structure	-	-47.2	-48.7	n.a.
2019-20 Budget				
Land tax – phased reduction in top marginal tax rate	-	-2.7	-5.6	-8.6
Land tax – aggregation	-	40.0	40.0	40.0

Land tax is determined using 'site values' that are assessed by the Valuer-General. They are an estimate of the value of the parcel of land including siteworks such as levelling, drainage, paths and retaining walls but excluding buildings and structures. The Valuer-General also assesses 'capital values' inclusive of buildings and structures, and these are used by Revenue SA to calculate land tax and Emergency Services Levy liabilities, by local councils to assess council rates, and by SA Water to set sewerage rates.

The Valuer-General has in progress a Revaluation Initiative which will boost land tax revenues over and above the effect of the marginal rate and aggregation measures in the Budget. The Revaluation Initiative is a staged review of all site values (and capital values) in the State Its recently completed 1st Cycle has produced some increases in assessed site values for the 2019/20 land tax assessment year that are far in excess of

contemporary market price movements.[1] It appears that assessed site values have been systematically below true market values for a number of years, and the Initiative is bringing them up closer to market. The Initiative is being implemented in three 'Cycles', with the recently completed first Cycle relating to a small group of regions and the coming two Cycles to extend the Initiative across the whole State. It seems likely that Cycles 2 and 3 will also produce some sharp increases in assessed site values with effect in 2020/21 and then 2021/22. In the Budget, the Government said that it expects growth in site values of 3 to 5 per cent per year from 2020-21 onward, a projection which it says takes into account the revaluation exercise.

The degree of exposure to the aggregation changes varies quite substantially from land holder to land holder. Those land holders who are affected by the aggregation changes will have the impacts of the changed taxation regime compounded by increases in the Valuer-General's valuations. The beneficiaries of the reduction in the top marginal rate (taking into account 2018-19 and 2019-20 announcements) will be those with holdings in excess of $1.302 million. Many of those affected by the aggregation measures will not have been on that top marginal rate, and as such they will see increases in their tax liabilities.

The forward estimates in the Budget have private land tax rising from $403 million in 2019-20 to $415 million in 2020-21, an increase of 3 per cent. Rise of about 2 per cent are projected for the following two years.

An additional prospective impost on taxpayers is the budgeted increase in the environmental/ solid waste levy in the metropolitan area from the initial forecast of $103 dollars per tonne to $110 dollars per tonne on July 1 2019, then to $140 dollars per tonne from 1 January 2020. The levy is imposed on councils but can be expected to be passed onto ratepayers either via higher rates or service cuts.

2.2   Details of the aggregation measures

The existing aggregation scheme in South Australia has the following features. To determine land tax liability, all of the land holdings held by an owner are aggregated and land tax is then levied on the owner based on the total taxable site value.

An owner might be a person, a trust, a company, an incorporated association, etc. There are also joint ownerships and these are generally regarded as distinct from the owners that comprise them.

In the main there is no attempt to assign joint ownerships back to individual beneficial owners (but this is what the Government proposes to change). Thus if John Smith owned an investment property with a site value of $400,000, Jane Smith owned and investment property with $500,000 site value, and John and Jane Smith jointly owned an investment property with site value of $600,000, there would be three distinct ownerships with aggregate holdings of $400,000, $500,000 and $600,000 respectively.

There are "minor interest" provisions which "address the practice where owners of more than one piece of land avoid paying higher marginal rates of land tax by structuring their ownerships so that another party (or parties) holds a minor interest in an individual parcel of land thereby creating different land tax ownerships" [Revenue SA 2019, p. 6]. A minor interest will exist when an owner in a joint ownership has a share of less than 5 per cent in the land, or a share of less than 50 per cent in the land and the Commissioner forms the opinion that the purpose of the ownership is to reduce the land tax payable. When a minor interest exists, then land tax will be assessed on the basis that the owners who do not have a minor interest own the land.

Where land is held in a trust by a trustee, that land is neither aggregated with the holdings of the trustee nor with the holdings of beneficiaries of the trust. If the trustee holds two pieces of land in respect of trusts with the same beneficiary(ies) then they will be aggregated.

The Government proposes to reform the approach to aggregation. Budget Paper (Number 5) says that an improved approach to the aggregation of land for land tax purposes will be introduced in South Australia to look through separate legal structures to determine the true owners of land, levelling the playing field for all taxpayers, with effect from 1 July 2020. It says that the approach will be similar to that used in Victoria and New South Wales and will include:

- a shift to aggregating based on an owner's interest in every piece of land, rather than only aggregating properties held in the same ownership structure;
- introducing a provision to allow two or more related companies to be grouped for land tax purposes; and

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[1]   DPTI (2019) says that the 2019-20 General Valuation has raised site values by 6.16 per cent, which is in excess of all indications of South Australian market movements during the year, and is consistent with large increases in assessed values in the Cycle 1 areas.

- introducing a surcharge on land owned in trusts in cases where the interests in land of trust beneficiaries are not disclosed or cannot be identified. This is designed to minimise the incentive to own properties in trusts to avoid aggregation by increasing the tax payable. Exceptions will be provided from the surcharge for certain trusts (e.g. special disability trusts, guardianship trusts, complying superannuation funds).

2.3   Rationale for reforms to aggregation measures

The land tax aggregation scheme has been the subject of ongoing discussion in South Australia over many years. In the Discussion Paper for the 2015 *State Tax Review* (South Australia 2015) the then Government said that *"aggregation is necessary to ensure land holders are treated equitably under the existing application of the progressive land tax rate settings"* and that:

> *"The current land tax regime in South Australia (rates and approach to aggregation) creates an incentive for land holders to hold land in different ownerships in order to minimise their land tax liability.*

> *"Land tax revenue has been impacted in recent years by property owners disaggregating their land holdings as opportunities permit. This has meant that land tax revenues have failed to grow in line with property value growth in recent years.*

> *"Ideally a land holder's tax liability would not be affected by the structure of the land ownership.*

> *The current land tax regime in South Australia (rates and approach to aggregation) creates an incentive for land holders to hold land in different ownerships in order to minimise their land tax liability." [p. 40]*

In its recent Budget the current Government says that "the current aggregation arrangements create an incentive for land owners to set up complex structures designed to avoid being aggregated and minimise land tax" (P6 Budget Paper No.5). It says that the current arrangements have a *"loophole that sees multiple property owners unfairly avoiding paying their fair share"*. The Premier says that *"it is just indefensible from my perspective to have say, someone who might have $7 million worth of property paying a completely different rate as someone who may have $7 million in multiple land holdings"*. (In- Daily)

For example:

- a taxpayer who ultimately controls 10 taxable land parcels across 10 trusts (with each trust having a slightly different composition of beneficiaries) could be subject to land tax on the individual value of each parcel rather than on the aggregated value of all parcels notwithstanding that they are all controlled by the same taxpayer, or

- a taxpayer may set up multiple companies to each own a taxable land parcel. These companies will then be subject to land tax on the value of the land owned by each company independently (a single parcel) rather than the aggregated value of the land owned by all the companies, notwithstanding they are controlled by the same taxpayer.

On the Treasury website a response to a *Frequently Asked Question* says that *'Aggregation of the value of all properties of an owner for land tax assessment purposes is applied by all Australian jurisdictions that impose land tax. It is not considered equitable that two owners holding land identical in total value, one with one property and the other with two or more properties should pay different amounts of land tax.'*

The Budget also makes provision for administrative costs (Table 2.2) in regard to the introduction of land aggregation for taxation purposes. This initiative provides additional administration costs of $4.6 million and systems development costs of $3.5 million to RevenueSA to implement necessary changes and assist taxpayers transition to the new arrangements.

Table 2.2   Land tax – aggregation: Budget implications ($'000)

	2018-19 Estimate	2019-20 Budget	2020-21 Estimate	2021-22 Estimate	2022-23 Estimate
Operating expenses	-	-1,275	-1,735	-1,607	-
Investing payments	-	-2,623	-875	-	-
Full time equivalents	-	13	14	13	-

While disaggregated ownership structures have the potential to reduce land tax, not all disaggregated land holding arrangements are motivated by avoiding tax. Some small to medium size land, business and property developers set up an investment vehicle to bring together multiple investors and thus to share capital contributions and risk. These structures are important enablers of development activity given the reluctance of banks to lend to small and medium sized property developers/business generally.

The strength of the reaction to the announced aggregation measures is a consequence of the sharply rising rate scale in the South Australian land tax system (see Section 4). At present a $500,000 land holding is taxed at a rate of just 0.1 per cent and if a $2 million holding were fragmented into four $500,000 holdings, the 0.1 per cent average rate would apply, implying a tax liability of about $2,000. If the aggregation measures group the four holdings into a $2 million holding, then the average tax rate will be about 2.0 per cent, implying a liability of about $40,000.

3.   Interstate Comparison of Land Tax Regimes

3.1   Land tax rates around Australia

Table 3.1 shows marginal land tax rates and fixed charge elements in each State for the 2019-20 financial year. Marginal rates in each State apply to the total holding of assessable land by the landholder, but there are differences from State to State in aggregation rules. For Queensland, the rate scales are shown separately for individuals and for companies and trusts. The Northern Territory does not have land tax.

A number of States have aggregation and grouping provisions that seek to assess land holdings on the basis of beneficial ownership, looking through the veil of joint ownerships, trust structures and related corporations. For example, in New South Wales and Victoria there are provisions to attribute the value of land holdings and land tax paid within trusts to beneficiaries. In these cases the trusts are taxed at standard rates and the ultimate beneficiaries have their land tax liabilities calculated inclusive of the land held via trusts, with adjustments then made to their tax liabilities in respect of the tax paid with the trust (which is effectively a withholding tax). When the identification of beneficiaries is not possible NSW taxes land holdings within some trusts at a flat 1.6 per cent rate. Victoria imposes surcharges on certain trusts unless the land holdings therein are allocated to ultimate beneficial owners.[2] The aggregation provisions are idiosyncratic and complex and we do not attempt any comprehensive interstate comparison of them here.

From Table 3.1, South Australia's tax-free threshold is lower than for NSW (general), Queensland (natural persons) and Western Australia but more generous than all other States and categories. South Australia's marginal tax rate on a $500,000 land holding (0.5 per cent) is lower than in NSW (trusts), Victoria (trusts), Queensland (companies and trusts), Tasmania and the ACT but higher than in NSW (general), Victoria (general), Queensland (natural persons) and Western Australia. South Australia's marginal tax rate on holdings in excess of $1.302 million at 3.7 per cent is higher than in any State, and this would be true even if the planned reduction in the top rate to 2.9 per cent were implemented today.

Table 3.1   Land tax rates (2019-20 FY)

NSW: general	NSW: trusts	Vic: general	Vic: trusts	Qld: natural persons	Qld: other	WA	SA	Tas	ACT
Flat fee ($)									
100	100	275	82	500	1,450	300	0	50	1,263
Flat fee threshold ($)									
692,000	0	250,000	25,000	600,000	350,000	300,000	391,000	25,000	0
Marginal rates (per cent) by commencement threshold									
$0 0%	$0 **1.6%**	$0 0%	$0 0%	$0 0%	$0 0%	$0 0%	$0 0%	$0 0%	$0 0.5%
$692,000 1.6%		$250,000 0.2%	$25,000 0.375%	$600,000 1.0%	$350,000 1.7%	$420,000 0.25%	$391,000 0.5%	$25,000 0.55%	$150,000 0.6%
$4,231,000 2.0%		$600,000 0.5%	$250,000 0.575%	$1,000,000 1.65%	$2,250,000 1.5%	$1,000,000 0.9%	$716,000 1.65%	$350,000 1.5%	$275,000 1.08%
		$1,000,000 0.8%	$600,000 0.875%	$3,000,000 1.25%	$5,000,000 2.25%	$1,800,000 1.8%	$1,042,000 2.4%		$2,000,000 1.1%
		$1,800,000 1.3%	$1,000,000 1.175%	$5,000,000 1.75%	$10,000,000 2.75%	$5,000,000 2.0%	$1,302,000 3.7%		
		$3,000,000 2.25%	$1,800,000 0.7614%	$10,000,000 2.25%		$11,000,000 2.67%			
			$3,000,000 2.25%						
Top rate (Per cent)									
2.00		2.25		2.25	2.75	2.67	3.70	1.50	1.10

Source: State Treasury websites.

Table 3.2 shows the total land tax payable in each State at different values of the taxable land holding and the average tax rate that is implied for the holding. Figures 3.1 and 3.2 present the average tax rates. The same data are presented, but in Figure 3.1 the average tax rates by holding value are shown for each State, while in Figure 3.2 the average tax rates by State are shown for each holding value.

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[2]   In Victoria discretionary trusts, unit trusts and fixed trusts are subject to the surcharge unless they identify beneficiaries. If beneficiaries are identified, the trust is taxed at the general rate, and each beneficiary's notional share in the land in the trust and the tax paid by the trust is assigned to the beneficiary. The beneficiary's aggregate land holdings are calculated inclusive of the notional holding relating to the land held for their benefit within the trust, the beneficiary's aggregate tax liability is calculated, and a deduction is then made in respect of the beneficiary's share of the tax that was paid within the trust. There are certain other trusts which are not subject to the surcharge but are instead taxed at the general rate, including administrative trusts (deceased estates), excluded trusts and implied or constructive trusts. Excluded trusts are charitable trusts, concessional trusts, publicly listed trusts and wholesale trusts (both of which typically have a large number of ultimate beneficiaries), trusts in which one or more of the beneficiaries is a club, and superannuation trusts (complying superannuation funds, approved deposit funds and pooled superannuation trusts as defined in the Commonwealth *Superannuation Industry (Supervision) Act 1993*.).

**Table 3.2   Land tax payable by aggregate land holding (2019-20 FY)**

Value of holding($)	New South Wales: general	New South Wales: trusts	Victoria: general	Victoria: trusts	Queensland: natural persons	Queensland: other	Western Australia	South Australia	Tasmania	ACT
					Tax payable ($)					
250,000	0	4,100	275	926	0	0	0	0	1,288	2,613
500,000	0	8,100	775	2,363	0	4,000	500	545	4,088	5,193
750,000	928	12,100	1,725	4,251	2,000	8,250	1,125	2,186	7,838	7,893
1,000,000	4,928	16,100	2,975	6,438	4,500	12,500	1,750	6,311	11,588	10,593
1,500,000	12,928	24,100	6,975	12,313	12,750	21,000	6,250	20,570	19,088	15,993
2,000,000	20,928	32,100	11,975	17,361	21,000	29,500	12,550	39,070	26,588	21,393
5,000,000	72,104	80,100	69,975	69,975	62,500	75,000	66,550	150,070	71,588	54,393
10,000,000	172,104	160,100	182,475	182,475	150,000	187,500	166,550	335,070	146,588	109,393
					Average rate of tax (%)					
250,000	0.0	1.6	0.1	0.4	0.0	0.0	0.0	0.0	0.5	1.0
500,000	0.0	1.6	0.2	0.5	0.0	0.8	0.1	0.1	0.8	1.0
750,000	0.1	1.6	0.2	0.6	0.3	1.1	0.2	0.3	1.0	1.1
1,000,000	0.5	1.6	0.3	0.6	0.5	1.3	0.2	0.6	1.2	1.1
1,500,000	0.9	1.6	0.5	0.8	0.9	1.4	0.4	1.4	1.3	1.1
2,000,000	1.0	1.6	0.6	0.9	1.1	1.5	0.6	2.0	1.3	1.1
5,000,000	1.4	1.6	1.4	1.4	1.3	1.5	1.3	3.0	1.4	1.1
10,000,000	1.7	1.6	1.8	1.8	1.5	1.9	1.7	3.4	1.5	1.1

Source: State Treasury websites, SACES calculations

Figure 3.1 illustrates that the average land tax rate shows a steeper increase over holding values in South Australia than in any other State. Figure 3.2 shows that at lower aggregate holding values ($250,000, $500,000, $750,000 and $1,000,000) South Australia's average rates of land tax are around the middle of the pack. But with larger aggregate holdings $2 million, $5 million and $10 million) South Australia has the highest average land tax rate. On a $5 million land holding, South Australia has an average tax rate of 3.0 per cent while for that value of holding the highest average tax rate anywhere else is 1.6 per cent (for NSW trusts).

Aggregation measures announced in the Budget will have the effect of grouping some separated land holdings into larger, single, holdings. Because average tax rates increase with the value of the holding, the aggregation changes will increase average tax rates on the affected land owners. Although the Government's proposal will bring South Australia's aggregation measures into line with New South Wales and Victoria, the average tax rates in application here will be considerably higher on holdings worth $2 million or more.

Figure 3.1   Average rate of land tax payable by holding value by State, 2019-20
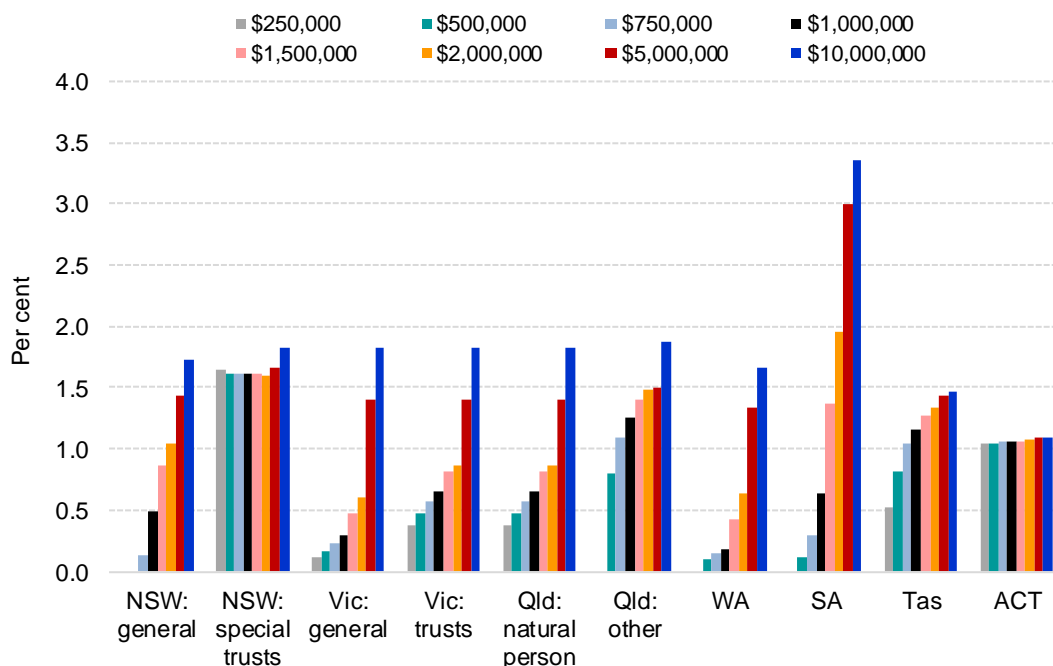
Source: State Treasury websites, SACES calculations.

It should also be noted that land tax is not the only government tax which has its primary incidence on land. Local governments are funded by rates, which in South Australia and most other States are levied on property values and thus on the land value component of the property value. In the Adelaide City Council jurisdiction, for example, SACES (2018) estimated that the average rate in the dollar for commercial property in 2014-15 was 0.85 per cent. Many States also have property taxes hypothecated to emergency services and a part of these taxes thus falls onto the land component of property values. In South Australia, the rates of emergency services vary across regions and land uses, but the highest marginal tax rate is 0.1145 per cent, which is relatively small compared to marginal land tax rates on high value holdings. Taking these charges in combination with land tax, it is apparent that for some high value holdings the total of all taxes against land value could be in excess of 4 per cent of land value. For example, for Adelaide City Council commercial land, the current land tax and council rate on the land would combine to give a marginal tax rate of 4.35 per cent (3.7 per cent plus 0.85 per cent). Even when the top rate has fallen to 2.9 per cent the combination of land tax and council rates would still be quite high at 3.75 per cent.

Figure 3.2 **Average rate of land tax payable by State by holding value, 2019-20**
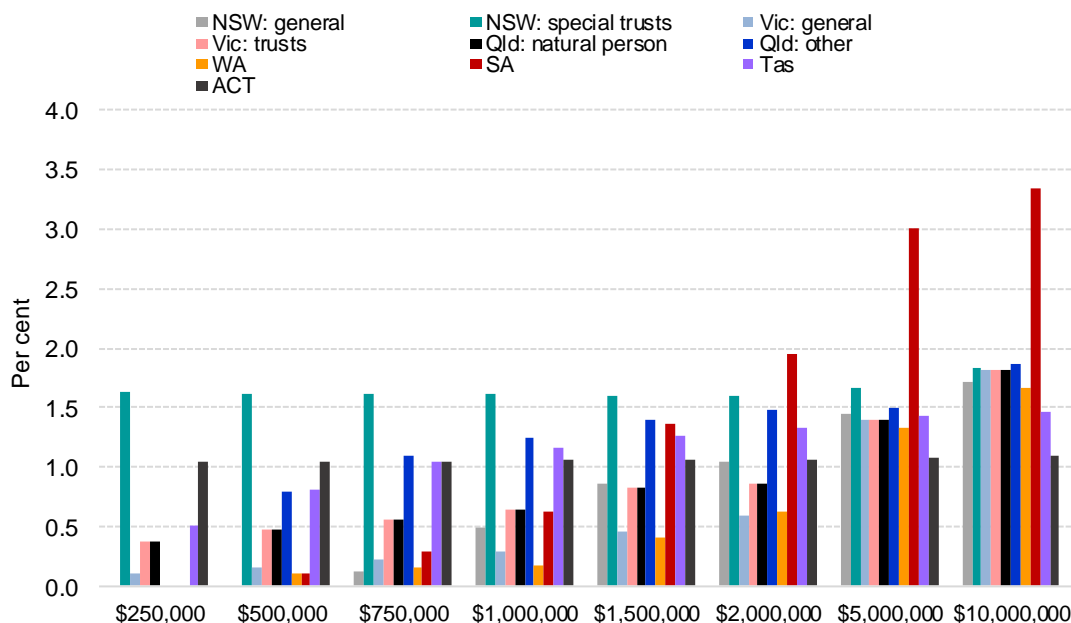
Source: State Treasury websites, SACES calculations.

3.2 Land tax capacity and revenue effort

The Commonwealth Grants Commission makes assessments of the States' capacity to raise revenue from land tax. These figure can also be used to calculate the degree of 'tax effort' made by the different States. The Commission's data shows that South Australia has a weaker than average land tax base but makes an above average level of effort on it (i.e. taxes harder than average).

The Commission includes in its 'land tax' assessment: land tax on residential investment, commercial and industrial land; property based Fire and Emergency Services Levies (FESLs); metropolitan levies (which are imposed in Victoria, Western Australia and the ACT); and the ACT's replacement revenue (general rate revenue raised to replace the revenue lost as a result of the ongoing phasing out of stamp duties on conveyances)—(Commonwealth Grants Commission, 2018). Revenues from the transfer of property are out of the scope of the Land tax assessment and are instead included in the Stamp duty assessment.

Table 3.3 shows the Commonwealth Grants Commission's calculations of per capita land tax for the three years to 2017/18.[3] In 2017/18, the average land tax collection across the Australian States (inclusive of the ACT and the NT) was $468 per capita. Per capita collections in South Australia were $107 lower at $361. South Australia was also below average in each of the preceding two years, although the gap was smaller.

Comparing across the States, per capita land tax collections in 2017-18 were highest in the ACT, followed closely by Victoria, and also above average in New South Wales and Western Australia. Leaving aside the Northern Territory, which does not collect land tax, per capita collections were lowest in Tasmania, followed by Queensland and then South Australia.

Table 3.3 **Actual land tax collections by State ($ per capita)**

Land tax	New South Wales	Victoria	Queensland	Western Australia	South Australia	Tasmania	ACT	Northern Territory	Total
2015-16	357	450	305	528	347	264	453	0	384
2016-17	408	565	320	502	355	271	499	0	431
2017-18	491	583	340	490	361	282	595	0	468

Source: Commonwealth Grants Commission (2019), Table **S2-2-2.**

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3   This is the latest year for which the Commission has published data. It is also the latest year of ABS *Taxation Statistics* data, which is the primary source for the Commission's calculations. The Commission's 'Land tax' category comprises both land tax as defined strictly (78 per cent of the total) and a range of other taxes on real property such as South Australia's Emergency Services Levy (22 per cent of the total).

An important factor that influences the interstate differences in per capita land tax collections is differences in the sizes of the land tax bases available to the States. The Grants Commission calculates what it calls 'assessed capacity' (to raise land tax) for each State, an estimate of how much land tax revenue each State would have raised if it had applied a States-average land tax policy in each year. These assessed capacities are shown in Table 3.4. In 2017/18, when the per capita land tax revenue nationwide was $468, South Australia would have raised only $284 at average effort, reflecting the State's relatively weak tax base. Among the States, only Tasmania had a weaker land tax base. The strongest base was in New South Wales, where application of the States' average land tax policy would have raised $588.

Table 3.4   Assessed land tax capacity by State ($ per capita)

	New South Wales	Victoria	Queensland	Western Australia	South Australia	Tasmania	ACT	Northern Territory	Australia
Assessed capacity									
2015-16	437	399	320	454	252	229	253	297	384
2016-17	509	481	335	440	266	244	267	332	431
2017-18	588	500	353	441	284	261	292	360	468
Revenue advantage									
2015-16	53	15	-64	70	-132	-155	-131	-87	0
2016-17	78	50	-96	9	-165	-187	-164	-99	0
2017-18	120	32	-115	-27	-184	-207	-176	-108	0

Source: Commonwealth Grants Commission (2019), Table **S4-3.**

Individual States' land tax regimes will differ from the all States' average. A State may set rates in such a way that it raises more or less than its assessed capacity, and we describe these departures from the average policy as variations in 'tax effort'. The State-by-State land tax effort levels are shown in Table 3.5, both in $ per capita terms and as a proportion of assessed revenue. The ACT stands out for its high land tax effort, raising $302 per capita in 2017-18 or 103 per cent more than it would have raised at average land tax effort. High land taxes in the ACT are a consequence of the ACT Government's ongoing, gradual transition of taxation away from stamp duties and onto land taxes. South Australia is the hardest-taxing among the rest of the States, at $77 per capita in 2017-18 or 27 per cent above the revenue it would have achieved at average effort. Victoria, Western Australia and Tasmania also have above average effort. The Northern Territory has an effort 100 per cent below average—since it has no land tax—and New South Wales also has a below-average effort.

Table 3.5   Relative land tax effort by State[1]

	New South Wales	Victoria	Queensland	Western Australia	South Australia	Tasmania	ACT	Northern Territory	Australia
$ per capita									
2015-16	-80	51	-15	74	95	35	200	-297	0
2016-17	-101	84	-15	63	89	27	232	-332	0
2017-18	-97	83	-13	48	77	21	302	-360	0
Per cent									
2015-16	-18	13	-5	16	38	15	79	-100	0
2016-17	-20	17	-4	14	33	11	87	-100	0
2017-18	-17	17	-4	11	27	8	103	-100	0

Notes: 1 This is the amount by which the State's actual revenue exceeded its assessed capacity.
Source: SACES calculations.

4. The Role of Land Tax in the Fiscal System

The Henry Tax Review (Australian Government 2009) and others (e.g., Productivity Commission 2017, IPART) conclude that land has the potential to be an efficient tax base for government essentially because it is immobile unlike labour and capital and hence cannot avoid the tax. The Henry Review concluded that this "means that economic growth would be higher if governments raised more revenue from land and less revenue from other tax bases" such as stamp duties and payroll taxes. Empirical work carried out for the Henry Review supports this view.

Problems arise when land taxes are applied unevenly, such as currently where the land tax system does not include an individual's principal place of residence. Land tax on residential investment properties is probably passed through to renters as higher rents. The Review noted that "existing land taxes are narrow, which make them less efficient and fair than they could be while levying higher taxes on larger holdings discourages investment in land by institutional investors in rental housing" (p247).

In general, where exemptions are allowed to any tax/levy then the efficiency of the tax will be compromised as resource allocation will be distorted towards exempt or concessionally taxed activities. With respect to land tax, exemptions are available for owner-occupied principal places of residence (PPR), some land used in primary production (PPL), some community service activities and the rate scale is discriminatory across owners according the value of their aggregated land holdings. The Henry Review estimated that the "exemption of owner-occupiers rules out around 75 per cent of residential land and, for the remainder, high thresholds in some States effectively exempt many small-scale investors" (p261).

This section considers the strengths and weaknesses of land tax from tax design principles. It identifies criteria that are strongly relevant to the design of the tax system. It outlines the performance of a broad-based flat-rate land tax against these criteria. And it then considers the implications of departures from the broad-based flat-rate structure in South Australia.

4.1 Market impacts of taxes

Tax incidence

An analysis of a tax needs to take account of its *incidence*. The *statutory incidence* of a tax lies on the person who pays it. But the *economic incidence* of a tax lies on the parties who bear the cost of the tax after market prices have adjusted in response to the tax. The distinction is well illustrated by Australia's GST: the statutory incidence lies with vendors but the economic incidence lies largely on consumers because vendors pass on the tax in higher prices.

In some cases the economic incidence of a tax is not so easily discerned, and careful consideration of the way that the tax impacts on markets is needed. For example, we might wonder: Does the imposition of land tax on investors in rental housing decrease investor returns or does it increase rents charged to tenants?

If the analysis of tax is to deliver valid results it needs to be based on a correct assessment of its economic incidence. This is especially the case when we consider the distributive consequences of a tax and thus its equity consequences.

It is common in the economic analysis of taxation to make use of *partial equilibrium* analysis, which is a simplified analysis in which we consider impacts in only one market. This is a valid approximation so long as there are not substantial flow-ons to other markets. To assess a tax comprehensively, making simultaneous allowance for its impacts in a number of markets, a *general equilibrium* analysis is used.

The importance of a general equilibrium perspective can be seen by considering a government which must choose whether to fund its operations with a land tax or a payroll tax. A broad-based land tax will clearly have its statutory incidence on landholders and its economic incidence will also fall on landholders. A payroll tax will not have its statutory incidence on landholders. But at least some of its economic incidence is likely to fall on landholders if, as is likely, employers seek to pass the payroll tax onto workers through lower wages, and workers are then at the margin encouraged to live and work in other States, with the result that the demand for land in South Australia is reduced.

This section seeks to develop a broad understanding of the impacts of land tax—both in a 'pure' sense and also 'as implemented' in South Australia—but it does not include empirical analysis. We make appropriate use of partial equilibrium analysis to develop insights but we have not carried out the general equilibrium analysis that would be needed to quantify impacts.

Capitalisation: the price of land and the price of land services

Owners of land receive a flow of future benefits, with these benefits typically bundled with benefits flowing from property established on the land. The benefits are in the form of a stream of rents and capital appreciation. The rents may be explicit rents charged to arms-length tenants or implicit rents equal to the value of the service benefits received by the owner.

In most cases land tax is levied on property which has buildings on it, and the rents (or prices, in the case of a sale) payable for the property then, in principle, incorporate elements relating to the land and the improvements. We can make a notional separation of the 'land' and 'structures and improvements' component of the rents accruing to a property by deducting the notional rental value attributable to structures. We do this by valuing the structure at depreciated replacement cost and then calculate the rent on the structures as the sum of depreciation (return of capital) and required rate of return on capital. This leaves us with a rental component attributable to land.

There are many possible future uses of a land parcel, some involving explicit rental and others involving owner use, and indeed mixtures of the two. For any conceivable pattern of uses we can identify a pattern of expected rental payments—explicit and implicit—in which case the owner's future returns are equal to the expected rental payments up to the point at which the land is sold plus the expected capital gains on the sale. The value to the owner of that set of rental payments and the capital gain can then be calculated with a present value calculation using the owner's required rate of return. This gives the value of the land to the owner in that pattern of use.

An owner will rationally deploy land to its most valuable use, and the valuation that an owner places on a piece of land will be equal to its value in this most valuable use.[4] In the market, owners then bid for and sell land according to their valuations, and in equilibrium land goes to the owner with the highest valuations.

This discussion of capitalisation is important because it establishes the link between land values and land rents. In the analysis that follows we will talk in terms of land rents: gross rents, land taxes and net rents. This will allow us to take a 'one-period' perspective on land use and avoid the analytical complexity that arises when we consider the many possible combinations of land use that might arise year-by-year over a period of many years.

Our model of property price formation offers some insights on the positions of investors choosing between States. We see property and land prices as being in effect the discounted present value of future net rents (in cash or in own use) to a land owner. When a State varies its land tax then the future net rents change, but in general the required rates of return of investors will not, so that the changes in the land tax outlook will flow through directly into land prices. Required rates of return may vary from State to State and this will affect land valuations, but this is a separate factor from the land tax regime.[5]

4.2   Tax design criteria

The mainstream economics approach to public policy analysis focuses in particular on the high-level objectives of *efficiency* and *equity.* A government seeking to optimise its tax system design will also need to take into account issues of *fairness.*

In the design of policy, these competing objectives will need to be weighed up, and sacrifices between them will be needed. Governments will need to make choices about what weights to put on the goals of efficiency, equity and fairness, and how to resolve the conflicts between them. The goal of the economic analysis here is to clarify the implications for efficiency and equity of alternative tax arrangements.

And although economics has less to say on the topic of fairness some useful observations can still be made.

Efficiency

When we think of the efficiency of a tax, we need to take into account the administrative costs (to the collecting government), the compliance cost (i.e. the costs incurred by taxpayers other than the actual tax payment) and also the costs of distortions caused by the tax. When a tax distorts the behaviour of an economic agent—a firm, an investor, a consumer, etc.—there are costs that arise from this, which we call *excess burdens* (of the tax)—see Box 4.1. For some taxes the costs of excess burdens are much larger than administrative and

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4   The most valuable use will *not* necessarily be the one with the largest cash flows. For instance, an owner might receive larger cash flows by subdividing their residential allotment and selling off one of the allotments, but might choose instead not to do that but to have a larger garden instead.

5   We do not directly observe required rates of return on investment, so it is hard to make interstate comparisons. We suspect that required rates are near to uniform across Australia. Owners of land realise returns both through rents and capital appreciation. In fast growing areas of the country, with better prospects for land price appreciation, we could expect to see somewhat lower rental yields. In slow-growing areas, we could expect higher rental yields to make up for the more limited prospect of capital appreciation.

compliance costs. Excess burdens tend to be large when they cause large changes in the behaviour of economic agents.[6]

In a consideration of efficiency it is a normal starting point to assume that the undistorted market behaviour of individuals, investors, etc. are efficient. But sometimes there are features of the market structure which undermine its capacity to produce efficient outcomes. Two relevant examples of this are *externalities* and *information asymmetries.*

Externalities exist when the behaviour of one individual produces positive or negative spillovers for another individual or group of individuals. For example, a landowner might consider establishing an abattoir in a residential neighbourhood, with adverse noise, smell and disruption consequences for adjacent residents. Taking into account only his own interests, the landowner would ignore the costs imposed on residents, yet from a societal perspective these are costs that should be taken into account. Thus the externality gives rise to a market failure, and is a source of inefficiency at the societal level. Zoning requirements are a regulatory intervention to address market failure of this type.

Sovereign risk is the risk that a government may use its powers over the ownership of assets and incomes earned in its jurisdiction to seize those assets and incomes for itself (or somebody else). It has the potential to undermine the effective operation of markets and is thus a potential source of inefficiency. Where sovereign risk is substantial it will be difficult for the potential purchaser of, say, a piece of land to know what they are buying, and the security and stability of the property rights regime is undermined. But in the absence of that stable regime of rights, it becomes more difficult for the market to allocate land to its most valuable uses.

While sovereign risk per se is undesirable, the future is inherently uncertain and it is neither possible nor desirable for a government to set its laws and regulations in concrete for all time. Laws and regulations will need to evolve in light of changing circumstances and some groups in the community will need to bear the brunt of adjustments—or reap windfalls from them—when they occur. One will sometimes hear it said that businesses want certainty for the future, but while this is an understandable wish it cannot be sensibly honoured as an absolute: somebody needs to bear the consequences of uncertainty and sometimes, although not always, it will be businesses. Governments make many decisions over time in response to the changing circumstances that they face, and for any particular individual some of these changes will be detrimental and others will be beneficial. Owners of property are likely to do better, over the long run, with a government that is committed to prosperity-enhancing reforms than with a government that is resistant to making changes that are not universally beneficial. Not many prosperity-enhancing reforms are good for everybody.

When the impact on an interest group from a policy change is large and is judged by government to be unfair, compensation or transitional assistance can be provided. When impacts are small they can more safely be regarded as part of the "ups and downs" of life to be absorbed by affected parties, having in mind that the transaction costs of providing compensation may be too great to justify compensating small losses, even when they are deemed to be somewhat unfair.

Box 4.1   The excess burden of a tax

> Rosa has a primary school child. She currently works 3 days per week and is considering whether to work an extra day.
>
> If she works the extra day, she will have to pay childcare costs, transport costs, etc., plus she will not have as much time to help her son with his homework. Weighing it up, she decides that she needs to bring home at least an extra $150 if work is to be worthwhile. This is Rosa's 'cost' of working.
>
> Rosa earns $200 gross per day. If her marginal tax rate is 20 per cent she will clear $160 per day, and since this more than covers her cost of working, she chooses to work. Rosa gets a net benefit of $10 and the tax office gets a benefit of $40. Thus there is a societal gain of $50 from Rosa working.
>
> But if Rosa's marginal tax rate was 30 per cent then she would clear only $140, and since this does not cover her $150 cost of not working, she elects not to take on the extra shift. In this case Rosa's labour supply choice is distorted and the societal benefit of $50 that would arise from her working is sacrificed.
>
> In this case we say that there is a 'deadweight loss' of $50 when the marginal tax rate is 30 per cent. This is the value that is lost as a result of the tax distortion. When the marginal tax rate is 20 per cent there is no deadweight loss (in the example). Although Rosa only benefits to the tune of $10, the tax office benefits to the tune of $40 which can then be used by the government to apply to valuable purposes (which could be additional spending or reductions in other taxes).

Vertical equity

Economists, and philosophers and thinkers about public policy more broadly have long had a concern over the degree of inequality in society. But when we think of inequality, the question naturally arises: Inequality of what?

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[6]   In some cases a tax can be used for the purposes of distorting economic choices in a way that is seen to be desirable from a societal point of view, e.g. tobacco taxes have been used to discourage smoking.

The mainstream economics approach is organised around the idea of identifying an interpersonally-comparable level of wellbeing for each individual in society—commonly referred to as utility—and then assessing the degree of inequality in its distribution. Because utility is not in fact observable, practical assessment of inequality requires some proxy for individual wellbeing. Income is the most commonly used measure for this purpose, perhaps with some adjustments to take account of numbers of dependants, etc. However, income is by no means a perfect indicator, and some more recent work is focused instead on consumption inequality.

From time to time analysts also consider inequalities in wealth, but there are difficulties with this, and a simplistic use of wealth as an indicator of wellbeing is likely to mislead. If wealth is to be used as an indicator of interpersonal differences in wellbeing, then careful allowance needs to be made for lifecycle differences. Consider for example a worker near retirement who has earned average earnings through their working life and a young worker five years into his working life earning an average income. The older worker may have more accumulated wealth than the younger worker, but it is not clear that he is better off than the younger worker: the two are just at different stages in a lifecycle trajectory where wealth starts out low, accumulates through one's working life, and then runs down through retirement.

An alternative to the welfarist view comes from Sen who argues that an emphasis on a single index of wellbeing is inadequate, and that what needs to be considered is inequalities in individuals' capabilities. Relevant capabilities are those that enable individuals to lead a fulfilling life. In practical implementations of this approach, emphasis has been placed on inequalities in aspects such as health, education, and human rights, and the desirability of avoiding deprivations on these grounds. These perspectives provide a rationale for taking into account issues such as equity of access to health services, education and justice (to name a few), in the design of public policy including taxation policy.

Regardless of the metric that is used for assessment, *vertical equity* is concerned with inequalities in the distribution of wellbeing. We will say that the tax system is more *progressive* if it promotes a more equal distribution of wellbeing. Usually we will take income as the relevant indicator of wellbeing.

One significant shortcoming from using cash income as an indicator of wellbeing is that it does not deal particularly well with housing. This point is well illustrated by considering how to treat the implicit incomes from owner-occupied housing in assessments. Compare two individuals with the same labour incomes and wealth at the same stage in their lives. One owns her own house and has all of her wealth in this asset. The other has a portfolio of bank deposits and share market investments but does not own the house he lives in, and rents instead. If we look only at cash incomes, we would conclude that the person who rents is better off. But if we looked at a holistic income measure that includes the imputed income to the owner-occupier—calculated as the rental value—we would conclude that the two have the same incomes.[7]

Land tax systems commonly have a 'progressive' rate structure, in the sense that marginal and average rates of land tax rise with the value of land holdings. This is *not* the sort of progressivity that is meaningful when we think of the impact of policy on vertical equity. Unless land holdings are closely correlated with incomes comprehensively measured, then a progressive land tax rate structure will not have much correlation with income. And if it does bear a correlation with a comprehensive income measure, then it would probably be best to address vertical equity issues within the income tax system and leave the land tax with a neutral structure.[8]

Horizontal equity is a situation in which like individuals receive like treatment from the tax system (or public policy more generally). A tax measure, or bundles of measures, enhances horizontal equity if it brings about a more equal treatment of like individuals. To illustrate, consider again the example above of two individuals with the same labour income and wealth but differing in their housing tenures. The renter has a higher cash income, so under the Australian tax system he would pay more income tax than the owner-occupier. This is horizontally inequitable.

Fairness

So long as one subscribes to the view that like individuals should be treated alike, then the attainment of horizontal equity can be seen as an important aspect of the fairness of the tax system. A horizontally equitable tax system would impose the same income taxes on an individual regardless of, for example, the extent to which she invested in a particular asset class like housing.

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[7]   This is an oversimplification, in that capital appreciation should also be considered, but we leave that aside for the purposes of the example.
[8]   If the income tax had a major flaw in the definition of its base, such as the exclusion of land income, then a progressive land tax structure might be rationalised. In Australia today, one major hole in the income definition is the value of the imputed rent of owner-occupiers. But since owner-occupiers are exempt from land tax, the progressive land tax structure does nothing to correct any of the anomalies in the income tax schedule.

From this perspective it might be argued that it is horizontally inequitable that a land owner pays land tax on her land holdings whereas a person who does not hold land but is in other respects the same does not pay land tax. But the argument does not hold when the land owner has purchased land at a price that factors in the future land tax liabilities. The land price to the purchaser is discounted in respect of the future land tax liability and there is then no horizontal inequity in its imposition. Moreover, to the extent that Governments expend funds in ways that boost land rents, then there is a case in horizontal equity for landowners to pay land tax to fund those expenditures.

Important issues of fairness arise when reforms to the tax system are considered. Because reforms may impact like individuals differently, they can be seen as undermining of horizontal equity. Where the violations of the horizontal equity principle are substantial enough, governments may choose to compensate the adversely affected, at least for a time.

It follows that while the existence of an established land tax is unlikely to be horizontally inequitable, unanticipated changes to the land tax regime may be horizontally inequitable. If, for instance, the land tax were doubled and this had not been anticipated, the land owner of the previous example would suffer an additional tax impost whereas the person who did not own land would not. Thus the unanticipated change would treat the land owner and the non-owner inequitably. And the converse is also true: if the land tax rate were halved this would confer an advantage on the land owner but not on the non-owner. Thus unanticipated changes to the land tax regime have potential horizontal inequities not just when they are to the disadvantage of land owners, but also when they are to the advantage of land owners.

There are dangers in taking a piecemeal approach to assessing horizontal equity. If for example the rate of land tax were increased and use to finance a payroll tax reduction, then the extra activity encouraged by the payroll tax change would tend to boost land rents and prices and thus to offset the impact of the land tax increase. It would be misleading to omit this benefit from an assessment of the horizontal equity of the land tax change.

Other criteria

It is sometimes suggested that **home ownership** is a worthy public policy goal in its own right. This idea needs to be unpacked. The advantages of home ownership might include:

- homeowners have access to adequate housing with secure tenure (an aspect of the equity considerations listed above);
- homeowners are induced to save and thus achieve higher future living standards (not paying rent on their homes, nor mortgage payments once the mortgage is discharged);
- homeowners make better neighbours because they contribute more to the community, e.g. because they look after their homes and gardens better and are more engaged in community issues (this is an example of an externality; empirical evidence suggests that it exists but it may not be particularly strong).

The first of these goals is probably the most important. But there is a problem in pursuing this goal purely through home ownership initiatives in that the most vulnerable groups in the community for access to housing are people who are not in a position to become home owners. To say that "home ownership" is a desirable public policy goal and then subsidising it is a bit like saying that "people being rich" is a desirable public policy goal and then subsidising being rich. Accordingly, we have not adopted "home ownership" in our list of tax design criteria.

It is common as well to hear assertions about the impact of government policies on **competitiveness**. When one considers the circumstances of an individual business, competitiveness has a fairly clear meaning. For a South Australian business trading out of the State, its competitiveness will improve when its cost structure improves relative to its out-of-State competitors and the opposite when there is a relative deterioration in its cost structure. An improvement in competitiveness might be brought about by favourable movements in input prices, reductions in the taxes paid by the business (net of subsidies) or increases in productivity. If we extend this perspective to the aggregate, the State's competitiveness is enhanced by driving down costs. But these costs include wages, which are one of the main sources of household incomes in the State. Driving down real incomes in the State might increase competitiveness, but ultimately the attainment of high average real incomes, which aligns with efficiency, would seem the more relevant objective.

4.3   A broad-based flat-rate land tax

A broad-based flat-rate land tax—a land tax at a flat rate with no exemptions, referred to as 'broad-based land tax' hereafter—is the gold standard efficient tax. A broad-based land tax will be broadly neutral for vertical equity. Once established it is also neutral for horizontal equity, because future land tax liabilities are factored into land prices.

Efficiency

A land tax has administrative costs in that the tax authority needs to maintain a current register of land valuations (or draw on one maintained by somebody else), it needs to issue assessments, and process payments and pursue non-payers. With a broad based structure, the costs that arise when decisions need to be made about whether particular land owners qualify for exemptions or concessional treatments do not arise because there are none. There are substantial economies of scale in these administration costs, so that they will be relatively large (relative to the revenue yield) at low rates of tax and relatively small at high rates of tax.

Compliance costs are kept down by a broad-based design because in the absence of exemptions or concessions the taxpayers has no need to document or establish her status and the compliance costs thus are just the transaction costs of paying the assessed tax. Again, the compliance cost per dollar of revenue will fall as the tax rate is increased.

The economic incidence of a broad based land tax will lie entirely on landowners and will not fall onto land users at all. The reason for this is that land is in fixed supply. With land allocated to its 'best' uses, sometimes with owner-occupiers and sometimes with tenants as occupants under rental arrangements, the landowner can extract a gross rent equal to the value in use of the land. The land owner's net rent is then equal to the gross return less land tax, and any change in land tax thus is associated with a dollar-for-dollar change in the land owner's net rent. The prices that potential purchasers of land will be willing to pay will depend on the expected future stream of net rents and their own required rates of return. As their required rates of return are independent of land tax rates, any changes in the outlook for land taxes will flow directly into the outlook for net land rents and thus into land prices. The economic incidence of the broad-based land tax falls directly on market values and entirely on the owner.[9]

A broad-based land tax gives rise to no excess burdens and is in this sense a highly efficient tax. With a land tax in place, the incidence of the land tax is on the owner and is independent of land use, so the land tax does not distort land use decisions. And because the land tax rate is the same regardless of who the owner is (or his characteristics) it does not distort the pattern of ownership. Land is allocated to the owner who is able to fulfil the ownership role at lowest cost—with landowners varying in the costs of fulfilling that role by virtue of differences in their knowledge and expertise, access to economies of scale, risk management capabilities, etc.

Because land is in fixed supply, the quantity of land supplied cannot be distorted. Changes in land tax diminish owner returns, but not the quantity supplied. This is in contrast to, say, changes in taxes on labour or taxes on fixed capital: if taxes on labour are high workers may choose to locate elsewhere and if taxes on the returns to fixed capital are high investors may choose to locate fixed capital elsewhere. While an individual owner may sell and 'leave the state', land cannot leave the state. There must be a purchaser for the sale to proceed and thus the seller is replaced by an alternative owner.

Equity

Land prices are equal to the discounted present value of anticipated gross rents less the discounted present value of anticipated future land taxes, thus the purchaser of land has the likely future land tax payments netted out of the price that she pays. Since anticipated future land taxes are capitalised out, it is not meaningful to talk about vertical equity aspects of these taxes, even if some correlation can be established with income. And for the same reason it is not meaningful to talk about horizontal inequities between like individuals who differ only in their land ownership choices.

The situation is more complicated when policy moves away from the anticipated path of land taxes. Departures from the anticipated path of land tax will give rise to windfall gains and losses to landowners, and these may impact on vertical and horizontal equity. For example, reducing land taxes below the levels that were anticipated when property was bought would deliver a windfall gain to owners of property and no gain to otherwise identical individuals who do not own property, thus generating a horizontal inequity. The opposite would be true for an unanticipated increase in taxes. These considerations illustrate as well that if policymakers

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9   There may on occasion be contractual arrangements which pass changes in land tax on to tenants after the event. But in a forward-looking negotiation, tenants will seek to pay no more than the marginal value of the land and the landowner will seek set rent to extract the tenant's marginal valuation, thus we expect gross rent to be equal to a forward-looking marginal valuation. Since marginal valuations are invariant to the land tax, the gross rent will also be invariant to the valuation.

adopted a principle of never implementing reforms that have any degree of horizontal inequity, then it would never be possible to do policy reform.[10]

It should be kept in mind that while governments raise land taxes with impacts on land owners, they also provide services and infrastructure that benefit land prices. Land in eastern Adelaide has far higher prices than land n sparsely populated rural areas. This reflects high population density and a concentration of economic activity in Adelaide, but that situation could not exist without the substantial activities of government in providing essential infrastructure and services. When thinking about the equity of levying a land tax one should also have a mind to the substantial government interventions supported by land tax that create land value.

4.4 South Australia's land tax

South Australia's land tax departs from the broad-based flat-rate case in two significant ways. Firstly, the tax is discriminatory on land use, and secondly it is discriminatory on owner characteristics. There is some entanglement between the two, but we will deal with them separately first and then make some comments regarding the interplay between them.

Land use distortions

South Australia's land tax discriminates on land use in three important respects:

- a substantial proportion of land used for housing—the owner-occupied component—is exempt;

- land used for primary production by (in effect) owner-operator farmers is exempt; and

- exemptions are available for land used in a range of 'community service' activities, including education, health, religion, assistance to the needy, various associations providing community recreational activities, etc.

The economic incidence of the discriminatory land tax is that it provides a subsidy to activities which are land-tax exempt and a tax penalty for non-exempt activities. The average rate of land tax will tend to fall on landowners, but the economic incidence of the usage-specific subsidies and tax penalties will fall on the activities to which they apply. This will be true because users of land buy it in the same market, whether as purchasers or tenants, and vendors will have no reason to accept different land prices or net rents to compensate for tax rate differences. Land tax exemptions that apply to housing, primary production and community service uses are effectively subsidises while activities like retail, offices, warehousing, heavy industry, etc. are effectively taxed.[11]

Non-neutralities in the land tax tend to distort patterns of land use. This is because the tax wedge between exempt and non-exempt activities will sometimes make it possible for exempt activities to bid successfully for land when, in the absence of the tax wedge, they would not be the winning bidder. Examples of distortions arising from the land-use discriminations in the South Australian land tax include:

a) Primary production exemptions have the potential to distort land use away from building (say) a factory to lower-valued grazing activity. However, we might suspect that distortions of this type are not on a large scale.

b) Distortions tend to be large when there are different tax treatments for activities that are strong substitutes for each other—e.g. if land was exempt when used to grow crops but not when used to run livestock. And distortions tend to be smaller when tax treatments differ across complementary activities, e.g. if land used for grain growing was exempt but land used for silos was taxable there might not be much impact on the amount of land used for silos.

c) Land used for retailing might also be used for housing, but retail services and housing have a degree of complementarity which would tend to attenuate the distortions to land use that are created by the different tax treatments. But once one takes into account the presence of online retailing the story is more complicated: the land tax drives retailing away from service modes with high land tax (malls, high streets) to service modes with low tax (online retailers with warehouses on cheap land in regional areas or at urban fringes).

Distortions to land use impose efficiency costs on the economy. This is so because under a distortion the market allocates land to exempt uses even when the value-in-use for the exempt activity is lower than the value-in-use for a non-exempt activity. But while there is a clear in-principle argument that distortions arise

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[10]   In principle, efficient reforms should generate net gains and thus create a situation where it is possible for winners from reform to compensate losers from reform. But in practice it is never possible to identify exactly what the gains and losses from reform are at an individual level, and in addition there are transaction costs in setting up a scheme of compensation payments. Policy reforms that are beneficial in the aggregate will usually hurt somebody, and practical policy design is likely to focus on assisting those who suffer large impacts, but leaving those who suffer small losses from reform to absorb them.

[11]   Some commentators have objected to describing land tax exemptions as "subsidies", arguing that not being taxed is not the same thing as being subsidised. This argument makes sense when one thinks only of the statutory incidence of land tax. But when one considers the economic incidence of land tax and the non-neutral treatments embedded in it, then it is meaningful to speak of "subsidies" to favoured land uses and "tax penalties" to non-favoured uses.

from tax wedges, and that there are efficiency costs associated with them, it is unclear how large those efficiency costs are. That will depend on how much the tax system discriminates between activities and how much it changes patterns of land use. Other things equal, tax distortions that cause only "small" changes to the pattern of land use will have small efficiency costs, while tax distortions that cause "large" changes to the pattern of land use will have large efficiency costs.

There are myriad land use choices that may be affected by non-neutral tax treatments. To estimate the distortions arising from a non-neutral land tax and the associated efficiency costs, a comprehensive quantitative assessment using a computable general equilibrium model would be needed. Partial equilibrium analyses may give an indication of impacts, but one needs to be careful not to omit important feedbacks through other markets.

The exemptions for favoured land uses have varying and sometimes unclear implications for tax progressivity (against income). Most significant is the different land tax treatments of housing provided through owner-occupiers and through landlords. To some extent—probably a substantial extent—the economic incidence of land tax on investors in rental housing will be on renters, whereas owner-occupiers get the benefit of a tax concession (effectively a subsidy to their costs). This would appear to be regressive as renters on average have lower incomes than owner-occupiers. In contrast, the availability of an exemption for a homeless shelter may well be progressive, as it diminishes the cost of servicing a poor group within the community. Even if land use exemptions have some implications for progressivity, the correlation is likely to be weak, and land use exemptions are a poor mechanism to pursue income distribution objectives.

Exemptions for community service activities may be targeted both at providing support for the disadvantaged and at functions which benefit the community more broadly. Providing support for the disadvantaged is likely to be supportive of vertical equity. The provision of services with broad relevance to the community will not enhance vertical equity but it is not necessarily harmful to it.

If tax concessions to community service organisations are intended to operate as a subsidy to their activities they may not be ideal for the purpose. A direct subsidy to the relevant organisation in respect of the service provided, and removal of land tax exemption, would avoid a potential bias in the organisation's input mix, whereas land tax exemption tends to encourage overuse of land. However, in some cases the administrative difficulties around establishing an appropriate set of output subsidies would be large, and if so the land tax exemption may be a reasonable second-best compromise.[12]

Ownership distortions

South Australia's land tax discriminates with respect to land ownership in the following respects:

• land used for housing is tax exempt when owned by its occupier but liable to tax when owned by somebody other than the occupier; and

• land used for primary production is tax exempt when it is used by a natural person who is the owner-operator of the farm enterprise on the land (roughly speaking) but liable to tax otherwise, for example when owned by a widely held corporation;

• the tax rate payable on taxable land varies with the aggregate value of the owners land holdings.

These preferential tax treatments have the potential to distort ownership structures. Distortions of this type are probably of a greater magnitude than the distortions arising from differing tax treatments by land use.

First, we illustrate with reference to the allocation of land between owner-occupied housing and rental housing. Land used for owner-occupied housing is exempt whereas land used for rental housing is not. Suppose that a house has a value-in-use of $25,000 per annum to a potential owner occupier, and a potential value in use of $30,000 per annum to a potential renter. However, a landlord who purchases the land and lets it to the renter is subject to a land tax of $10,000. If an investor bought the property and let it to the would-be renter it could earn a gross rent of $30,000, pay the land tax of $10,000, and be left with a net return of $20,000. But the owner-occupier, with a valuation of $20,000, can outbid the potential renter. In that case the market allocates the land to the owner-occupier with the valuation of $20,000 ahead of the would-be tenant who had a valuation of $25,000. This is a form of inefficiency, and it is brought about by the non-neutral structure of the land tax.

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12   To see why, consider the circumstances of a school in Kensington and a school in Kingscote, each with an oval. The land tax exemption might mean that a school oval in Kensington receives a concession of (say) $100,000 whereas a school oval in Kingscote receives a concession of (say) $20,000 as a result of lower land values. If the schools were subject to land tax, the school in Kensington might find that its bill was large enough to find a way to share an oval with another organisation, whereas the school in Kingston might not, and these would be efficient outcomes. But deciding on a set of output subsidies could be problematic. Should all schools receive an equal subsidy towards sporting ovals, in which case schools in areas with high land costs would be disadvantaged relative to schools in areas with low land costs? Or should the subsidies be adjusted to allow for different land costs? Issues such as this would need to be addressed if it were decided to shift from a system that supports community organisations through land tax exemptions to a system that supports them through output subsidies.

Secondly, land tax exemptions for owner-operated primary production land undermine the development of large-scale corporate agricultural enterprises with the economies of scale that attend them.

Thirdly, the application of a sliding rate scale generates potential inefficiencies in that:

- the sliding rate induces owners to fragment their land holdings but this comes at a cost—e.g. legal fees, inefficient management structures; and
- the rate structure induces an inefficient pattern of ownership, encouraging the holding of land by small investors instead of large investors, even when the returns that small investors can generate from the land are larger than the returns that large investors can realise.

An important practical implication of the sliding rate scale in application to rental housing is that it significantly disadvantages the establishment of large multi-unit medium density residential buildings. The Henry Review noted that the administrative system that favoured the aggregation of land holding for tax purposes was to introduce a bias "against large investments in residential property" (because) the much larger share of rent that land tax represents places large investors at a significant competitive disadvantage" (p262) with the result that the land/housing development market tends to be distorted toward housing arrangements that suit small investors. Large medium density developments cannot be fragmented to avoid high marginal rates at the top of the rate scale but housing in the form of single-dwelling allotments can be. The Henry Review concluded that progressive rate structures applied in the Australian States' land tax regimes discourage large-scale investment in land, particularly for rental housing.

The sliding rate scale in application to taxable primary production land will tend to encourage the holding of land by small investors such as hobby-farmers instead of large investors who have economies of scale and can generate greater returns.

To examine the progressivity of the sliding rate scale, we compare it against a revenue-equivalent flat rate land tax on taxable land. If we compare natural persons who own land, it is probably true that the owners of large holdings will tend to have higher incomes than owners with small holdings. From this point of view the tax may have a mildly progressive character, although is it a very imprecise mechanism to introduce capacity-to-pay considerations into the tax system. But if we consider as well the presence of widely held investment vehicles, such as super funds, these entities by their size will tend to have large holdings and pay high rates of land tax. But their membership is drawn from across the income distribution more broadly, and the sliding rate scale thus produces the result that the landholding entities pay high rates of tax for some beneficial owners whose incomes are low. Widely held investment vehicles are not 'mums and dads', but mums and dads have a stake in widely held investment vehicles and their interests are no less important than the interest of mums and dads with direct property holdings. We conclude that the sliding rate land tax scale cannot be rationalised on the ground of delivering a more equitable distribution of the tax burden across those with high and low incomes. It achieves little for progressivity and has many random side effects for the income distribution.

The differing treatments of owner-occupiers and rental housing is potentially horizontally iniquitous. Owner-occupiers and investors face the same price in the market for the purchase of housing, so the land tax paid by the investor will have its economic incidence either on the investor or on tenants. We can expect that the average rate of land tax might fall on renters. And departures from that average rate of land tax arising from the progressive rate scale would tend to accrue to investors, so that investors with a below average rate of land tax would have their rates of return boosted and the opposite for those with an above average land tax rate. There are thus horizontal inequities of two types: a horizontal inequity between renters, who are forced to carry the cost of land tax, and owner-occupiers; and a horizontal inequity between different investor groups, with those having small land holdings getting a concession from the average tax rate and the opposite for those with large land holdings. Adopting a flat rate structure would remove the horizontal inequity between investors. Removing the inequity between owner-occupiers and renters of PPRs would require taxing both types of occupiers the same, which mean both being taxable or neither being taxable.

Interaction between land use and ownership distortions
The degree of distortion to land ownership patterns from the sliding rate structure is likely to vary across land uses. It will also depend on the impact of aggregation measures (see below).

There will be limited capacity to break up land parcels used for major industrial, retail and commercial developments into small ownerships that can access lower average rates of tax. Gross returns on activities of this type will therefore need to be higher so as to meet the higher rate of land tax while still delivering the market net rent.

In contrast, the potential to fragment holdings of land used for rental properties is much greater. Free-standing houses on land holdings worth a few hundred thousand dollars are the predominant form of rental housing in South Australia, and the sliding rate creates incentives to hold these investments in ways that avoid aggregation. As a result, average tax rates on rental housing will tend to be lower than average tax rates on industrial, retail and commercial developments. And gross returns on land used for rental housing will also therefore be lower than gross returns on land used for industrial, retail and commercial.

Midnight 30 June assessment point

Land tax liability is determined according to land use and ownership at midnight on 30 June and is assessed for the whole financial year. And although there are some concessions available to allow for a change in circumstances during the financial year, these are not comprehensive. The use of a 30 June determination date may distort the timing of landowners' decisions. Where a change of ownership or a change of land use is in prospect, there is an incentive to adjust the timing to minimise land tax liability. A specific example of this arises in the development of residential allotments. When developers install physical infrastructure and incur legal and other costs in subdividing land to form marketable allotments, their expenditures trigger an increase in the assessed value of the land. This is at odds with the spirit of land tax as a tax on unimproved land value, and introduces potential distortions to developer decisions. One example of the distortions is that it creates an incentive for developers to activities in the lead up to June 30 and push them back into July to avoid land tax impacts.

Aggregation measures

In concept we can think of aggregation measures having varying intensity:

a) Least powerful would be a scheme with no aggregation, i.e. each parcel of land treated as a standalone entity in its own right. In this case the sliding rate scale would create an incentive to break land into small parcels to reduce the average tax rate. The sliding rate scale distorts the size of land holdings, inducing a sub-optimal structure of land parcels with an associated efficiency loss.

b) Somewhat more powerful would be a scheme like that which is presently in force in South Australia, which aggregates based on legal ownership. This removes the incentive for a legal owner to break its land holdings into small parcels and mitigates the associated inefficiency. But it introduces an incentive to fragment ownership across different legal entities to reduce average rates of land tax, introducing a new inefficiency. The balance of the two effects is an empirical issue and cannot be deduced from principles.

c) More powerful still is the scheme proposed for South Australia, which seeks to aggregate based on beneficial ownership for narrowly held ownerships. To the extent that assessment based on beneficial ownership reduces incentives to create artificial legal structures a source of inefficiency is mitigated. But there is now an intensified incentive to fragment beneficial ownership, e.g. having more property investors with small holdings, and there are potential inefficiencies associated with this. Again, the balance of the two effects is an empirical issue and cannot be deduced from principles.

d) The most powerful scheme would be one which aggregates based on beneficial ownership taking into account all ownerships. For widely held vehicles—pooled superannuation funds, widely held unit trusts, investments by publicly listed companies—it is administratively impractical to attribute beneficial ownership.

In each of these cases we have identified potential distortions to the structure of land ownership from aggregation. This is not to say that all ownership structures are chosen with the objective of minimising tax. The choice of ownership structure for a piece of land will reflect a variety of factors including: the management of risk, access to finance, the merits of collaboration between different people and individuals in developing and using the land, and tax treatments.

In the cases (a) to (c) above there are some land holdings which are not allocated to ultimate beneficial owners for aggregation. This raises the possibility that ownership structures which avoid taxation will be appealing to land holders. One way to minimise this is to increase land tax rates on forms of ownership which cannot be captured effectively in the aggregation mechanism; the higher the tax rate applied the greater is the incentive to shift into ownerships which do face aggregation. New South Wales applies a flat 1.6 per cent rate to land held in certain trusts, which is equal to or greater than the marginal tax rate on holdings up to $4.2 million. Thus the flat rate effectively wipes out any incentive to restructure a holding worth less than $4.2 million for land tax minimisation. Victoria imposes a surcharge on the lower marginal land tax rates for land held in trusts, but they are apparently still widely used, which would suggest that the penalty is not very powerful.

Empirical assessments

There have been a number of studies of the efficiency costs of land tax in Australia but, to our knowledge, no investigation of South Australia specifically. These include:

- In a study prepared for the Henry Tax Review, KPMG Econtech (2010) estimated that the marginal excess burden of land taxation in Australia is 8 per cent—i.e. for every $100 raised by revenue offices from land owners there is an additional $8 in distortion costs imposed on the economy. The average excess burden is 6 per cent. These excess burdens are entirely due to uneven application of land tax, as a broad-based land tax would have zero excess burden. KPMG Econtech goes on to qualify its results in that its coverage of land-tax related distortions is incomplete: it does not directly model the implications of progressive rate structures, its model is not sufficiently detailed to capture some potential distortions to land use, and it does not allow for some land-use substitutions that could occur.

- Murphy (2016) reports a much higher marginal excess burden of 48 per cent. This is a surprisingly high estimate. It is driven by different average rates of land tax across industries, and it would appear therefore to rely on the assumption that the allocation of land between, on the one hand, housing and primary production and, on the other hand, use in other industries where it is subject to land tax is quite sensitive to the land tax.

- Nassios et al (2019) model the State and national implications of land taxation in New South Wales. They incorporate industries providing low-density and high-density dwellings, with each of these industries then producing the two distinct goods 'owner-occupied housing' and 'rental housing'. A choice model then captures households' choices between owner-occupied and rental tenures, and tenure-based differences in land tax rates affect the choice. The authors find that the NSW land tax has a (national) marginal excess burden of 8 per cent, but the marginal excess burden of land tax on dwellings in isolation is 25 per cent, reflecting the distortions engendered by the owner-occupier exemption.

4.6 Design conclusions

A broad-based flat-rate land tax has a number of appealing features for a Government whose objective is to design a tax system that supports prosperity while securing the funding that it needs to deliver infrastructure and public services. It is not a particularly effective mechanism to promote an equitable distribution of the fruits of prosperity, but if implemented in an equitable way it need not be harmful to achieving equity goals. The pursuit of distributive goals is probably best left to the income tax-transfer system rather than pursued through a land tax that is poorly suited to the task.

It is a failing of the design of the South Australian land tax (and the land taxes in most other States) that the land tax base is narrow, the efficiency of the tax is compromised by exemptions and exclusions, and there are administrative and compliance cost impacts that follow from this. Taxes on owners of rental residential property will in the main be passed on to tenants with adverse equity consequences. The idiosyncrasies of the tax design distort land use, land ownership and the timing of land development and transactions in land.

All the forgoing would suggest the need and the potential benefit of comprehensive reform to land tax including broadening the base of land tax and flattening the rate scale. This could be done in a revenue neutral way. Or it could be done in a revenue-positive way with the proceeds use to remove inefficient taxes such as stamp duty on conveyances. Potential reforms are discussed further in Section 6.

5. Impact of the Aggregation Measures

Our brief is to investigate the potential impact of aggregation on the development sector. In thinking about these impacts it helps to make the conceptual distinction between the passive activity of holding land inventories for later development (or application in other uses) and development activity, which includes both making improvements to land in advance of construction and the construction of buildings on developed land. Of course some developers will be engaged in more than just one of these activities, e.g. holding land inventories and then developing them.

In this section we discuss potential impacts of the aggregation measures on land values—which is particularly relevant for holders of land inventories—and impacts on providers of land development and subsequent construction services. Our discussion is qualitative in nature, supported by limited 'back of the envelope' calculations which are intended to illustrate potential magnitudes of effect. We have not carried out comprehensive whole-of-economy modelling,

5.1 Impact on Land Values

We proposed previously that land values can usefully be understood as the capitalised value of (expected) future net rents. Consistent with this model, changes in land tax and the fiscal regime more broadly will impact on land values via their impact on expected future net rents. (Land values will also depend on the discount rates that potential investors apply to net rental streams but it seems reasonable to regard these as independent of the land tax regime.) From this perspective, we assess the impacts of policy changes on land values by assessing their impacts on net rents.

An increase in land tax collected will, by itself, reduce net rents in the hands of land owners by the amount of the land tax collected. But this is only part of the story. In the absence of the land tax collected, the Government would need to make compensating adjustments elsewhere in its budget, either increasing other revenues, reducing spending, or pushing the budget in a deficit direction. Adjustments of this type would tend to push down gross rents and, with land tax unchanged, push down net rents. The following examples illustrate the point:

a) If payroll tax were increased to balance the budget, even in the absence of any employment or wage adjustments there would be a squeeze on the profitability of employers. Some employers would no longer be viable and they would cease to use property and the land under it. The demand for land would be reduced and to bring the market for land into equilibrium it would be necessary to drive down gross rents.

b) If expenditure on, say, school education was cut to balance the budget then the incomes of people who work for and sell services to the school sector would be reduced. They would need to adjust their spending patterns, including by reducing their outlays on goods and services that are produced with land. This would flow on to a reduced demand for land and lower gross rents.

Whatever the budgetary adjustment that was made, the quantity of land used in the economy would stay the same—for land is in fixed supply—but gross rents would in most scenarios be driven down and, as a result, net rents would be driven down.

When we take a whole-of-budget perspective on the impacts of increased land tax revenues from land tax aggregation, we see that our view of the impact of land tax on expected future net rents—and thus land values—is heavily dependent on the counterfactual scenario in which land tax aggregation does not go ahead. In the scenarios when it does not go ahead, the other adjustments in the budget that are required in its absence will tend to reduce gross rents and thus net rents. Consistent with this, it is highly unlikely that the aggregation reforms will reduce expected future net rents by as much as $40 million per year. It is even possible that there are some counterfactual budget scenarios that reduce rents by more than $40 million per year. It is distinctly possible for instance that, after allowing long-run adjustments to take place, the budgetary strategy of securing an additional $40 million per year from an increased payroll tax rate or stamp duties might actually have more negative impacts on net rents than the aggregation measures.

We will conclude this discussion by considering land value impacts in a 'worst case' scenario: the case in which the counterfactual budget scenario is one with no impact on gross and net rents. In this case then on the Budget estimates the aggregation measures do indeed diminish net rents by $40 million relative to the counterfactual. What then would the impact on land values be? We have not carried out detailed modelling that would allow for the economy to adjust fully to the new tax structure, but we take as an illustrative scenario the scenario in which all of the extra revenue comes from investors in residential property. The ABS reports that the total value of land in residential use in South Australia was $248.6 billion in 2017/18. If the real net return on land were 4 per cent that would imply about $10 billion per year in net rent. If this were decreased

by $40 million then net rent would be reduced by 0.4 per cent. If this reduction applied to expected future net rents throughout time, the effect would be to reduce residential land prices by 0.4 per cent.

Our conclusion is that the changes to aggregation will have very small impacts on land prices, if any. Even in a worst case scenario land prices are unlikely to be reduced by as much as 1 per cent. And it is entirely possible that aggregation is better for land prices than some of the budgetary adjustments that might be made in the absence of aggregation revenue, e.g. an increase to the payroll tax rate.

5.2 Impacts on the Development Sector

The development sector holds land both to prepare it for development (installation of basic infrastructure, siteworks, legal preparations such as establishing zoning and creation of titles, etc.) and also while it develops buildings on the land. These activities are not exempt from land tax and therefore the application of the land tax has implications for developers' costs.

The new aggregation measures are likely to increase average rates of land tax to parts of the development sector. Particularly affected will be those developers who have multiple small projects which are not aggregated under the current rules, but which will be aggregated under the reforms. This is particularly relevant to developers of residential allotments and also has some relevance for speculative building of detached dwellings. The changes to aggregation may have less impact on projects that have large sites such as major commercial and developments and also for large residential apartment developments for those projects will already tend to be in the higher land tax brackets.

Developers that are involved in the purchase of greenfield sites for subdivision to residential allotments typically work on several projects. If the land holdings in these projects aggregated the aggregate site values for developers would commonly be large enough to put them in the top tax land tax bracket. However, it is industry practice to hold projects in distinct legal entities. This is done for a variety of reasons which may include tax minimisation but also objectives such as establishing limited liability on distinct projects and establishing "joint venture" arrangements suitable to the circumstances of the project. Whatever the motivations, the effect of separating projects is that average land tax rates on projects are lower than they would be under a more forceful aggregation regime such as the one proposed in the Budget.

The impact on average tax rates from the proposed aggregation measures will vary from project to project and from developer to developer. The examples in Table 3.2 illustrate that a developer holding four projects with $500,000 of land in each would, under a disaggregated treatment, face a land tax bill of $2,100 across the four projects but would, under an aggregated treatment, face a land tax bill of $39,070.

The increase in average land tax rates will tend to discourage developers from purchasing and holding greenfield sites in anticipation of development at a later date. There will be an increased emphasis on 'just in time' acquisitions of land. This dynamic may be reinforced by the operation of PPL exemptions, because developers in many instances would not satisfy the criteria for land tax exemption even if they use their land holdings for primary production (e.g. under lease arrangements with farmers). However, just-in-time acquisitions are not as straightforward as they sound, for many land parcels are offered for sale quite infrequently and, as a consequence, developers sometimes acquire land some years in advance of converting it to residential allotments. There will also be a pressure on developers to sell allotments to end users more rapidly, and thus to reduce their land tax liabilities.

The aggregation reforms are likely to prompt some rearrangement of the structure of activity in the development sector. We can expect to see increased activity from entities that are eligible for lower average tax rates at the expense of entities whose tax rates are increased by the new aggregation measures. Thus aggregation reforms will disadvantage medium-sized developers with several projects relative to small developers with one or two projects. (The South Australian does not in the main have developers that would be called large by Australian standards.) The reforms will tend to increase the difference between the average tax rates faced by medium and small developers. The expansion of the tax wedge will tend to shift activity to smaller developers who have higher costs as a result of their lack of economies of scale, access to capital, risk management, etc. This is an inefficient outcome. It is not known how large the induced distortion will be.

While restructuring of ownerships within the sector will attenuate the impacts of the new arrangements on average tax rates, it is implicit in the estimated $40 million revenue impact that there will be an increase in average land tax rates. The impact on developer cost structures will vary widely depending on the circumstances of the project and the developer. But if the average land tax went from 0.5 per cent to 2.5 per cent on a project to develop residential sites, with the sites being held by the developer for one year at an average site value of $150,000, there would be an extra $3,000 of land tax payable per allotment.

When average tax rates go up, developers will need to pass them on. The development sector is competitive and as such operates only on 'normal' profit margins which leave no room to absorb extra costs. Any extra costs will therefore need to be passed forward to purchasers of developed land or back to the suppliers of undeveloped land for development. The question of where the economic incidence of such a tax change would fall is complicated and a meaningful empirical estimate would require use of a well-specified computable general equilibrium model.

While the cost impacts of aggregation changes on the development sector will need to be passed in to the community, the overall impacts on competitiveness of the State are likely to be small if indeed there are any. The use of less efficient taxes to adjust to the GST-related budget shortfall, such as increases in payroll taxes or stamp duties, would almost certainly have worse effects. It is probable the complexion of activity related to land use will vary under aggregation, however the overall activity in South Australia will not. For every seller who liquidates their South Australian land holdings, there must be a buyer. Whoever is left holding the land has a commercial interest in allocating the land to its most valuable use, and this is true both before and after any aggregation changes.

6. Reform Options

Here we discuss the pros and cons of a number of possible reforms to the land tax arrangements.

6.1 The average (effective) rate of land tax

One key area for reform is to adjust average rates down or up to change the amount of land tax revenue flowing into the Budget. Any decision of this type is tied in with decisions about what services and infrastructure the Government will provide and how much it will rely on other revenue sources available to it.

In this context, we note that the eventual reduction in the top marginal tax rate to 2.9 per cent will decrease tax revenue by about $20 million dollars per year. However, the aggregation changes are expected to boost revenues by about $40 million per year. And in addition the revaluation work of the Valuer-General will further boost revenues. These influences taken as a package will increase effective average tax rates on land in 2020/21.

There is no firm basis to say that land tax revenues across the board in South Australia are either too high or too low. In an economy that has private ownership of land, it would clearly be problematic to set land tax at a rate that extracted a tax payment larger than the gross rent that the owner can secure in the market. We cannot directly observe that achievable gross rent, but when the tax rate is pushing up to or even above 4 per cent the net return to landowners starts to look quite thin, which may not be entirely compatible with a private ownership model.

6.2 The structure of land tax

The structure of land tax is likely to be improved by shifting it towards a broad-based flat-rate structure. This need not preclude different rates in rural versus urban areas but a move to a closer-to-neutral system in respect of land use and especially ownership structures would be beneficial. Key measures include:

a)   inclusion of land used for owner-occupied housing (expand the revenue base);

b)   land tax rate to be independent of the characteristics of the landowner, requiring a flattening of the rate scale and less exemptions; and

c)   possibly accompanied by the phased abolition of stamp duty on conveyances.

Below we suggest a range of reforms to land tax that might be considered, and Table 6.1 summarises their likely impacts on government revenue, administration and compliance costs, cost of distortions, vertical equity and horizontal equity. We make no observations on political feasibility. Although some reforms listed here are alternatives to each other, others are complementary, and could be combined in a modular way, thus reducing budgetary impacts and impacts on particular stakeholders.

Removing exemptions

A)   End the land tax exemption for owner-occupied principal places of residence.

There would be a large increase in revenue if this change were introduced with land tax rates fixed. Ending the PPR exemption would increase administrative costs in that more assessment notices would need to be sent, but there would also be administrative cost savings in that it would no longer be necessary to make determinations about eligibility for exemption of residential land. There would be an increase in compliance costs in that more landowners would be liable for land tax but on the other hand there would be less costs in the form of establishing eligibility for exemptions, rearranging affairs, etc. Costly distortions to the structure of land ownership would be reduced. Because the incidence of the tax premium for rental property falls substantially on renters, and because they tend have lower incomes, the reform would be progressive. Horizontal equity would be enhanced because the tax advantage of owner-occupier versus renter housing tenures would be reduced.

B)   Extend the land tax exemption to rented principal places of residence.

There would be a substantial revenue cost. It might be desirable to ensure that the exemption went to PPRs but not second homes and vacant homes. There is a question as to whether the landlord would claim exemption or whether a rebate would be paid to the tenant. The administrative costs might be higher than in (A) as there would still be eligibility assessments to make and possibly a claim and rebate process. The reduction in distortion costs and impacts on vertical and horizontal equity would be similar to (A).

C)   End the land tax exemption for primary production land. Large increase in revenue with land tax rates fixed. Ending the owner-operator PPL exemption would increase administrative costs in that more assessment notices would need to be sent, but there would also be administrative cost savings in that it would no longer be necessary to make determinations about eligibility for exemption. There would be

an increase in compliance costs in that more landowners would be liable for land tax but on the other hand there would be less costs in the form of establishing eligibility for exemptions, rearranging affairs, etc. Costly distortions to the structure of land ownership would be reduced and in particular the changes would facilitate the establishment of larger primary production enterprises with attendant economies of scale. Limited impacts on progressivity and horizontal equity. Could be combined with a geographically-differentiated tax (low rate in agricultural areas) to reduce the tax cost to landowners.

D)   End the land tax exemption for land used for community service purposes. Large increase in revenue with land tax rates fixed. But it would be necessary to recycle some or all of the revenue back to community organisations. The effect then would be to transition from an input subsidy (on land) to an output subsidy which would encourage more efficient land use decisions. Could be very difficult and costly administratively, at least it compensation were implemented. Negative for progressivity if people on low incomes draw more on the services of the organisations losing their tax-exempt status. Horizontal equity implications unclear.

E)   Review and if appropriate reform the eligibility criteria for non-PPR, non-PPL exemptions. The objective would be to ensure that exemptions are targeted appropriately, based on efficiency and equity objectives

Flattening the rate structure

F)   Replace the progressive rate structure with a uniform flat rate across land uses while preserving exemptions. Revenue impacts would depend on the rate chosen, but it could be implemented in a revenue neutral way. Administrative and compliance costs could be reduced moderately as there would no longer be varying tax rates for different landowners. While there would still be some distortion of land use away from taxable uses towards exempt use, there would be no distortions to taxable land use and no distortions to ownership of taxable land. Little implication for progressivity because taxable land ownership is only loosely correlated with income. Horizontal equity would be improved because the set of concessions against and penalties on average land tax rates that are implicit in the progressive rate structure would be abolished.

G)   Allow rate to vary across land use classes but introduce a flat rate for land tax within land use classes (residential, primary production, other taxable, etc.). This is similar to (F) with similar consequences, except that distortions to land use remain as a result of different tax rates. However, these distortions may not be large.

H)   Introduce geographically differentiated land tax rates e.g. as with Emergency Services Levy zonal differences. This would perhaps be of interest as an adjunct to ending exemptions on PPL. Inter-regional land tax variations need not impose significant administrative or compliance cost and are non-distorting. By setting rates low in rural areas, the effect of extending land tax to PPL could be diminished while still achieving efficiency and equity gains.

I)   Introduce a fixed charge. A number of other States have fixed charges. This would increase government revenue. If imposed on currently taxable landholders there would be minimal administrative and compliance costs. Some potential for inefficiency as the spike in land tax liability at the threshold for the fixed charge might distort decisions, but probably of limited consequence. Would have a discouraging effect on measures to avoid aggregation because disaggregated holdings would occur multiple fixed charges.

J)   Introduce aggregation reforms. These reforms only matter in the presence of a progressive rate structure. The reforms will increase government revenue, although over time there may be some disposals by landholders to reduce their holdings to smaller sizes, thus diminishing the revenue impact. There will be extra administration costs. Impacts on compliance costs are ambiguous: there are likely to be increased reporting costs but diminished expenditures on entities that avoid aggregation. Impact on costs of distortions also is ambiguous: on the one hand there is less incentive to use contrived ownership structures but on the other hand some economies of scale in ownership may be lost as landholders shrink portfolios. Neutral on vertical equity. Some enhancement to horizontal equity.

K)   Accelerate the scheduled reduction in the top land tax rate to achieve a 2.9 per cent rate in 2022-23. Comes at a cost to revenue. Little impact on administrative and compliance costs. Reduces distortions to ownership structures as it flattens the rate scale. Impacts on vertical equity unclear, because top rate landholders include not only—probably not even mainly—high wealth individuals but also widely held investment vehicles. Enhances horizontal equity.

L)   Reduce the top land tax rate below 2.9 per cent. As per (K) but with greater force.

M)   Raise the threshold at which the top rate cuts in. (This might be particularly relevant bundled with the aggregation reforms as it would provide partial relief to landowners who are facing a large rate increase hardest hit while still removing the anomalies that arise under aggregation.) Reduces revenue. Little impact on administrative and compliance costs. Probably neutral on distortions. Little impact on vertical equity and horizontal equity.

Period for calculating liability

N)   Introduce real-time treatment of exemptions instead of the current 'midnight 30 June' approach. When a piece of land transitions from taxable to non-taxable or vice versa during the year the exemption is awarded for the appropriate fraction of the year. The 30th June date coupled with full-year impact creates incentives to accelerate and delay some transactions and land use changes to minimise land tax liabilities. Given the planned reforms to the land tax databases to support aggregation it might be possible as well to move to real-time assessments.

O)   Introduce quarterly treatment of exemptions. This would be a halfway house between the current 'midnight 30 June' assessment basis and the real-time assessment basis in (N).

Other taxes

P)   Reduce or abolish stamp duties on conveyances. There would be a substantial sacrifice of revenue. Moderate (relative to revenue cost) savings in administrative and compliance costs. Large reduction in distortion costs. Neutral for vertical equity. Positive for horizontal equity because at present taxpayers who need to move and sell houses are treated more harshly than similar taxpayers who do not have to or do not move.

Factors relevant specifically to developers

Q)   Provide a land tax exemption for developers of residential allotments and buildings (possibly time limited). The likely incidence of this would be on the purchasers of residential allotments and new dwellings. It would avoid a situation in which the aggregation reforms boost the price of serviced, subdivided land.

R)   Exclude developer value-adding from land valuations. Developers add value to greenfield sites by adding physical infrastructure and also legal infrastructure in the form of new allotments with individual titles. This can triple the value of the greenfields site, and the Valuer-General flows this into higher land values on completion. This reform would come at a revenue cost. This would remove the distortion that arises from incentives to developers to delay the crystallisation of their activities into higher land prices. Neutral for progressivity. Enhances horizontal equity, removing the anomaly whereby a landholder who makes expenditures to subdivide land is then faced with a higher tax bill than another landholder who does not create allotments.

S)   Delay the flow through of developer value-adding into land values to the date of sale. If developer value-add is to be factored into assessable land values the uplift could be delayed to the sale of the allotment. Similar to (Q).

6.3   Pathways to reform

It is apparent from Section 6.2 that there is a number of interrelated potential reforms in the land tax space. The reform process is likely to be less disruptive to land owners and land users if the Government identifies a clear 'reform direction'. At present the Government has announced phased reductions in the top rate and a new aggregation approach. But, arguably, more should be done to take the land tax closer to the ideal of a uniform rate structure and to ensure that necessary departures from it are structured so as not to have too many unintended side effects. It would be useful if the Government were to set out its reform directions in a holistic way.

As part of articulating a holistic reform agenda, the Government should also think carefully about appropriate transition arrangements. Transitional arrangements allow market participants to adjust their activities to new tax arrangements without being negatively affected by surprise changes in the rules. A balance needs to be struck: overly long transitions are undesirable but this does not mean that no transition should be allowed.

The current changes to aggregation, for example, take effect with less than a year's notice, a short timeframe in which to sell out of property holdings that face sharply higher land tax bills. There are a number of mechanisms that Government could employ to 'phase in' any sharp increases in land tax bills, including:

A)   Delay the implementation of the aggregation reforms until the Valuer-General's Revaluation Initiative is complete.

B)   Limit the one-year increase in any owner's average rate of land tax to, say, 0.5 percentage points. For an owner with an existing average rate of 0.5 per cent, but facing an average rate of 2.0 per cent under the new aggregation arrangements, that the reforms would take their full effect over three years.

C)   Limit the one-year increase in the land tax payable in respect of a piece of land to, say, 33 per cent of the land tax applicable at normal rates. This would give a graduated phase-in of any tax increases resulting from the aggregation reforms and any sharp increases in assessed site values resulting from

the Revaluation Initiative. In the extreme case where the landowner was starting from a position of zero tax he would transition to fully-taxed over a three year period.

The structuring of transition arrangements is not an exact science. But transition arrangements are still useful. They make it possible to get to the desired reform endpoint but with a diminished extent of large unintended shocks to market participants who have structured their affairs according to existing rules and are adversely affected by changes to the rules.

Table 6.1 Possible land tax reforms and preliminary assessment of impact

Measure	Government revenue	Administrative and compliance costs	Costly distortions	Vertical equity	Horizontal equity
T) End PPR exemption	positive	unclear	decrease	strongly progressive	enhance
U) Extend PPR exemption to renters	negative	increase	decrease	strongly progressive	enhance
V) End exemption for PPL	positive	unclear	decrease	neutral	minimal
W) End exemption for community service with supplementation	neutral	increase	decrease	neutral	minimal
X) Review/reform community service exemptions	unclear	unclear	unclear	progressive	minimal
Y) Introduce uniform flat rate	possibly neutral	reduced	reduced	neutral or slightly regressive	enhance
Z) Introduce flat rate within land use classes	possibly neutral	reduced	reduced	neutral or slightly regressive	enhance
AA) Introduce geographically differentiated tax rates	possibly neutral	neutral	neutral	neutral	neutral
BB) Introduce a fixed charge for every non-exempt land holding	positive	increase	Possible increase	neutral	neutral
CC) Introduce aggregation reforms	positive	increase	decrease	neutral	enhance
DD) Reduce top rate faster	negative	nil	reduced	unclear	enhance
EE) Reduce top rate below 2.9%	negative	nil	reduced	unclear	enhance
FF) Increase threshold for top rate	negative	nil	minimal	neutral	neutral
GG) Real time application of exemptions	unclear	increase	reduced	neutral	Neutral
HH) Quarterly assessment	unclear	increase	reduced	neutral	neutral
II) Abolish stamp duty on conveyances of land	negative	moderate decrease	large reduction	neutral	enhance
JJ) Land tax exemption for developers	negative	unclear	unclear	neutral	neutral
KK) Exclude developer improvements from land valuations	negative	decrease	reduced	neutral	enhance
LL) Delay inclusion of developer improvements in land valuations	negative	decrease	reduced	neutral	enhance

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Appendix A   Interstate comparison of land tax regimes

Table A.1   Land Tax Comparisons

Tax	NSW	VIC	QLD	WA	SA	TAS	NT	ACT
Land Tax **Tax Scale:** Marginal rates apply to excess above the lower limit of the range unless explicitly specified.	The tax rate scale comprises 3 steps separated by 2 thresholds, which are indexed annually by the increase in the average unimproved value of NSW land over the previous three years. Tax scales for the 2017 and 2018 land tax years are: <u>2017 land tax year:</u> **$0-$549,000:** Nil, **$549,001– $3,357,000:** $100 + 1.6%, **Over $3,357,000:** $45,028 + 2.0%. <u>2018 land tax year:</u> **$0-$629,000:** Nil, **$629,001 – 3,846,000:** $100 + 1.6%, **Over $3,846,000:** $51,572+ 2.0%. <u>Foreign Landowner Land Tax Surcharge:</u> For the 2017 land tax year, surcharge land tax of 0.75 per cent applies to NSW residential land held by foreign persons. For the 2018 land tax year onwards, the surcharge is 2.0 per cent.	For 2017 land tax year- <u>General</u>: **Less than $250,000:** Nil, **$250,000-$599,999:** $275+0.20%, **$600,000-$999,999:** $975+0.50%, **$1,000,000-$1,799,999:** $2,975+0.80%, **$1,800,000-$2,999,999:** $9,375+1.30%, **$3,000,000 and over:** $24,975+2.25%. <u>Trusts</u>: **Less than $25,000:** Nil, **$25,000-$249,999:** $82+0.375%, **$250,000-$599,999:** $926+0.575%, **$600,000-$999,999:** $2,938+0.875%, **$1,000,000-$1,799,999:** $6,438+1.175%, **$1,800,000-$2,999,999:** $15,838+0.7614% (a), **$3,000,000 and over:** $24,975+2.25%. (a) Surcharge on trusts effectively phased out for land holdings valued above $1.8m; Above $3m, no surcharge applies. Since 1 July 2004 land tax has been payable on electricity transmission	For 2017-18 land tax year- <u>For resident individuals</u>: **Less than $600,000:** Nil, **$600,000 - $999,999:** $500+1%, **$1,000,000-$2,999,999:** $4,500+1.65%, **$3,000,000-$4,999,999:** $37,500+1.25%, **$5,000,000 and over:** $62,500+1.75%. <u>For Companies, trustees and absentee</u>: **Less than $350,000:** Nil, **$350,000-$2,249,999:** $1,450+1.70%, **$2,250,000-$4,999,999:** $33,750+1.50%, **$5,000,000 and over:** $75,000+2%. Absentee Surcharge **Less than $350,000** Nil **$350,000 and over** 1.5% of each dollar over $349,999	<u>**For 2016-17 land tax year-**</u> **$0-$300,000:** Nil, **$300,001-$420,000:** $300 **$420,001-$1,000,000:** 300+0.25%, **$1,00,001-$1,800,000:** $1,750+0.90%, **$1,800,001-$5,000,000:** $8,950+1.80%, **$5,000,001-$11,000,000:** $66,550+2.0%, **Over $11,000,000:** $186,550+2.67%. The <u>Metropolitan Region</u> Improvement Tax (MRIT) is levied on the unimproved value of land situated in the metropolitan region at ~~the rate of 0.14%~~ for land valued over $300,000. A 50% cap on annual growth in land value applies for land tax and MRIT purposes.	<u>For 2017-18 land tax Year-</u> **$0-$353,000** Nil, **$353,001-$647,000:** 0.50%, **$647,001-$941,000:** $1,470+1.65%, **$941,001-$1,176,000:** $6,321+2.40%, **Over $1,176,000:** $11,961+3.70%. From 1 July 2011, all tax thresholds are indexed annually in line with average site value increases as determined by the (South Australian) Valuer- General.	**$0-$24,999:** Nil, **$25,000-$349,999:** $50+0.55% above $25,000. **$350,000 or more:** $1,837.50+1.50% above $350,000.	Not imposed.	<u>For 2017-18</u> <u>Residential land tax</u> Composed of fixed charge and marginal rate of Average Unimproved Value. Tax applies per parcel with no aggregation. **Fixed charge:** $1,145, **$0-$150,000:** 0.50%, **$150,001-$275,000:** 0.60%, **$275,001-$2,000,000:** 1.08%, **Over $2,000,000:** 1.10%. <u>Commercial land tax</u> **Abolished from 1 July 2012.**

Tax	NSW	VIC	QLD	WA	SA	TAS	NT	ACT
Land Tax (continued):	There is no tax-free threshold for surcharge land tax. From the 2018 tax year, permanent residents will be exempt from surcharge land tax on their principal place of residence. Foreign-owned Australian-based developers are exempt, subject to conditions. Commercial-residential properties are also exempt.	easements (from 2007, the top rate was 5% instead of 2.25%). Absentee: 1.5% of site value in addition to any land tax payable. The Metropolitan Parks Charge is levied annually on all metropolitan properties via water bills. It is calculated by multiplying the property's 1990 Net Annual Valuation by a rate in the dollar. The minimum yearly Parks Charge in 2017-18 is $75.85.						
EXEMPTIONS:	Principal place of residence is exempt, except if owned or part owned by a special trust or company.	Exemption applies to the principal place of residence, except if owned by a company or by certain trusts.	Full exemption available for land owned by individuals who use it as a home and land owned by trusts where all beneficiaries of the trust use the land as their home. Partial exemption available where part of residence used for non-residential purposes. On and from midnight 30 June 2014, full exemption is available for land that does not receive a home exemption because the owner is in the process of selling their old home and moving into a new one, where appropriate conditions are met.	Principal places of residence are exempt except for those owned by companies and trusts.	Principal place of residence at 30 June exempt. A waiver or refund is also available in some circumstances where land becomes a principal place of residence after 30 June. Additional criteria apply where a business activity is conducted from the principal place of residence (full or partial exemption may apply). Extends to motels, hotels, services apartments and other similar accommodation (if conditions met). Purchasers of off the plan apartments between 22 June 2017 and 30 June 2018, who are eligible for a stamp duty off-the-plan concession, may be eligible for an exemption from land tax for up to five years from the date of settlement.	Principal residence land and primary production land charged a 0% land tax rate.	Nil.	All residential properties exempt apart from properties that are rented, owned by a company, or owned by a trustee. From 1 July 2018, principal place of residence exempt.

Tax	NSW	VIC	QLD	WA	SA	TAS	NT	ACT
Primary Production Land:	Exempt if rural/non-urban zoning, otherwise exempt subject to commerciality test.	Exempt with conditions.	Exempt to the extent it is used for primary production.	Exempt, if certain conditions are met.	Exempt, if certain conditions are met.	Charged a 0% land tax rate.		Exempt.
Other exemptions: (Note: Generally Charitable, Religious and Educational Bodies are exempt with conditions.)	Exemption for child care centres, aged care facilities, low cost accommodation and caravan parks used for retirement purposes. Various conditional exemptions for owners who have to move from their principal place of residence to an aged care facility or hospital.	Exemptions for various entities and land uses including: aged care facilities, supported residential services, armed services personnel, health centres and services, rooming houses and caravan parks.	Exemption for certain caravan or residential parks where more than 50% of all sites occupied or available for occupation for residential purposes for periods of more than 6 weeks at a time. Various other exemptions apply with conditions including: - Aged care facilities - Retirement villages - Support accommodation - Government land -Port authority land -Recreational and public land - Societies, clubs, trade unions and associations.	Exemption for private aged care providers and caravan parks. Various other exemptions also apply.	Exemptions (some with conditions) for various associations; land used for benefit of Aboriginal people; caravan parks; supported residential facilities; retirement village or retired persons' relocatable home park that is a person's principal place of residence; residential aged care facility, real property making up the principal place of residence of the beneficiary within a Special Disability Trust.	Exemption may apply to land used for various purposes by a range of organisations: Property owned by a religious body or charity and used for religious, charitable or educational purposes; property used as an eligible medical establishment; land used for the purpose of a retirement village; Aboriginal land within the meaning of the Aboriginal Lands Act 1995 used principally for aboriginal cultural activities; land owned by the Crown or local Government authority used for public purposes; land owned by ex-servicemen used for the purposes of the association. Rebates: Landowners, who, at June 30, have purchased a new principal place of residence but have not yet sold their current principal place of residence, may apply for a rebate (a transitional rebate) on their land tax. Land tax would normally be payable for the residence not being used as a principal place of residence on 1 July of the tax year. Landowners may apply for the transitional rebate whether or not	Nil.	Residential land used as a retirement village, nursing home, or by a religious institution to provide accommodation to a member to perform their duties, is exempt from land tax. Other exemptions from land tax include: broad-acre subdivision; a property with a guardian or manager for a person with a legal disability; residential land owned by a trustee under a will of a deceased person and occupied by a life tenant; residential land owned by a trustee or a guardian on behalf of a person with a legal disability; and residential land owned by a not-for-profit housing corporation.

Tax	NSW	VIC	QLD	WA	SA	TAS	NT	ACT
Land Tax (continued):						the land tax has actually been paid. Where a principal place of residence is built on vacant land owned as at 1 July of a financial year, a rebate up to the amount of the land tax paid or payable can be claimed.		
Reference Period:	Based on the three-year average of unimproved land values at 1 July, if owned at midnight 31 December of the previous year.	Based on aggregate value of land owned as at midnight 31 December of the previous year to the assessment year.	Based on three year average of land values at midnight on 30 June. The land tax value is the lesser of the value at 30 June or the average of the values at 30 June over the last three years.	Based on the aggregated unimproved value of land (as determined by the Valuer-General) as at 30 June of the previous year.	Based on aggregate value of land as at midnight on 30 June immediately preceding the financial year.	Based on aggregate value of land as at 1 July of the assessment year.	NA	Based on the rolling three year average of unimproved land values. Liability is assessed quarterly based on the rental or ownership status of the property on the liability dates of 1 July, 1 October, 1 January and 1 April.