Committee for Sydney

Federal Financial Relations Review

Submission from the Committee for Sydney

November 2019

The Committee for Sydney, herein after referred to as simply 'The Committee', welcomes the opportunity to respond to the Discussion Paper released as part of the *Federal Financial Relations Review*, hereafter referred to as 'The Review'.

This submission has been structured to respond to issues numbered 1 through 5 in The Review.

About the Committee for Sydney

The Committee for Sydney is an independent think tank and champion for the whole of Sydney, providing thought leadership beyond the electoral cycle. Our aim is the enhancement of the economic, social, cultural and environmental conditions that make Sydney a competitive and liveable global city.

Issue 1: A modern tax system that causes minimal disruption to citizens' lives and the economy will be essential for maintaining and improving our quality of life.

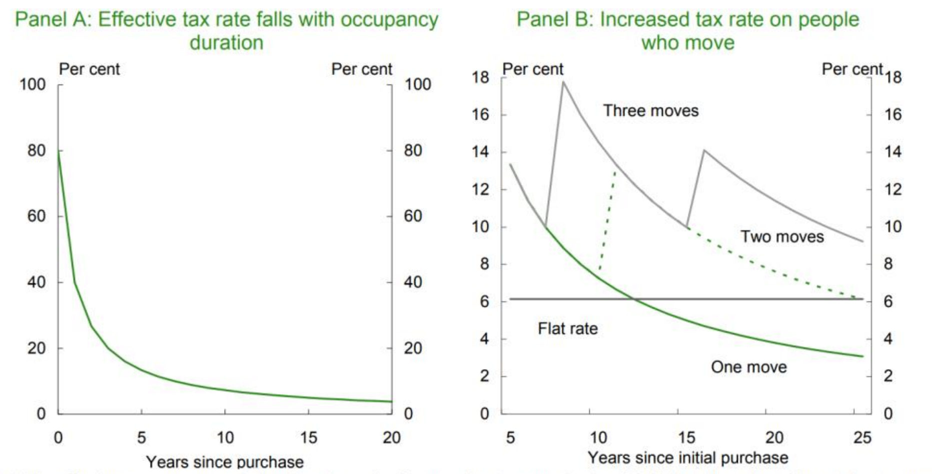
Which state taxes impact citizen and business choices the most?

The Committee welcomes the reforms to stamp duty made by the Berejiklian Government in 2018 to index stamp duty brackets to inflation. While these reforms improved the fairness and efficiency of the current scheme, the Committee is nonetheless of the view that the scale of reform needs to be broader still. Stamp duty remains both an inefficient tax and a tax that negatively impacts both the lives of NSW residents and the economy more broadly. This point has been well established by the federal Productivity Commission, the Australian Treasury, Infrastructure Australia, the Henry Tax Review, the NSW Government's own Lambert Review of State Taxation, by leading thank tanks including the Grattan Institute, the Centre for Independent Studies, the McKell Institute, and by leading academic research institutes including the Australian Housing and Urban Research Institute (AHURI), and the City Futures Research Institute. The Committee welcomes the Review's acknowledgement that:

> *"Stamp duty on residential properties are particularly costly as they add to the cost of buying a house and therefore discourage people from downsizing, or moving closer to preferred jobs, schools and family"*

The Department of Planning an Environment has already calculated that there are over half a million homes in NSW with at least two or more empty bedrooms. Planning Minister Rob Stokes has acknowledged that this equates to roughly 20 years of housing supply that could potentially be unlocked for first home buyers and young families. Stamp duty acts as a major financial disincentive for retirees seeking to downsize, and as such, has negative impacts for multi-bedroom dwelling affordability.

Stamp duty also acts as a disincentive for people to relocate to be closer to their place of employment, which not only adds to congestion, but which directly undermines the Greater Sydney Commission's objective of delivering a 30-minute city. It is also inequitable in that it penalizes those who need to move houses more frequently while leaving those who remain in one-location largely free of any requirement to contribute to the tax base. The below graph from the Henry Tax Review captures the inequity of the current system.



(a) The effective tax rates are calculated as the ratio of stamp duty (assumed to be $20,000) to the value of imputed rent over the period the property is owned (assumed to be $25,000 per annum). In Panel B, the 'flat rate' reflects a constant tax on imputed rent, with the rate equal to the effective rate faced by a person making two moves in 25 years (which is not average but intended to be indicative).

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Stamp duty is also a highly volatile revenue stream, which poses a challenge for the state budget. The most *2019-20 NSW Government Budget* noted that:

> *"The volatility of transfer duty revenue is a significant fiscal challenge for New South Wales. During the property market boom, transfer duty grew to be the State's largest tax, representing 31.4 per cent of tax revenue in 2016-17. The decline in the property market over the past 18 months has seen forecast transfer duty fall to 21.6 per cent of tax revenue in 2019-20. Since the 2017-18 Budget, the four-year forecast for transfer duty has been reduced by $10.6 billion"*

Beyond the challenge of revenue volatility, the NSW budget's over-reliance on inefficient and impactful transfer duties is acting as a drag on the broader economy. The NSW Business Chamber and the NSW Council of Social Services (NCOSS) commissioned research by KPMG which found that replacing stamp duty with a broad based land tax would could create up to 10,000 jobs and boost the Gross State Product by $5 billion.

Given that the overwhelming weight of evidence would suggest that stamp duty is an economically inefficient tax which undermines housing affordability while increasing congestion and introducing high levels of revenue volatility to the NSW budget, the Committee commends the NSW Treasurer for opening a dialogue around reform options to replace this particular revenue stream.

Response to Issue # 1:

1. **Finding: Consensus is strong that stamp duty is a highly damaging tax.**

Issue 2: Current revenue sources may not be sufficient to fund the future.

How can the tax system work better for citizens and businesses and improve the economy for future generations, keeping in mind: the changing environment, and the increasing volatility to state tax revenue bases.

The Committee acknowledges that a central theme of this review is also to address the challenges of an increasingly constrained fiscal environment. As such, it is appropriate that the revenue lost be replaced by an alternative revenue stream, and one that causes minimal economic or societal disruption.

The NSW Treasurer Dominic Perrottet has suggested that the abolition of stamp duty could be funded via a broadening of the Goods and Services Tax (GST). Despite some states having indicated that they would be open to such a reform, both the Morrison Government and the Opposition have outright rejected such a proposition, rendering any further consideration of this particular reform largely academic.

Other options for reform that do not require consensus across all state and territory governments are more likely to be delivered. The easiest pathway to reform is simply to undertake reform from entirely within the existing tax structure of the state government. However, even these reforms can encounter political and economic barriers, and as such, a case could be made for federal government incentives to help smooth a pathway to reform. Such federal incentives for tax reform are not unprecedented, with the Federal Government's former asset-recycling bonus proving an obvious case study in how federal incentive structures can be used to encourage state governments to embark on otherwise challenging reforms, in this case, through the privatisation of state assets. The Committee feels that federal incentives could also play a role in helping to facilitate a reform agenda that will replace stamp duty with other state-based forms of taxation.

The Committee feels that the most obvious solution lies in transitioning away from Stamp Duty towards a broad-based Land Tax, in order to reduce revenue volatility and reduce the dis-incentive for properties to trade. We suggest the voluntary phase-in approach that the Australian Capital Territory has developed as a useful starting place. Under the ACT model, the transition will occur over a 20 year window, split into four five-year stages. The reform program has also been designed to be broadly revenue neutral over time, with the reductions in revenue from phasing out stamp duty being replaced through gradual increases in general rates.

The ACT Government is not the only government which has made this transition. The Scottish Government has been pursuing its own Stamp Duty Replacement Tax, which is being rolled out nation-wide, and which has already seen house prices stablise, bringing welcome relief to aspiring home buyers.

The Committee's proposal is not new one. Former NSW Treasury Secretary Michael Lambert used his NSW Financial Audit 2011 to call for the introduction of a Stamp Duty Replacement Tax (SDRT), effectively leading to a transition away from stamp duty and towards a broad-based land tax. The Lambert Review set out a pathway for reform, under which SDRT would apply only after a property is transferred for the first time, effectively grandfathering existing home-owners. It was estimated that under this approach, about 50 per cent of residential properties would be subject to the SDRT after nine years, 70 per cent after 15 years, and 80 per cent after 20 years.

The Lambert review acknowledged however that this reform would leave the NSW Government with a revenue shortfall in the initial years. It found that if the objectives of revenue neutrality were honoured, transitional debt would peak at $15.4 billion in Year 10, but that this would be fully paid off in Year 23 of the scheme's operation. While the reform would be budget neutral over the long-term, it would provide substantial constraints in the short-term, which is why the Committee feels that some of this shortfall should be met through federal bonus payments to states as incentives for reform.

This need not come at the long-term expense of the federal treasury either. A forward-thinking federal government could simply provide a smoothing payment to the states, which would then be repaid once full revenue replacement has been achieved. Assuming the 23-year revenue repayment cycle still holds, then the extremely reasonable price of 30-year bonds would suggest that sufficient additional revenue could be made in later years to make such a bond issuance an affordable proposition for a federal government seeking to incentivize state tax reform. At present, there are no 30-year TCorp bonds being issued, meaning that the federal government better placed to provide assistance in bridging the revenue gap, though the NSW Government could also simply choose to let its own debt levels increase temporarily. Alternatively, it could identify new, external forms of revenue, or savings in other areas of government expenditure. Most likely, a combination of all the above would be required to help maintain AAA credit ratings throughout the transition period.

While this submission is primarily economic in focus, the Committee acknowledges that there is a political barrier to reform, in that voters may be more likely to punish a government for increasing debt in the short term, even if that debt is paid off in the long-term. Although this was not the case in the ACT, where the incumbent Government saw a swing towards it following the introduction of the reforms, it needs to be acknowledged that NSW is a very different state, and that therefore, the politics of reform are likely to be more challenging.

In acknowledgement of that, the Committee feels that it is might be worth considering a more politically palatable approach put forward by PwC. Under the ACT model, land tax would automatically apply once a property has sold for the first time, while under the PwC model, the purchaser would be given a choice about whether to pay upfront stamp duty or ongoing land tax. Once a property has land tax applied to it however, the next purchaser could not revoke that choice.

By offering grandfathering to all existing property owners and choice to all future property owners, the prospect of a political scare campaign centered on the introduction of a "great big new tax" would be substantially eroded.

The downsize to this proposal is that the transition towards a full-land tax model would likely take even longer than the 20-year timeframe envisioned under the ACT model. The upside to a slower transition however is that the immediate upfront hit to the budget would be sharply reduced, all but eliminating the need for short-term debt to cover the reform. That would in turn reduce the political risk for governments who are seeking to maintain their image as responsible fiscal stewards.

The Committee notes that sufficient research has now been undertaken into pathways for transition that are both politically manageable and limited in their fiscal disruption. Other jurisdictions have provided valuable lessons that the NSW Government could learn from with its own reforms. However, even acknowledging the above, the reality is that all complex tax reform comes with a degree of political risk, and to reward states for showing ambition in this area, the Australian Government should provide financial rewards to those states which choose to reform, as has previously been done with other complex reform, such as the Asset Recycling scheme.

Response to Issue # 2:

1. **Recommendation 1:** That the NSW Government gradually replace stamp duty with a broad-based land-tax, with all existing property owners being grandfathered, and with future property purchasers given a choice over whether to have stamp duty or land tax applied to their property, provided that land tax is not already in place at that dwelling.

2. **Recommendation 2:** That the Australian Government provided financial incentives to states which undertake this reform.

Issue 3: Commonwealth tax revenue sources are eroding which will make it more challenging to fund services across the country

Is there a better way that the Commonwealth Government can ensure its revenue sources remain sustainable in a changing environment?

One of the bigger challenges facing the Australian Government's budget over the long-term is the decline in fuel excise revenue as Australians transition from petroleum to electric vehicles. This challenge has been identified by Infrastructure Australia, the Productivity Commission, the Harper Competition Policy Review, the Grattan Institute, Deloitte, and more recently, Infrastructure Partnerships Australia.

Given such warnings, the Committee was heartened when in 2018, then Urban Infrastructure Minister Paul Fletcher agreed that Australia needs to revamp its approach to funding roads, flagging a review of fuel taxes in Australia. It is disappointing that since that time, the Australian Government has walked away from talk of such reform. With an election now out of the way, we remain optimistic that the topic may finally be revisited.

The Committee views a transition towards road user pricing as critical to offsetting the decline in revenue associated with a transition towards electric vehicles. The argument for reform goes beyond simple fiscal considerations however. The *NRMA's 2019 Business Members Survey* has confirmed that congestion remains an enormous drag on the productivity of Sydney. A well-designed road pricing scheme can solve for both of these issues. The key barrier to implementation of reform is not technical but political - so further work is needed to change the conversation on road pricing.

Infrastructure Partnerships Australia recently released a report which attempts to solve for the political challenges associated with the introduction of *Road User Charging for Electric Vehicles*. That report debunked a number of common misconceptions to emphasise that the rise in electric vehicle demand may be upon the government sooner than many anticipate, and warned that reform will only become more difficult to implement as the total number of electric vehicle owners continues to increase. The Committee agrees that the easiest time to introduce road-user pricing on electric vehicles is when their uptake remains low. The Committee also agrees that the application of road-user charging to electric vehicles could provide an important steppingstone to the expansion of such a taxation model to the entire vehicle fleet. A broader roll-out of road-user pricing as an outright substitute for fuel excise will be politically more palatable once such a model has already been in operation for a large proportion of Australia's car fleet.

It needs to be acknowledged that the application of road user pricing to electric vehicles in absence of its application to petroleum-based vehicles could slow down the uptake of electric vehicles by introducing a dampening price signal to the market, resulting in marginally higher transport emissions. However, Until renewables comprise more of the generation mix, electric vehicles will remain primarily fossil-fuel powered, and Australia will miss out on the scale of emissions reduction benefits of electric vehicle uptake experienced in other countries, though there will remain some benefit overall.

It also needs to be acknowledged that by not adequately pricing private motor transport in the same way that is applied to other vehicles through the fuel excise, the existing market structure is incentivising a modal shift towards private vehicle use amongst electric vehicle owners. This is because purchasing an electric vehicle requires a large up-front cost. Purchasers of electric vehicles could then view their initial and sizeable investment as 'wasted' if the car is never used, and given that the cost of fuel for an electric vehicle is substantially cheaper than petrol vehicles, and affordable relative to other modes of transit, the incentives for using a private vehicle for all journeys is larger than would be the case were road-user charging to be implemented. A lack of road user charging on electric vehicles could therefore lead to increased congestion, which would concurrently result in other non-electric vehicles idling in traffic for longer, using more fuel in the process. None of the above should be taken to mean that a shift towards electric vehicles is going to result in an overall cost for the environment. Rather, a shift towards electric vehicles will deliver net environmental and health benefits in the long run, particularly as Australia's grid continues to become less dependent on fossil fuels. The above points have simply been highlighted to emphasise that the environmental arguments which are commonly made in other jurisdictions against the introduction of road user pricing for electric vehicles are less applicable in the Australian context.

The Committee is also of the view that a healthier fiscal balance is also more likely to grant the Australian Government with additional funding for investment in other environmentally friendly initiatives, and for investment in mass-transit networks.

Infrastructure Partnerships Australia has rightly noted one final obstacle, which is that there are Constitutional challenges with a road user charge being levied by the Federal Government, because roads are state property, unlike fuel. Given, road-user charging will invariably need to be introduced by state governments, ideally through a coordinated approach negotiated through the COAG process. Although this would result in a situation where the states pick up an additional revenue stream while the federal government loses one, the reality is that the fuel excise revenue currently being raised is already being redirected in full to state and territory governments at present. Logically, the introduction of road-user charges collected at the state government level would concurrently see more infrastructure funded directly by state governments, and less directly by federal governments, though the federal government would still retain the ability to provide additional funding at its discretion through consolidated revenue.

Finally, the Committee would like to re-emphasise that the long-term objective should be to move towards nation-wide road-user pricing for all vehicles, ideally delivered through a mechanism for time, distance and place (TDP) road pricing, as consistent with our 2016 report: *A Fork in the Road*.

Response to Issue # 3:

1. **Recommendation 3:** That states and territory governments use the COAG process to develop a nationally consistent road-user charging model that is applied initially to electric vehicles, but which should eventually be rolled out to all vehicles as a direct replacement for the current fuel excise system.

Issue 4: Financial dependence on the Commonwealth needs to be reviewed

How can the states reduce their dependence on the Commonwealth?

Recommendation 3 of this submission would have the effect of reducing the states dependence on the Commonwealth by granting them access to a revenue stream which is currently controlled by the federal government. This would also address the current issue whereby a larger share of fuel excise is collected from drivers in NSW than is returned to NSW in the form of infrastructure funding.

Response to Issue # 4:

1. **Response:** Adopt recommendation 3 of this submission.

Issue 5: The distribution of funding between states should complement reform

How can Commonwealth – state relations encourage states to innovate and reform?

This submission has already suggested that the Australian Government provide financial incentives to state and territory governments to encourage them to transition their own tax bases away from stamp duty and towards more broad-based land tax. This could be done in the form of direct bonus payments, as was done with the Asset Recycling Scheme. Given that the Australian Government has indicated a hesitance to provide substantial funding to the states for infrastructure, such bonuses may be unlikely until such time that the federal budget is returned to a healthy surplus. A more immediate alternative could be to provide states with access to cheaper debt through the development of a national financing authority that allows state and territory governments to take advantage of the federal government's issuance of 30-year loans.

Ultimately, the Committee takes no view on the most appropriate form of incentive payment, except to urge the federal government to accept that tax reform is less likely to occur in the absence of federal support, depriving the nation of potential economic growth. Infrastructure Australia's *Making Reform Happen* report put the potential gain from a nationwide shift away from stamp duty and towards broad-based land taxation would reap an economic dividend of $24.3 billion per year by 2047. State and territory governments would also increase their tax base by $11.2 billion per annum over the same time period, granting them additional capacity to fund infrastructure and to invest in other economy enhancements at a time when economic growth more broadly will be under pressure from both climate change and the ageing of our population.

Response to Issue # 5:

1. **Response:** Adopt recommendation 2 of this submission.