

Buying better income taxes with better land taxes

How to cut taxes for Australia's highest-taxed workers

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Prosper's first report for the year, released in March 2024, highlighted the potential for significant income tax reform through even a modest shift towards greater taxation of land rents.

Public debate around the restructured "Stage 3" tax cuts in early 2024 was focused heavily on fairness in the distribution of income tax and who wins and loses from changes in tax rates.

However, as our report demonstrated, meaningful tax reform comes from replacing bad taxes with good ones – changing the tax mix, as outlined in our Tax Shift discussion paper.

The report examined how extensively states tax land and rezoning windfalls, and what additional revenue from levelling up tax rates to the benchmark jurisdiction – the ACT – could fund in welfare system reform.

Our modelling showed that if other states taxed land like the ACT, we could raise enough additional revenue to cut taper rates on major welfare payments by half, giving one million people on welfare part-payments an effective tax cut of 20–30 cents in the dollar.

Below are edited highlights from the report.

If Australian states were to meet a benchmark level of efficient taxation from the land base, what could the additional revenue fund?

Our modelling suggested that best-in-class land taxation amongst Australian states could raise sufficient revenue to remove the most significant distortions in the tax and transfer system – leading to higher workforce participation, economic activity, and well-being.

Welfare withdrawal is a tax on working

Around 5 million Australians receive income support from welfare payments, primarily targeting the aged, families, and the unemployed. Around 1 million of these recipients are on part-payments due to means-testing.

Withdrawing welfare payments as incomes rise is economically identical to taxing income. Taper rates for many welfare payments are as high as 50% or 60%, and combined with income taxation, these taper rates produce extraordinarily high effective marginal tax rates (EMTRs) for many workers.

Figure 1 shows how EMTRs vary by income for recipients of the major payments. Over substantial income ranges, EMTRs exceed 50% – higher than the top income tax rate.

The shape of the curves illustrates how the system discourages workforce participation and how regressive a tax-plus-clawback system is relative to the alternative of universal benefits funded by higher taxes.

High EMTRs mean we work, produce, and earn less

High EMTRs discourage people from taking on work or increasing hours. EMTRs of 75–80% mean a worker receives just a quarter or fifth of their value to the employer as take-home pay, which divorces pay from effort, discourages work, and increases labour costs, reducing GDP. High EMTRs also create 'poverty traps' at low incomes.

These problems are well known, but solutions are limited by the so-called 'iron triangle' of tax and welfare design – the unavoidable trade-off between income adequacy, work incentives, and fiscal cost.

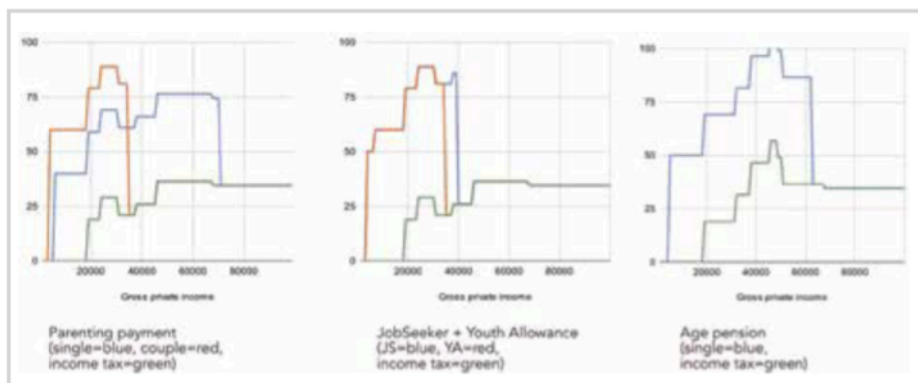


Figure 1: EMTRs for major welfare payment recipients

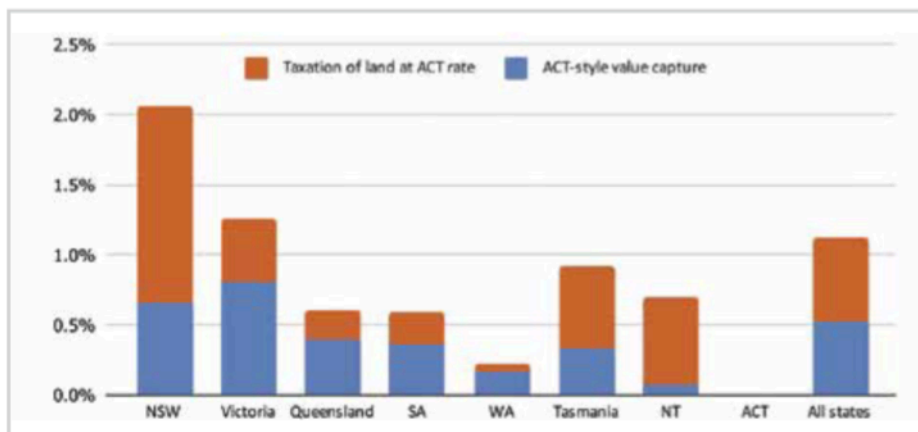


Figure 2: Additional revenue as of percent of GSP from ACT-style taxation of land

Lowering taper rates to improve work incentives necessarily requires either higher spending, as eligibility is expanded to higher incomes, or lower top payment rates, if the cost is to be held constant.

Indeed, this tension applies to income taxation more generally: flattening any part of a rate scale either reduces revenue or requires higher rates elsewhere.

This is a problem inherent in any system in which we fund adequate incomes for all by taxing the incomes of people who work and earn more. To escape it, we need to raise revenue from elsewhere – by changing the tax mix.

We underuse our best tax base, and pay for it by overtaxing workers

Some taxes avoid trade-offs between revenue and efficiency entirely. A basic principle of tax design is to tax things we want less of, such as speculation and pollution, rather than things we want more of, such as investment and employment.

Taxes on land pass this test. Land taxes reduce land values without reducing the quantity of land available. By curbing speculation, land taxes can even increase the amount of land put to productive use.

States have access to the land base, but they underuse it, relying heavily on Commonwealth grants funded by less efficient taxes on work and investment instead.

As a result, the tax mix in our federation is both 'back to front' and 'upside down': we use the wrong taxes and we tax at the wrong level.

The result is a complex and inefficient system, and a fiscal imbalance between the Commonwealth and states which dilutes accountability for spending.

Some states tax land better than others – levelling up would raise \$27 billion

The Australian Capital Territory (ACT) stands out amongst states and territories for its high rates of land tax and unique system of rezoning value capture.

The ACT puts a price on rezoning via its Lease Variation Charge (LVC), which captures 75% of the windfall gains landowners would otherwise receive from permission to redevelop at higher density. Because it owns all rural land, the ACT also captures 100% of the gains from rezoning for greenfield development.

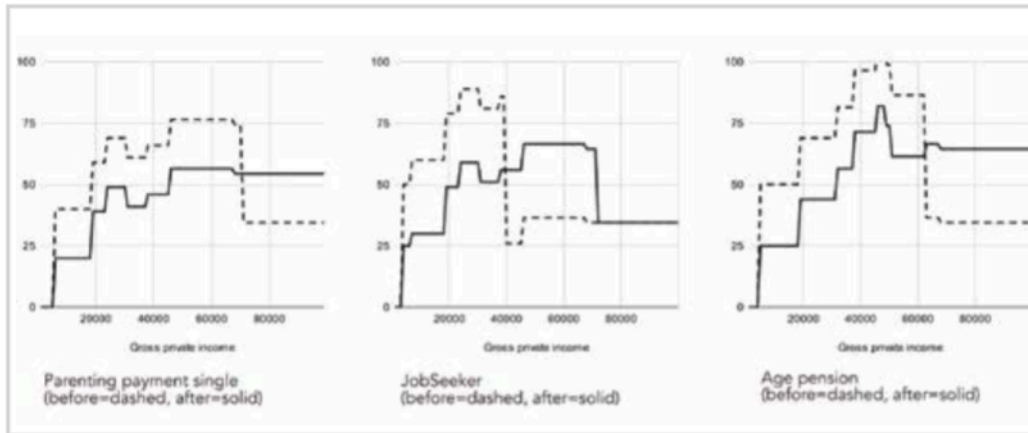


Figure 3: EMTRs for selected welfare payments before and after halving taper rates

Adjusting for property values and transaction volumes, we estimated that other states could collectively raise:

- \$12 billion per year by pricing rezoning like the ACT
- \$15 billion more per year by meeting the ACT benchmark for regular taxes on land.

For all states to achieve best-in-class taxation of land would raise an additional \$27 billion in revenue per year – all without reducing investment or growth. For under-performing states, the impact would be significant: New South Wales (NSW) could raise another \$15 billion per annum, equivalent to 2.1% of GSP (Figure 2).

\$27 billion could fund a halving of welfare taper rates – reducing EMTRs by 20–30 cents for one million workers

What could \$27 billion fund if Commonwealth-state transfers were adjusted to bring revenue and expenses for each level of government closer to balance?

One option is a universal income of over \$1,000 per Australian. Another is a 10% reduction in personal income tax. But more economically significant would be a targeted reduction in the high EMTRs and work disincentives created by strict welfare means-testing.

We estimated that halving welfare taper rates, with no reduction in maximum payments, could be funded at a cost of roughly \$17–22 billion, leaving \$5–10 billion for incentive payments to states or other reforms.

For the one million Australians currently on welfare part-payments this would deliver an effective tax cut of 20 to 30 cents per additional dollar earned (Figure 3).

Most recipients would more than double their net-of-tax return to working more hours. These people,

primarily in the low-to-middle income range up to \$70,000, would see their incomes boosted by roughly \$4,000 to \$7,000 per annum, even before accounting for any increase in work effort.

For another 800,000 or so FTB part-recipients, halving taper rates would reduce EMTRs by 6–12 cents per dollar earned. With the addition of these taxpayers and others on higher incomes who now qualify for welfare payments or FTB, it is likely that 3 million or more Australian workers would benefit.

An economic impact worth billions, and an improvement in vertical fiscal imbalance

Estimating the effect on work effort and GDP is challenging, since the response of workers to taxation varies significantly by circumstance, but a ballpark estimate indicated a range of around \$2–7 billion for the macroeconomic impact of this tax cut due to better work incentives.

Since states receive Commonwealth grants, rebalancing revenue between levels of government is an administrative matter that the Commonwealth can initiate. This could involve, for instance, shrinking the GST pool distributed to states over a fixed timeframe or reducing other payments as funding agreements expire.

A new funding agreement could provide incentives for states via top-up payments proportional to additional revenue raised from land tax rate and design changes (but not tax base growth). Rezoning windfall capture could also be made a condition of infrastructure funding.

With incentivised, co-ordinated action driven by the Commonwealth, the political barriers to better land taxation that each state faces alone would be markedly reduced. •