SUBMISSION

TO

PRODUCTIVITY COMMISSION INQUIRY

INTO

FIRST HOME OWNERSHIP

FEBRUARY 2004

1. OVERVIEW

The NSW Government agrees with the Productivity Commission's assessment that rising house prices over the past decade primarily relate to exceptional demand for residential property outpacing housing supply.

The convergence of a number of historically significant economic factors such as income growth, a low interest rate environment, and more accessible housing finance has stimulated demand for dwellings.

The Productivity Commission's suggestion that governments be cautious in their approach to assisting home ownership is appropriate. In particular, the Discussion Draft highlights the risk that across the board subsidies may simply lead to higher prices and no gains to households.

Possible Abolition of Residential Stamp Duty

While the Discussion Draft has much to commend it, the NSW Government does not consider the Commission has made a compelling case for including residential stamp duty in the 2005 Inter-governmental Agreement (IGA) Review of State Taxes. In particular, the Discussion Draft fails to demonstrate that the abolition of residential stamp duty would:

- materially improve first home ownership affordability; or
- represent a priority taxation reform.

Moreover, the NSW Government has major reservations about the feasibility of the tax increases canvassed in the Discussion Draft as ways to fund the abolition of residential stamp duty.

The Commission needs to address these concerns in order to demonstrate that residential stamp duty warrants future consideration for possible abolition.

Section 2 considers the effectiveness and practicality of this proposal.

Tightening Eligibility for the First Home Owners Scheme

The NSW Government endorses tightening eligibility for the First Home Owners Scheme (FHOS). This would improve the equity of the grant while minimising its impact on overall demand and property prices. In addition, the NSW Government supports allocating the savings from tightening FHOS eligibility to increased targeted relief for first home buyers.

2. POSSIBLE ABOLITION OF RESIDENTIAL STAMP DUTY

While abolition of transfer duty may hold some theoretical appeal, the NSW Government does not believe it is a realistic goal given the tax increases or spending cuts needed to fund it. Furthermore, as the Discussion Draft concluded, "as stamp duties add only marginally to the price of housing, their removal could not be expected to have a large effect on housing affordability" (p77).

The Discussion Draft does not make an adequate case for the abolition of transfer duty as a measure to improve first home affordability or to improve overall tax efficiency.

Abolition of transfer duty on property transactions would put Australia in a small group of OECD countries. The Discussion Draft (figure 5.3) shows that most countries impose some form of tax on property transactions. Only three OECD countries – Canada, Hungary and Poland – do not have a transaction tax on the sale of property.

The final report should focus on measures that are feasible rather than theoretical and which provide an effective means of assisting first home ownership.

2.1 Improving First Home Ownership

The Discussion Draft rightly concludes that "as stamp duties add only marginally to the price of housing, their removal could not be expected to have a large effect on housing affordability".

The NSW Government currently provides significant first home buyer stamp duty concessions.

First home buyers are likely to be disadvantaged as abolition of transfer duty would stimulate across-the-board demand for housing. This stimulus would be only partly offset by an increase in other taxes (required for revenue neutrality) so that in most cases, this increase in effective demand would largely translate into higher housing prices. Under these circumstances, the outcome for first home buyers already in receipt of transfer duty concessions is that prices would rise and they would be relatively disadvantaged.

The Discussion Draft recognises that measures that stimulate demand for housing on a broad front, such as the FHOS, will tend to push up house prices, particularly while demand for housing remains strong relative to supply. In this regard, it should be recognised that abolishing transfer duty could provide a one-off stimulus to demand much larger than FHOS, given the revenue forgone would be some 17 times the cost of FHOS (based on 2002-03 figuring).

The NSW Government is concerned the proposal may disadvantage first home buyers or at best leave them no better off. The Productivity Commission needs to clearly show that removing transfer duty will assist in improving housing affordability for first time buyers. It appears inconsistent to consider tightening the eligibility for FHOS while simultaneously considering looser access to transfer duty exemptions (effectively extending them from first home buyers to all home buyers).

2.2 Priority for Tax Reform

The Commission's case for abolishing transfer duty seems based more on tax efficiency grounds than on the improvements it could generate for first home ownership. The Discussion Draft notes the theoretically inefficient aspects of transfer duty, particularly in inhibiting turnover of the housing stock. As the Commission also notes, the significance of this aspect is subject to some debate.

The Commission does not demonstrate that abolishing transfer duty should be a priority for taxation reform. To warrant consideration for possible abolition, it is necessary to establish that the economic benefits from the abolition of transfer duty are sufficiently large compared to alternative tax reforms, including those listed for review in the IGA.

The IGA identifies the taxes to be reviewed by 2005:

- Stamp duty on non-residential conveyances;
- Stamp duty on non-quotable marketable securities;
- Stamp duty on leases;
- Stamp duty on mortgages, bonds, debentures and other loan securities;
- Stamp duty on credit arrangements, instalment purchase arrangements and rental arrangements; and
- Stamp duty on cheques, bills of exchange and promissory notes.

Further quantitative and qualitative evidence is required of the economic benefits that could be derived from abolishing transfer duty on residential property relative to alternative tax reform options.

2.3 Alternative Revenue Sources

Abolishing transfer duty on residential properties would have profound financial ramifications for the State budget. NSW currently expects to receive $4 billion in transfer duty revenue in 2003-04, representing slightly over 10 percent of NSW General Government Sector total revenue. Around three quarters of transfer duty relates to residential property.

Clearly, no government's budget could cope with a 10 percent loss of revenue and replacement revenue sources would need to be found to ensure revenue neutrality.

The Discussion Draft canvasses three possible revenue replacement sources: GST revenue growth, land tax and payroll tax.

GST revenue growth will not allow the States to abolish transfer duty. In 2004-05, the amount of GST revenue above the revenue the States would have received under pre-GST arrangements is currently estimated to be only some $800 million, compared with total transfer duty revenue of $8.5 billion. Moreover, the GST gains are distributed unevenly, with more than half accruing to one State and none at all to New South Wales for some years.

Clearly, it would take many years of GST revenue growth to replace transfer duty even if the States were willing to agree that transfer duty abolition should have first claim on any additional fiscal flexibility provided by GST revenue growth.

Whereas the immediate removal of transfer duty in all States could theoretically be funded by an increase in the GST tax rate from 10.0 to 12.5 percent[1], such an increase is not realistic and the NSW Government would not support such a proposal.

However, the tax rate estimate of 12.5 percent is provided here to highlight the challenges involved in replacing such a significant revenue source.

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[1] This estimate assumes that the additional revenue is allocated to each State on the basis of their existing stamp duty collections rather than in accordance with horizontal fiscal equalisation. If allocated according to existing horizontal fiscal equalisation arrangements, a higher rate of GST would be required.

Turning to State taxation options, land tax and payroll tax would need to be increased very substantially in order to maintain the State's fiscal position. The NSW Government estimates that:

- Land tax revenues would need to more than triple from $1.4 billion to $5 billion in order to fund the abolition of transfer duty. This would require raising the land tax rate from 1.7 percent to 6.2 percent, with the current base and threshold.

- Payroll tax revenues would need to increase by two thirds from $5.4 billion to $9 billion in order to fund the abolition of transfer duty. This would require increasing the payroll tax rate from 6.0 percent to 10.0 percent, again with the current base and threshold.

To achieve revenue neutrality it is evident that dramatic increases in existing taxes would be required to fund the abolition of transfer duty. Again the estimates highlight the unrealistic nature of the proposal to abolish transfer duty.

More radical reform - such as a comprehensive land tax - as canvassed in the Discussion Draft, is not supported. Replacing residential transfer duty with a comprehensive land tax would create a new annual tax bill of $1,800 for the average household in NSW in addition to existing local government rates. Such a tax would place a relatively high burden on low income families.

In short, this more radical option fails the reality test and existing State taxes do not provide the scope to acceptably fund the abolition of transfer duty.

Further reform to Commonwealth-State Financial Relations and the current system of horizontal fiscal equalisation would be necessary to provide the States with access to revenue sources that could be used to fund the abolition of transfer duty.

3. TIGHTENING ELIGIBILITY FOR THE FIRST HOME OWNERS SCHEME

The NSW Government favours tightening eligibility for FHOS to improve the equity of the grant. It would also free up funds to enhance assistance to first home buyers in greatest need.

There are two ways eligibility for FHOS could be tightened:

Introducing a cap on property value

A cap on property value would be administratively simple. Capping the eligibility of FHOS to NSW properties worth over:

- $1 million would reduce the number of grants by approximately 1 per cent (400 a year) and save almost $3 million.
- $700,000 would reduce the number of grants by around 4 per cent (1,500 a year) and save over $11 million.
- $500,000 would reduce the number of grants by around 14 per cent (5,600 a year) and save over $39 million.

Although the savings may not be large, they could be directed to enhancing FHOS assistance and/or enhancing State transfer duty concessions for first home buyers to account for recent growth in house prices. The savings would not be sufficiently large to fund significant across-the-board cuts to transfer duty as canvassed in the Discussion Draft.

Currently, the IGA does not permit capping the eligibility of FHOS to property value and would require renegotiation.

Means testing applicant income

An income means test would be a more sophisticated way of targeting FHOS. This method would also require renegotiating the IGA which currently disallows means testing altogether.

An income test would require the applicant to provide more information and so impose higher compliance costs on the home buyer and increased administration costs for State governments.

NSW had an income test and property value cap on first home buyer stamp duty concessions until 2000. The income test was abolished because of concerns that an income tax assessment and/or group certificate was not always an accurate record of a person's actual income.

Furthermore, it was considered that determining eligibility based on just one year's worth of income was not a reliable indicator of financial need (particularly where termination payments may distort income in a given year). For these reasons, the income test was abolished while retaining the property value cap to target assistance.

The Productivity Commission would need to be satisfied that the administrative process of an income test would ensure first home purchase assistance reached those most in need.

3.1 Evaluation of the options to tighten FHOS eligibility

Horizontal Equity

If the property cap or income test were applied uniformly it would have significant equity implications. Property values vary widely between the States. A uniform property value cap would therefore affect NSW residents more than residents of other States. Such an outcome would be unacceptable.

To address this, it would be necessary to set different caps in each State based on property values. The caps could then be indexed in each State according to State property values.

In addition, in recognition of the variation in housing costs, the savings from means testing should in part be used to enhance the level of assistance in States with relatively higher average property values.

An income test would also vary in its impact across States, although to a lesser extent than a property test. If a uniform test is favoured then an income test would be less distorting than a property value test.

Operation of the Intergovernmental Agreement

While, in principle, redirecting savings from tightening FHOS eligibility to enhance stamp duty concessions is attractive, it would require the modification of the Intergovernmental Agreement.

Under the agreement, the States are compensated with Budget Balancing Assistance (BBA) if their GST revenue falls short of a Guaranteed Minimum Amount based on pre-GST funding arrangements.

New South Wales is currently estimated to receive Commonwealth BBA until 2005-06, so that any FHOS savings would flow to the Commonwealth Government through reduced BBA grants. If there were to be changes to FHOS resulting in cost savings, New South Wales would expect the Commonwealth to remit those savings to the State.

Assessment

If a uniform approach is favoured, then an income test would be more equitable. If applied on a State by State basis, there would be some administrative advantages in tightening FHOS eligibility through a cap on property values.

The savings should be directed to enhancing targeted assistance for first home buyers, either through FHOS or through enhanced State stamp duty concessions.

Given the operation of the IGA, arrangements may be required to ensure that any savings generated under either method of tightening FHOS eligibility are returned to NSW first home buyers and are not retained by the Commonwealth Government.

4. CONCLUSION

In summing up, the NSW Government would like to see the final report focus on measures that would directly assist first home ownership.

To warrant future consideration of the possible abolition of transfer duty, the Productivity Commission needs to demonstrate that its removal would assist first home buyers and represent a priority taxation reform compared with the abolition of other taxes.

Moreover, the Commission needs to consider the feasibility of abolishing transfer duty given the revenue shortfall that would eventuate and make a more realistic appraisal of the issues and constraints in regard to raising revenue to replace the revenue forgone.

Lastly, there is merit in tightening FHOS eligibility. However, the Commission needs to be mindful that a radical tightening of the Scheme would create horizontal inequity across the States. The NSW Government supports allocating any savings from tightening FHOS eligibility to fund increases in targeted assistance to first home buyers.