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Replacing stamp duties: Securitisation can hold the key

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FINANCIAL POLICY BRIEF

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In this ACFS Financial Policy Brief, Professor Kevin Davis provides a simple solution for State Governments to transition away from reliance on stamp duties towards property taxes – as advocated by the Productivity Commission. It involves abolishing stamp duty and applying property taxes only to those properties on which the last sale did not incur stamp duty, which avoids "double taxation" of home-owners. Securitising future property tax receipts enables the government to avoid the adverse cash flow effect of loss of stamp duty revenue. The securities so created are long term, suitable for superannuation funds and the design of retirement income products, and could (depending on design) provide indirect exposure to the asset class of residential property – facilitating enhanced diversification of investment portfolios.

The Productivity Commission's latest report[1] has argued for the replacement of stamp duty on property transfers by an annual property tax on economic efficiency grounds. This is not a new argument (in fact it is a very old argument) and has widespread support amongst economists. For example, the Grattan Institute in 2015 produced a report[2] outlining the potential economic gains.

The key sticking points in making such a shift are the immediate impact on State Government budget revenues, and considerations of equity and fairness. For example, introducing property taxes on properties where the owners have already paid stamp duty would be viewed as unfair. Abolishing stamp duty implies an immediate, and large, hit to budget revenue which needs replacing.

While some states (SA, ACT) have moved down the path of removing stamp duties, with some innovative arrangements, there are better approaches than these which the remaining states should consider.

In particular, removing stamp duty on future transfers of ownership and imposing future property taxes only on properties where the last sale did not incur stamp duty should be considered. The buyer of a property gains from not paying stamp duty (at a time often of

[1] Productivity Commission Shifting the Dial: 5 year productivity review (Supporting Paper 10), 24 October 2017

[2] John Daley and Brendan Coates [Property Taxes](), Grattan Institute, 14 July 2015

financial stress) and this is offset by future property tax obligations. Those current owners who have paid stamp duty when buying their property do not pay property taxes on that property.

Of course, there are many complicated issues involved in determining the appropriate rate of property tax and the base to which to apply it, and dealing with situations where home owners are in financial difficulty which property tax liabilities can aggravate. (An appropriate calibration, recognising the likely trade-off home buyers would make between paying stamp duty now versus future property taxes, is needed to avoid shocks to property prices).

But making such a change has some significant beneficial effects in addition to the economic efficiency arguments advanced by economists.

First, replacing stamp duty with property tax removes one of the financial disincentives to downsizing by older home-owners,[3] which recent government changes to superannuation contribution limits are attempting to promote.[4]

Second, by solving the budget revenue problem with securitisation, a new, low risk, long-term asset class suitable for superannuation and retirement income product creation can be developed. Essentially, the government can ”sell” a claim on some part of the future property tax revenues to investors in order to offset the current loss of cash flow from stamp duty revenues.

The securitisation solution is relatively simple, and certainly something that the financial sector should be easily able to develop. In each year following the abolition of stamp duty the government will no longer receive the large revenue amount which would arise from stamp duty on house sales in that year. Suppose that were $5 billion (a conservative estimate for the larger states). Instead there will be a future stream of property tax revenue; its size each year will depend on the tax rate imposed and future property prices. But assume, for example, that the tax rate was set such the expected cash flows over the next 30 years would have a present value of $5 billion.

It would be fairly straightforward for the government to issue $5 billion worth of securities which provide the holders with the entitlement to the corresponding future stream of property tax

[3] The funds freed up from downsizing can be relatively small partly due to stamp duty and selling and moving costs. See Sinclair S, Boymal J and De Silva A 2014, ‘The marginal cost of a bedroom: an Australian case study’, Pacific Rim Property Research Journal vol. 20, pp. 31–44.

[4] The changes announced in the 2017 budget allow individuals over 65 to place surplus funds arising from downsizing into superannuation, although those assets then become counted in the age pension asset means test.

revenue for the next 30 years.[5] (There will be some accounting and legal issues to deal with to ensure that the loan proceeds are essentially treated as revenue rather than borrowing to avoid perceptions of a budget “blowout”).

However, while such securities could be attractive to long term investors (such as superannuation funds), there are risks arising from the possible variability of receipts due to property price movements and future government changes to the tax rates. The latter risk can be avoided by legislatively fixing the tax rate for, say, 30 years,[6] but there is still the risk arising from property price movements. It may be that superannuation funds are happy to absorb this risk, treating investments in these securities as an exposure to the asset class of (primarily) residential property – which is not otherwise readily available and which may help diversify portfolios. But not all investors may want such risk.

It is not possible to remove all types of risk, but one possibility is to determine (or let the market determine through a book-build process) a specified annual rate of return for the security and provide the holder with the entitlement to all tax revenue until the date at which the accumulated proceeds have reached the level at which their (issue date) present value is $5 billion. That could be more or less than 30 years, so that the investor is subject to variable maturity risk. The nature of that maturity risk could be moderated by incorporation of issuer call or investor put options (for example at 30 years) in the structure of the security (or other means).

The Table below provides a simple illustration assuming that the $100 billion of houses sold in year zero on which stamp duty is not levied (and which would have otherwise generated $5 billion of stamp duty revenue) are expected to rise in price by 3 per cent per annum. Suppose investors in the securities require a 5 per cent per annum return. Setting the property tax rate at 0.222 per cent per annum gives an expected stream of revenue over 30 years which, when discounted at 5 per cent, has a present value of $5 billion, as shown in Panel A. However, as shown in Panel B, if property prices only grow at 2 per cent per annum, then after 30 years the revenue received is only equivalent to a date zero present value of $4.38 billion. Panel C illustrates that if the security’s life does not cease until the date zero present value of receipts is $5 billion, the security would, for a 2 per cent house price growth, have a life of 37 years.

[5] Given that the revenue stream is, in principle, infinite, this example does involve a long run increase in overall taxation of property. Long run budget neutrality considerations would require, for example, the government only receiving say $4.5 billion for issuing securities promising present value of an expected $5 billion of tax receipts over 30 years.

[6] Alternatively the cash flows to investors could be calculated by applying a prespecified tax rate to the property base, to apply regardless of future changes made to the tax rate.

As Panel C illustrates, that design replaces yield to maturity risk with maturity risk which may affect the rate of return investors require. However, this can be moderated in several ways. One is to "tranche" the securities issued along somewhat similar lines to a standard securitisation. This would involve allocating cash flows in such a way that higher tranches are paid out sooner with little maturity risk. Investors less concerned about maturity risk could invest on lower tranches, or the most junior tranches could be retained by the government to absorb the maturity risk. (While doing so may reduce the yield required by investors, to the benefit of the government, it would mean that less than $5 billion would be raised, requiring the government to determine the best trade off).

Table 1: Example, revenue from securitisation ($billion)

		(A) ASSUMING 3% P.A. HOUSE PRICE INFLATION		(B) ASSUMING 2% P.A. HOUSE PRICE INFLATION		(C) ASSUMING 2% P.A. HOUSE PRICE INFLATION	
Year	**Stamp Duty**	**House values**	**Property tax revenue**	**House values**	**Property tax revenue**	**House values**	**Property tax revenue**
0	-5	100					
1		103	0.23	102.0	0.23	102.0	0.23
2		106.1	0.24	104.0	0.23	104.0	0.23
3		109.3	0.24	106.1	0.24	106.1	0.24
⋮							
29		235.7	0.52	177.6	0.39	177.6	0.39
30		242.7	0.54	181.1	0.40	181.1	0.40
⋮			*PV = 5*		*PV = 4.38*		
35						200.0	0.44
36						204.0	0.45
37						208.1	0.46
							PV = 5

This illustration is for the issuance of securities in the first year when stamp duty is abolished. But this is not a once-off occurrence. In the following year there will be a different group of existing property sales on which no stamp duty is received and new securities are issued. Of course, there will be, as time goes on, sales of some existing properties which are already subject to property tax with those revenues hypothecated to already issued securities. Thus the value of new securities issued per year would be expected to decline over time – although governments could decide to include future property tax revenues from new dwellings to support securities issuances, rather than taking the tax revenues directly into the budget.

Conclusion

In conclusion, it is possible to abolish stamp duties and transition to a property tax regime while:

a) Avoiding “double taxation” of home owners who have previously paid stamp duty by only applying property taxes to houses which have been sold without incurring stamp duty.
b) Avoiding deleterious cash flow consequences for the government budget by securitising the future property tax revenues
c) Creating a new class of long term assets suited to superannuation fund investment and design of retirement income products which may, depending on their design, also provide enhanced, albeit indirect, access to the risk and expected returns of the asset class of residential property.

There are many practical details which require attention to implement such a change, but they are hardly insurmountable.

This Financial Policy Brief was prepared by Professor Kevin Davis, Research Director of the Australian Centre for Financial Studies

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