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Submission to the Northern Territory Government's Revenue Discussion Paper

John Daley, Brendan Coates and Trent Wiltshire

Summary

We welcome the opportunity to make a submission to the NT Government's Revenue Discussion Paper. This submission summarises recent work by the Grattan Institute on property taxes that is relevant to the inquiry.

Previous Grattan Institute work shows that replacing stamp duties with general property taxes would produce a big economic payoff. Shifting from stamp duties to a broad-based property tax could leave Northern Territorians up to $85 million a year better off, while also helping to improve housing affordability.

Stamp duties are among the most inefficient and inequitable taxes available to the states and territories. In contrast, property taxes – which are levied on the value of property holdings – are the most efficient taxes available to the states and territories. If they are designed well and applied broadly, they do little to change people's incentives to work, save and invest. Property taxes are also likely to be a more sustainable revenue source than stamp duties: over the longer term, property values are likely to keep rising, and revenues from property taxes tend to be less volatile than stamp duties on property sales.

Despite the obvious benefits, only one Australian government – the ACT – has made the move from stamp duties to a broad-based property tax. Property taxes are often unpopular precisely because they are highly visible and difficult to avoid. And effective rates of stamp duty have risen sharply in all states and territories in the past two decades. NT stamp duties are higher than most states, partly because the NT currently has no annual land taxes.

The right design for a property tax to replace stamp duty can help overcome the politics. A low-rate, broad-based property levy in the NT using the council rates base could raise **$105 million a year** through an annual levy of just $5 for every $1000 of unimproved land value – enough to fund the abolition of stamp duties. Alternatively, replacing stamp duties with a progressive property levy calculated separately for each individual land plot – as the ACT has done – could minimise the windfall gains to larger home-owners from the swap.

A gradual transition to a broad-based property tax such as that adopted in the ACT would provide a stable revenue stream while delaying the full impost on those who recently paid stamp duty. The NT Government should ensure asset-rich but income-poor households can stay in their homes, by allowing them to defer paying the levy until they sell their property.

Alternative proposals to 'grandfather' existing homeowners from any recurrent property tax until the property is next sold pose significant threats to state and territory budgets. They require state and territory governments to forego stamp duty revenues received up-front in favour of a much smaller recurrent property tax paid each year. Such a shortfall could be financed, but would still show up as a large deterioration in headline budget balances.

The NT Government should also abolish grants and stamp duty concessions for first home-buyers. These concessions cost the NT Government $23 million a year. Beyond their sizeable budgetary costs, giveaways to first home-buyers have actually worsened housing affordability by further inflating demand for housing, with most of the benefit flowing to existing home-owners.

1 The NT Government should swap stamp duties for a broad-based property tax

The NT Government should abolish stamp duties and replace them with a general property tax, as the ACT Government is doing. The economic gains from this reform would be large: shifting from stamp duties to a broad-based property tax could leave Northern Territorians up to $85 million a year better off, according to estimates based on the excess burden of taxes.[1]

Property taxes are also likely to be a more sustainable revenue source than stamp duties: over the longer term, property values are likely to keep rising, and revenues from property taxes tend to be less volatile than stamp duties on property sales.

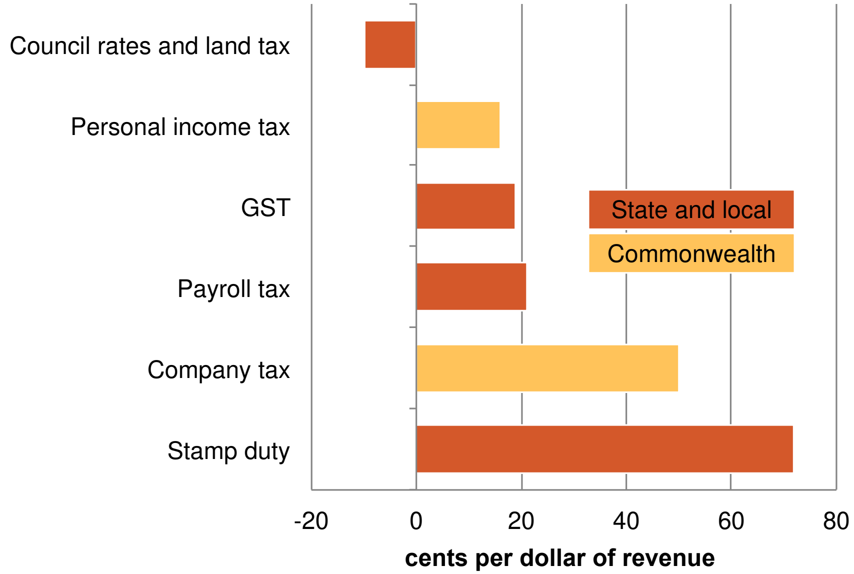
1.1 Stamp duties should be replaced with a broad-based property tax

All taxes reduce growth because they distort decision making by households and firms. But some taxes drag on growth more than others.

Stamp duties on the transfer of property are among the most inefficient of taxes: they discourage people from moving to housing that better suits their needs so that the housing stock is used more efficiently. Sometimes they discourage people from moving to better jobs.[2]

Figure 1: Stamp duties are the most costly state and territory taxes; re-current property taxes are the least damaging

Loss of economic activity for each $ increase in tax



Sources: Cao et al. (2015); ABS (2017c); Grattan analysis.

[1] Updated from Daley and Coates (2015), p. 11 using updated estimates of the excess burdens of taxes provided in Cao, *et al.* (2015) and ABS (2017c). A national shift from stamp duties to a broad-based property tax could leave Australians up to $17 billion a year better off (Daley, *et al.* (2018), p.122).

[2] Hilber and Lyytikäinen (2017) found that stamp duties on UK residential property strongly discouraged moving a short distance or for a better dwelling, leading to misallocation of dwellings in the housing market. But they found stamp duties were less likely to discourage a longer-distance move to take a new job.

Figure 1 shows the estimated loss of economic activity, or marginal excess burden, from each dollar increase in a range of taxes.

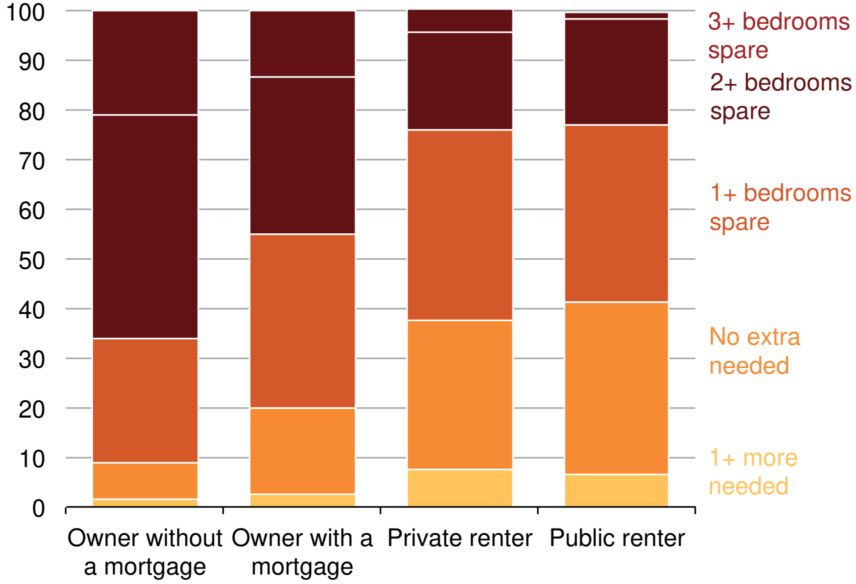
Stamp duties are also unfair. One family could pay more tax than another with similar income and assets, simply because it moves house more often. Stamp duties especially penalise young people, who tend to be more mobile.

The effects of stamp duty are material: one study found that a 10 per cent increase in stamp duty can reduce housing turnover by 3 per cent immediately, and 6 per cent in the long run.[3] The misallocation of housing stock is now obvious in Australia: spare bedrooms are much more prevalent in owner-occupied dwellings – where housing moves are constrained by stamp duty – than in the private rental market, where they are not (Figure 2).[4]

The economic drag of stamp duties has increased over the past two decades. Average rates of stamp duty have risen substantially in all states and territories, because thresholds have not kept pace with rising house prices (Figure 3). This is probably a material cause of housing turnover nationwide falling from 8 per cent a year in the early-2000s to below 5 per cent today.[5]

Figure 2: Owner-occupiers are more likely than renters to have multiple spare bedrooms

Households needing extra bedrooms or with spare bedrooms, 2015-16, per cent



Source: Daley et al. (2018), Figure 7.1.

The NT has some of the highest stamp duty rates in Australia, in part because it is the only state or territory that does not levy any annual property or land tax.[6]

[3] Davidoff and Leigh (2013).

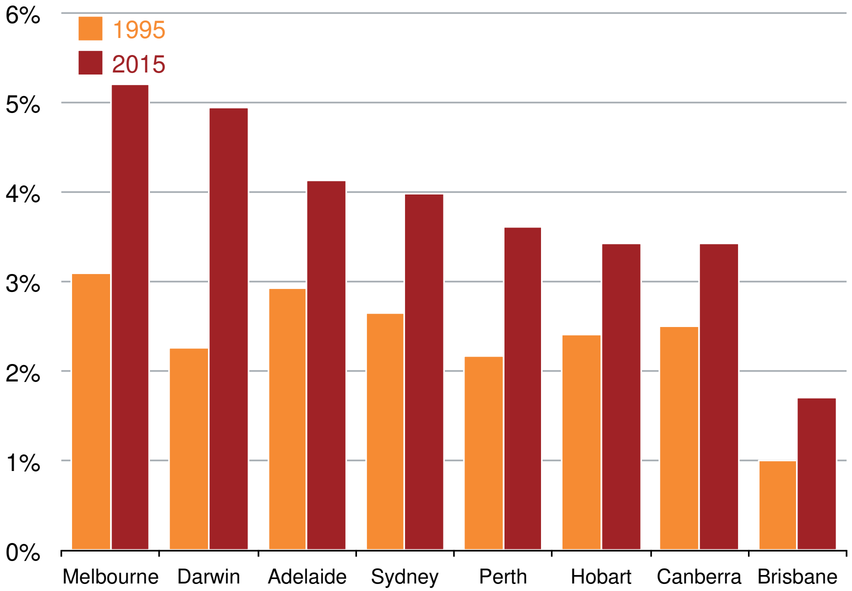
[4] While an owner-occupier could move and avoid paying a second round of stamp duty by keeping their home and renting a new home, very few households do so (Leal*, et al.* (2017), p.23). This is not surprising given that home-ownership provides much more secure tenure than private rental in Australia (see Daley*, et al.* (2018), p.75).

[5] Leal*, et al.* (2017), Graph 1. It is difficult to disentangle the precise effect of stamp duties on turnover. Housing turnover rates might also have fallen because of an ageing population (older households move less), and lower rates of interstate migration. On the other hand, housing turnover rates would be expected to rise with higher rates of international migration, high price growth, and lower rates of home-ownership (ibid.).

[6] Northern Territory Department of Treasury and Finance (2017), p.25.

Figure 3: Effective rates of stamp duty have risen sharply in all states and territories in the past two decades

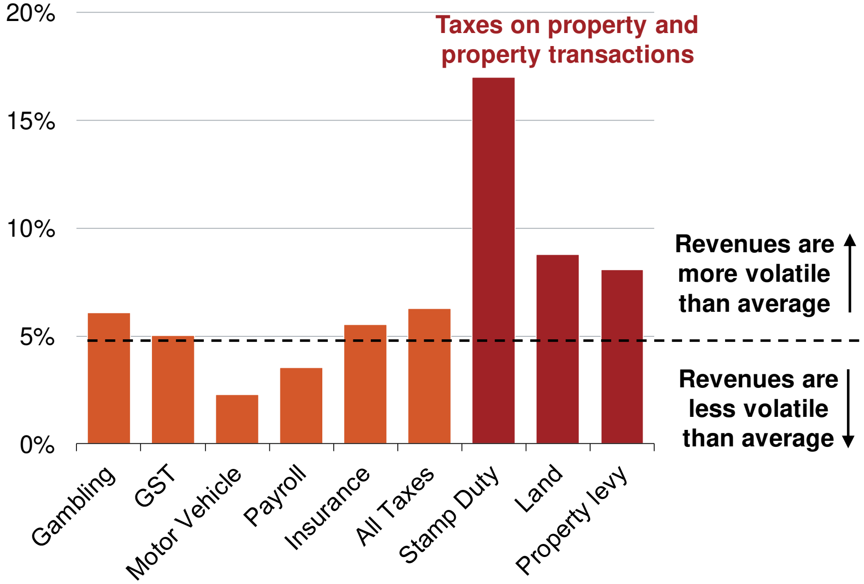
Stamp duty payable on median-priced house in each capital city



Notes: Median prices are for a detached house. Darwin median price is for 2000. Assumes that the purchaser is not eligible for a concessional rate of stamp duty.
Source: Daley et al. (2018), Figure 7.2.

Figure 4: Volatility in property tax revenues can be reduced by levying taxes on the average of recent property valuations.

Standard deviation between annual revenue growth and long-run average growth in Australia, (2000-01 to 2015-16)



Notes: 'Property levy' shows the revenues that would have been raised with a broad-based property levy of 0.5 per cent applied to unimproved land values had it been in place since 2000-01.
Source: Daley and Coates (2015), Figure 4, updated to 2015-16 using ABS (2017c).

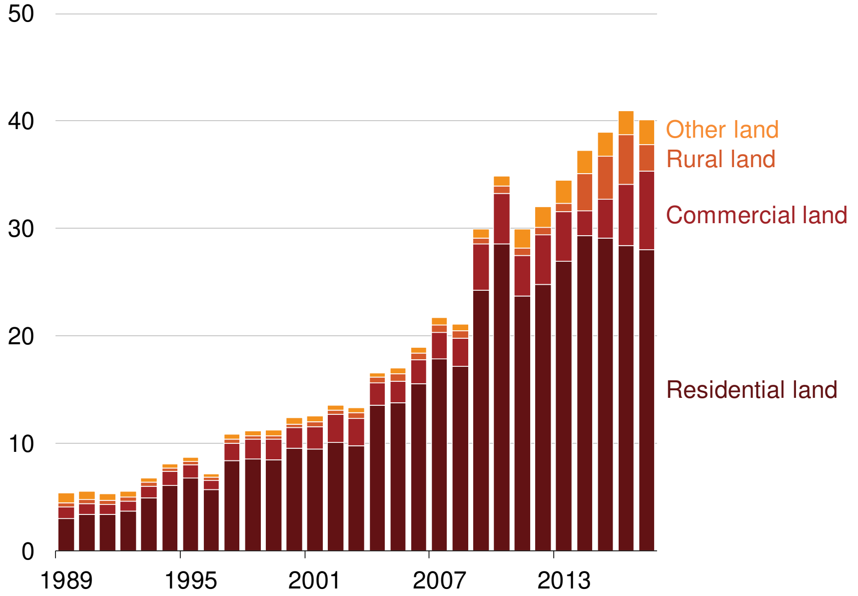
Stamp duty revenues are also volatile (Figure 4). They depend on both property prices and turnover. Any slowing of property sales as the property market cools could punch a big hole in state and territory budgets. Broad-based property taxes deliver more stable revenues because they are not affected by turnover.[7]

In contrast, land taxes do not distort decisions about land use, provided they apply in a way that the landowner can't avoid.[8] For example, a constant-rate land tax applied to the unimproved value of all land prevents landowners from reducing their liability to such a tax by changing the way they use their land. The tax on a vacant block of land would not increase even after the block was developed.

Property taxes are also likely to be a more sustainable revenue base than stamp duties. NT land values have risen rapidly over the past two decades (Figure 5).[9] Unlike capital, property is immobile – it cannot shift offshore to avoid higher taxes. The risks of multinational tax avoidance, the increasing mobility of capital, and the increasing value of residential property relative to incomes, should make property taxes a priority in any tax reform.

Figure 5: Northern Territory land values grew quickly in the past decade

Real market value of NT land, $2016-17 billions



Source: ABS (2017a) and ABS (2017b).

[7] Daley and Coates (2015), pp.6-7. Northern Territory Department of Treasury and Finance (2017) (p.29) estimates that the unimproved capital value of rateable land in the Darwin, Palmerston, Litchfield, Alice Springs and Katherine local government areas is about $21 billion.

[8] Treasury (2010), p.247.

[9] Over the longer term, land and property values are likely to keep rising, even if the pace of growth is slower than over the past two decades. Some of the growth over the past two decades resulted from the long-term decline in interest rates. In future, property values, and therefore revenues from property taxes, may grow more slowly. In the long run, property prices are likely to at least keep pace with incomes, and may well rise faster, depending on population growth, household size and whether supply of new properties keeps pace with the growth in demand. Daley, *et al.* (2018).

1.2 Council rates are a better taxation base than state land taxes.

The right design for a property tax to replace stamp duty can help overcome the politics. Rather than copying existing state land taxes – which exclude more than half of all land by value, especially owner-occupied housing – the NT Government should fund the abolition of stamp duties through a property levy imposed via the council rates base.

Existing state land taxes are a compromised tax base. For a given tax rate, they generate much less revenue than a broader-based land tax would. States raised $7.2 billion from land taxes in 2015-16.[10] Exempting the family home from land tax excludes about 75 per cent of the value of residential land; it means state government budgets forgo about $7 billion in revenue.[11] Exemptions for agricultural land remove almost a further 10 per cent of land by value from the land tax base.

State land taxes are also levied on a progressive scale, so that people with larger land holdings pay a higher rate of land tax per dollar value of land owned. No tax is levied on people with total landholdings less than a threshold. These tax-free thresholds range from $25,000 in Tasmania to $600,000 in Queensland.[12] Progressive land taxes levied on total landholdings and generous tax-free thresholds discourage larger landholdings and largely explain why small investors dominate Australia's rental housing market.[13]

In contrast, municipal rates are applied to all properties within a council area, with very few exemptions. There are no exemptions for owner-occupied housing or agricultural land, there is no minimum threshold, and constant rates apply from the first dollar of property value. The largest exemption from council rates is for some non-profit, non-government organisations such as charities, schools and public hospitals.[14]

Municipal rates regimes vary across councils. But individual councils levy rates at the same rate per dollar of land value of a property, regardless of the overall size of ratepayers' total property holdings, and so do not discriminate against large property investors.[15]

An NT government levy added to council rates would be relatively simple to administer. In practice the government could set a territory-wide rate, with the council rate as an additional charge that varies by council.

Governments in Victoria, South Australia, Western Australia and the ACT already use the council rates base for state-wide property-based levies to fund fire and emergency services. These levies provide a template for reform. They are charged as a share of land or property values. The levy rates are set at the state level. In Victoria and Western Australia (but not South Australia), notices of liability are issued as part of council rates notices, and

[10] ABS (2017c)

[11] Daley, *et al.* (2018), p.100. Even though owner-occupied housing accounts for 75 per cent of all residential land, imposing land tax on it would raise only $7 billion because it would be taxed at comparatively low rates under the highly progressive rates of land tax currently in force.

[12] Ibid., p.125.

[13] Ibid., pp.76-77.

[14] Daley and Coates (2015), p.16.

[15] In Victoria, for example, most councils determine rates on the basis of the assessed capital value of the property. See Hefferan and Boyd (2010), p.154.

levies are collected by councils and passed on to state governments.

The property levy could be applied to only the unimproved value of land – the existing tax base used for council rates in the NT – or to the combined value of land and buildings.[16] An annual flat-rate tax on unimproved property values of $5 for every $1,000 of unimproved land value, raising $105 million in annual tax revenue, would be sufficient to fund the abolition of stamp duties on property in the NT.[17]

Alternatively, a levy on capital-improved property values of roughly half that rate would be sufficient to fund the abolition of stamp duties.[18] And replacing stamp duties with a progressive property levy calculated separately for each individual land plot – as the ACT has done – could minimise the windfall gains to larger home-owners from the swap.[19]

[16] Although a levy on unimproved value is theoretically better, the practical impacts on investment of a levy on capital-improved values would be small. For example, with a 0.5 per cent property tax on land and buildings, a landlord doing capital improvements of $100,000 would need to collect a mere $40 extra a month in rent to recoup the costs of the tax: Daley and Coates (2015), Box 2.
[17] Northern Territory Department of Treasury and Finance (2017), p.30. Conveyance duties on NT property are expected to raise $104 million in 2017-18 (DTF NT (2017), Budget Paper 2, p.78).
[18] The precise tax rate required to replace stamp duties in each state and territory depends on the stamp duty regime and the rate of housing turnover, as well as potential impacts on the distribution of GST revenues among all states and territories. Coates (2017), and Daley and Coates (2015), p.8.
[19] Coates (2017), and Freebairn (2017), p.15.

1.3 A gradual transition is the best way to manage the politics of reform

Proposals to switch from stamp duty to land tax have stalled because the politics are hard.[20] Recent purchasers would be reluctant to pay an annual property tax so soon after paying stamp duty. Meanwhile a property tax would pose difficulties for people who are asset-rich but income-poor, especially retirees who have limited incomes but own their own home. And property taxes cause considerably more angst among voters than stamp duties because they are more visible: quarterly property tax bills are a far stronger reminder of the tax than stamp duties that are paid in full upon purchase, even though the stamp duty bill is much larger.[21]

The right reform design can help manage the politics of the transition from stamp duty to a property tax. A gradual transition to a broad-based property tax, such as that adopted in the ACT, is best.[22] It would provide a stable revenue stream while delaying the full impost on those who recently paid stamp duty. Over time the property tax would hit asset-rich, income-poor households.

[20] Some states may also be discouraged from unilateral reform since any state moving first may be 'penalised' by the way the GST sharing formula currently operates (Productivity Commission (2017), p.100), although the state would be better off overall (Daley and Coates (2015), pp.8-10).
[21] For example, Marika Cabral and Hoxby (2012) find that American jurisdictions where property taxes are built into mortgage repayments – known as tax escrow – tend to have higher average property tax rates than jurisdictions where property owners pay the tax directly.
[22] The ACT Government is six years into a 20-year plan to replace stamp duties with broad-based property taxes. Annual general property rates on a family home on land worth $500,000 increased from roughly $2,200 a year in 2012 to $3,000 just four years later. At the same time, the stamp duty on a home worth $500,000 has fallen by more than five times that amount: from $18,050 to $13,460. Daley and Coates (2016).

That's why state and territory governments should ensure asset-rich but income-poor households can stay in their homes, by allowing them to defer paying the levy until they sell their property. Deferral arrangements are already available for seniors paying council rates in South Australia, Western Australia and the ACT.[23]

Exempting or providing concessions to asset-rich but cash-poor landowners would be unfair to younger taxpayers. It also ignores the substantial resources of some retirees. Concessions based on pension eligibility are already poorly targeted: many wealthier Australians receive the Age Pension. About 80 per cent of mature-age households with $1 million of net assets receive welfare benefits in 2012-13.[24]

Alternative proposals to 'grandfather' existing home-owners from any recurrent property tax until the property is next sold,[25] or to allow purchasers to choose between paying stamp duty or land tax,[26] would fully exempt asset-rich, income-poor households from paying the levy unless they chose to move. These options would also neutralise perceptions of unfairness among those who have recently paid stamp duty. However, both options pose significant threats to state and territory budgets, because the state or territory foregoes stamp duties received up-front in favour of a much smaller recurrent property tax paid each year. Such a shortfall could be financed,[27] but would still show up as a large deterioration in headline budget balances.[28]

[23] Daley and Coates (2015), p.20.
[24] Daley*, et al.* (2013), p.37. This excludes the impact of changes to the Age Pension assets test that took effect from 1 January 2017, which reduced the entitlements of 326,000 Age Pensioners (Daley*, et al.* (2018), p.35).
[25] Bentley and D'Cruz (2016).
[26] Treasury (2010), p.269.
[27] PBO (2016).
[28] Coates (2017).

1.4 Property tax reform would modestly improve housing affordability

Replacing stamp duties with general property taxes would not affect housing prices much in the short run, but in the long run the prices of larger dwellings might reduce a little.

In the short run, dwelling prices would be largely unchanged: the boost to the purchasing power of prospective buyers as stamp duties were abolished would be offset by higher recurrent property tax bills, which would be capitalised into property values.[29]

But in the long run, a better allocation of the housing stock would lead to lower prices, particularly for larger dwellings. Overall, the average price of housing would fall a little.[30] Abolishing stamp duties may help some households by lowering the deposit hurdle.[31]

[29] Both stamp duty and a broad-based land tax would be fully capitalised into land values, in which case a stamp duty/land tax swap would have no impact on house prices. See: ibid. and Freebairn (2017), p.5.
[30] For example, Abelson (2016) estimates that abolishing stamp duties in NSW could increase the effective NSW housing stock by up to 2 per cent, based on an analysis of unneeded spare bedrooms, reducing NSW house prices by 6 per cent.
[31] Daley*, et al.* (2018), p.20.

2 The NT Government should abolish first home-buyers' grants and stamp duty concessions

The NT Government should abolish grants and stamp duty concessions for first home-buyers. These schemes do not improve affordability overall and have significant budgetary costs totalling $23 million a year.[32] The First Home Owner Discount for stamp duty costs the NT Budget $13.2 million a year in foregone tax revenue. The First Home Owner Grant of $26,000 available to people who purchase or build a new home costs a further $10 million a year.

2.1 First home buyers' grants have worsened housing affordability

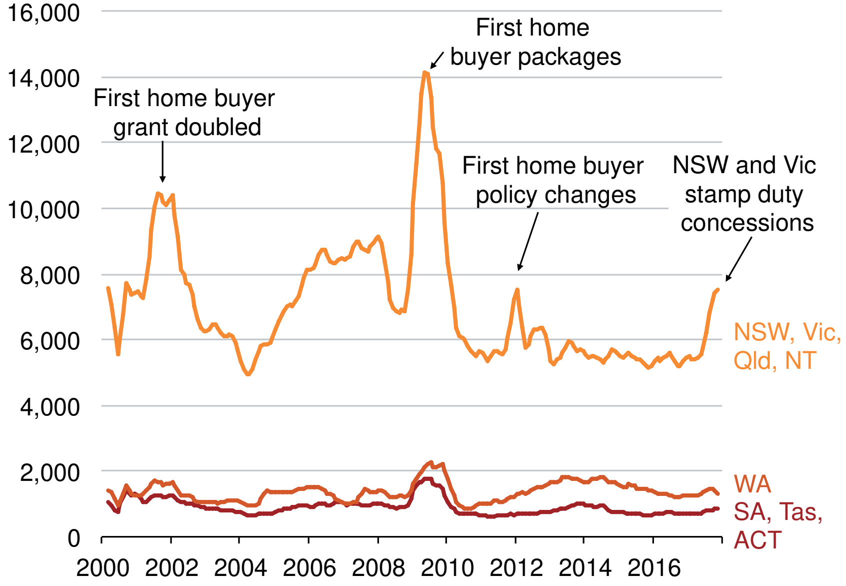
Over recent decades, Commonwealth, state and territory governments have spent billions of dollars giving cash and tax concessions to first home-buyers.[33] These policies have resulted in spikes of first home-buyer activity, but haven't improved affordability. Typically first home-buyers' purchases are brought forward, then there is a lull in activity, and in the end housing affordability does not improve overall.

Beyond their sizeable budgetary costs, giveaways to first home-buyers have actually worsened housing affordability by further inflating demand for housing. While first home-buyers' grants may help some individuals to outbid an investor and buy a house, they do little to make houses affordable at an aggregate level.

[32] Northern Territory Department of Treasury and Finance (2017), p.26.
[33] Eslake (2013). Daley, *et al.* (2013), p.49, estimated that abolishing all subsidies for first home-buyers could save Commonwealth, state and territory budgets a combined $1.3 billion a year.

Figure 6: First home-buyer grants and stamp duty concessions increase demand temporarily

Number of dwellings financed, first home-buyers, seasonally adjusted



Note: Includes refinancing.
Source: Daley et al. (2018), Figure 8.1.

Instead these policies artificially inflate the demand for housing, resulting in house prices being higher than otherwise, with most of the benefit flowing to existing home-owners. Economist Saul Eslake has suggested they are more accurately described as 'second home vendors' grants'.[34]

[34] Eslake (2013)

Stamp duty concessions act in a similar way to cash grants for first home-buyers.[35] When buyers don't have to pay as much stamp duty, they're prepared to pay more for a property, thereby increasing demand. In practice, first home-buyers have consistently, over a long period of time, been prepared to borrow an average of 83 per cent of the purchase price (after transaction costs).[36] If this leverage is the binding constraint, the concession could induce first home-buyers to increase the final house price by much more than the value of the stamp duty cuts.[37] The Victorian Government's first home-buyer stamp duty concessions likely contributed to the increase in prices for new houses in Melbourne's outer suburbs in 2017.[38]

Nor can stamp duty exemptions for first home-buyers be justified on the basis that stamp duties discourage people from moving. By definition, first home-buyers don't face obstacles to moving to a new job or a house that better meets their needs – they have not already paid stamp duty on their existing home.[39]

[35] Davidoff and Leigh (2013).
[36] Simon and Stone (2017).
[37] A first home-buyer with a deposit of $100,000 would be prepared to pay $455,000 for a house and, after paying stamp duty (at 5 per cent) of $23,000, would be 83 per cent leveraged. The same first home-buyer would be prepared to pay $588,000 for a house and, if they did not have to pay stamp duty, would still be 83 per cent leveraged.
[38] Daley, *et al.* (2018), p.137.
[39] Stevens (2017), p.9.

2.2 Improving housing affordability will involve tough choices

If governments really want to make a difference to housing affordability, they need to stop offering false hope through policies, such as first home-owners' grants, that are well-known to be ineffective. Instead they need to explain the hard choices to prepare the ground for the tough decisions that need to be made. Our recent report, *Housing affordability: re-imagining the Australian Dream* shows what needs to be done.[40]

The first step to making housing more affordable is to face up to the size of the problem.[41] Demand for housing has risen as interest rates fell, incomes rose, migration increased and government policies artificially inflated demand. But the supply of well-located homes has not kept up, resulting in higher land prices. Even though land prices have risen, supply has not increased enough because of legislative restrictions on the effective supply of residential land – both limits on rezoning for urban infill and limits on developing land at the urban fringe.

Building an extra 50,000 homes a year for a decade could leave Australian house prices 5 to 20 per cent lower than what they would have been otherwise, and stem rising public anxiety about housing affordability. For that to happen, State, Territory and Commonwealth governments must act.

To build more homes, State and Territory governments should fix planning rules to allow more homes to be built in inner and middle-ring suburbs of our largest cities. More small-scale urban infill projects should be allowed without council planning approval.

[40] Daley, *et al.* (2018)
[41] For further analysis of the drivers of rising house prices, see ibid., Chapter 3.

State and Territory governments should also allow denser development 'as of right' along key transport corridors. They should swap stamp duties for general property taxes. And state land taxes on investment property should be set with reference to a person's total landholdings, to encourage more institutional investors likely to provide longer-term tenancies.

It took neglectful governments two decades to create the current housing affordability mess. They preferred the easy choices that merely appear to address the problem. The politics of reform are fraught because most voters own a home or an investment property, and mistrust any change that might dent the price of their assets. But if governments keep pretending there are easy answers, housing affordability will just get worse. Older people will not be able to downsize in the suburb where they live, and our children won't be able to buy their own home.

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