Self-funding infrastructure and the redundant GAIC

A submission by **Prosper Australia** to the Inquiry by the Outer Suburban/Interface Services and Development Committee of the Parliament of Victoria into the ***Impact of the State Government's decision to change the Urban Growth Boundary***

ONE-PAGE SUMMARY

We submit that:

(1) Any claim that the State Government prefers urban density to urban sprawl will have no credibility as long as the Government allows local councils to *tax infill development* by means of rates on the "capital-improved value" (CIV) or the "net-annual-value" (NAV), both of which include values of buildings, in contrast to the **site value** (**SV**), which is the value of land and airspace alone.

(2) Suburban home owners will not tolerate increased population density in their suburbs unless it comes with a credible promise of improved infrastructure, especially **public transport**. But they *will* welcome density if they see it as a magnet for infrastructure that will enhance values of existing properties.

(3) Promises of new and improved infrastructure will have no credibility until the Government establishes a **sustainable method of *financing* the infrastructure**.

(4) The one sustainable method of financing infrastructure is to **recycle part of the benefit** to cover the cost—that is, to claw back a fraction of the resulting **uplift** in site values (the remaining fraction being a windfall for the property owners—a windfall that they would probably not otherwise receive, because the infrastructure would probably not otherwise be built).

(5) Point (4) does *not* mean increasing taxes in order to pay for infrastructure. It means redesigning the revenue *base* so that future expenditure on infrastructure **pays for itself** by expanding the base *without* changes in rates or thresholds.

(6) In view of points (2) to (5), any claim that the State Government prefers density to sprawl will have no credibility until the revenue base is redesigned to capture uplifts in site values.

(7) The excuse for the GAIC and development levies—namely that land values are increased by permission to develop and by public provision of infrastructure upstream and downstream of the development—will have no credibility until the charges are **(i)** *explicitly apportioned to uplifts in site values*, and **(ii)** *payable by the parties that actually receive the uplifts*. Development levies violate the first requirement, while the proposed GAIC—which taxes *areas*, not values, let alone uplifts in values—violates both.

(8) A transfer charge on property, payable on sale and proportional to the real increase in the site value since acquisition, could not only **replace the GAIC** and **development levies** but also replace **conveyancing stamp duties**—and would be politically advantageous because, unlike the taxes that it would replace, it could not turn a capital gain into a capital loss or magnify a loss.

(9) If urban density is promoted by *positive* policies that encourage and facilitate infill development, instead of *negative* policies that prohibit development outside some rubbery boundary, the profits of developers will depend on the quality of their developments instead of the quality of their lobbying. The result will be better development.

(10) Livability is **density done right**. But until infrastructure is financed by capturing uplifts in site values, density will continue to be done badly, so that proposals to increase density will continue to provoke opposition, to the continuing delight of those who profit from extensions of the Urban Growth Boundary.

Contents

1 The overthrow of local democracy in favour of sprawl 3

2 Tolerance for urban density 5

3 Self-funding infrastructure 5

4 Is the UGB necessary? 6

5 Livability and density 7

6 Conclusions addressing the Terms of Reference 7

1 The overthrow of local democracy in favour of sprawl

As this submission is being written, the "land-banking" developers who stand to gain from the current expansion of the Urban Growth Boundary are quietly celebrating an even bigger victory, namely the imminent **demise of site-value rating** in Victoria. Current events indicate that from next financial year, the rating systems of *all* Victorian municipalities will discourage infill development and therefore, by default, increase the demand for living space at the urban fringe, increase the pressure on the State Government to extend the Urban Growth Boundary (**UGB**) yet again, and thus increase the likelihood that the "land bankers" will reap unearned windfalls when land subject to their call options is approved for development.

Before 1920, all Victorian municipalities levied rates on the **net annual value** (**NAV**) of land *and buildings*. This was an obvious deterrent to construction, reconstruction, extension, renovation and maintenance, and favoured speculators holding vacant land.

In 1920, ratepayers gained the right to demand a local referendum as to whether rates should be levied on the **site value** (**SV**), which is the value of land and airspace alone, or on the NAV, or as a "shandy" (an average of NAV and SV).[1] A referendum to initiate a change, or to overturn a change resolved by the council, would be held if 10% of the voters demanded it. In the years 1920 to 1986, there were 90 such referenda, and in 70 out of 90 cases the voters chose SV. During this period the Land Values Research Group, under its founding director Allan R. Hutchinson, produced several studies which showed—not surprisingly—that SV-rating municipalities had more construction, renovation and other economic activities than their non-SV neighbours. Victoria was the only jurisdiction in the world in which this methodology could be used on such a large scale over such a long period.

The Cain government, in the Local Government Act 1989, phased out the "shandy" and introduced the option of rating on the **capital-improved value** (**CIV**), which is the lump-sum value of the site and buildings. Most significantly, the new Act blatantly encouraged taxation of buildings by permitting councils to impose arbitrary numbers of differential rates *only if they used CIV*. The Kennett government was similarly pro-CIV. Subsequent amendments took away the right to a referendum, so that when council after council succumbed to the pressure to change from SV to CIV, the ratepayers could not reverse the decisions. The pressure was high for SV councils, but not so high for NAV councils, because the NAV could exceed 5% of the CIV for commercial/industrial property but was fixed at 5% for residential property, giving a *de facto* differential in favour of the more numerous residential ratepayers. By 2005/6, half a dozen councils still used NAV, but the last SV domino standing was the City of Monash.

At the "Ordinary Meeting" of October 6, 2009, the Monash City Council carried the recommendation of its Rating Strategy Steering Committee, which began:

> ***1.*** *Council resolves to change to CIV with a differential rate of 1.25 times the general rate on Commercial/Industrial properties, for the financial year beginning 1 July 2010 and commence formal public consultation. . .*[2]

Acknowledging that the outcome of a "formal public consultation" held after the Council "resolves" would be a fait accompli, the Council had previously held an "informal consultation", including six public meetings—where, according to the report of the Steering Committee,[3] "The clearest support emerged for a change from SV to CIV." Comparing that statement with what we observed at the meetings merely confirms the suspicion, voiced by several ratepayers in attendance, that the outcome of the "informal consultation" was *also* a fait accompli.

[1] The "shandy" was not available until 1968 (correction added Oct. 13, 2009).
[2] http://monash.vic.gov.au/reports/pdftext/minutes/06oct09decision.pdf .
[3] http://monash.vic.gov.au/reports/pdftext/cp06oct09/7.1.pdf .

The same report contains the revealing statement that "A key issue for SV is that it does not reflect the landowners [sic] ability to pay rates where ability to pay is *defined* by the value of improvements to the property" (emphasis added). In the end, the contention that improvements reflect capacity to pay had to be a matter of *definition* because it sank like a stone at the second public meeting, was not explicitly stated at subsequent meetings lest it be further attacked, and was logically dismantled in s.9 of the submission by the Land Values Research Group.[4] The same submission showed that every other allegedly pro-CIV argument heard during the consultation was better addressed by some combination of a municipal charge, a garbage charge, and appropriate use of the waiver provisions of the Local Government Act. Of all the arguments in the Steering Committee's report, the only one that was *not* comprehensively demolished in the LVRG's submission was the alleged need to shift the burden from residential to commercial/industrial ratepayers. That required differential rating, which the Act—very conveniently—permitted only for CIV!

So after 90 years, the rating system whose superiority is demonstrated by empirical evidence and basic economic theory, and which the ratepayers of Victoria usually voted for when given the chance, and for which many lifetimes of service have been given in researching and campaigning, is to be put to death for reducing the profits of a certain faction of the development industry—not the whole industry, but only that part which reaps unearned windfalls from the demand for land at the urban fringe. The execution will be public, but is not expected to be well attended. It will take place at the "Ordinary Meeting" of the Monash City Council at the Civic Centre, 293 Springvale Rd, Glen Waverley, on the evening of December 8.

N.B.: By taxing values of buildings, CIV and NAV rates invite neglect of existing buildings, reducing the values of surrounding sites, hence reducing State revenue from stamp duties, "land tax", and any proposed charge on uplifts in site values. The effect on State revenue is highly pertinent to this Inquiry, which is occasioned in part by the perceived difficulty of financing infrastructure for new suburbs. ***If the State cannot afford to tolerate tax avoidance or tax evasion, neither can it afford to tolerate municipal rating schemes that erode the State revenue base.***

In view of the 20-year bipartisan acquiescence in the legislative bias in favour of CIV, we are not confident that the present Committee's attitude to the demise of SV will be anything other than "Mission accomplished!" We are not even confident that the Parliament will not seize the opportunity to drive a stake through the corpse by mandating CIV! But just in case this State is run by the elected representatives of the people and not by the land-bankers, we submit that ***SV rating should be mandated***, and that any municipal "service charges" that amount to *de facto* taxes on buildings (e.g., charges of so much per year per dwelling, or per some other unit whose presence is correlated with that of a dwelling) should be subject to a limit like that presently imposed on the "municipal charge".[5] If political considerations dictate that "flat" SV rating does not place enough of the burden on commercial and industrial land and/or multi-unit residential complexes, the appropriate response is to allow a higher differential *SV* rate on commercial and industrial sites and/or sites approved for multi-unit residential developments.

The political pain caused by changes in the rating base can be minimized by explicitly allowing councils to cap annual increases in bills. As the same caps would apply to increases caused by periodic revaluations, the overall volume of dissatisfaction with increases in bills would be less than under present arrangements, notwithstanding the changes in the rating base.

Caps on increases in rates bills should be decided by councils. They should not be imposed by the State, lest they unduly constrain the ability of councils to fund necessary services (as allegedly happens in NSW).

[4] http://blog.lvrg.org.au/2009/09/lessons-on-politics-of-rates-reform.html .

[5] Local Government Act, s.159 .

2 Tolerance for urban density

For a given total population (taken as "given" because policies affecting population are determined mainly at the Federal level), population *density* varies as the inverse square of the linear dimensions. But when commuting times are allowed for, the density (i.e. the number per unit area) of *moving* commuters is more like the simple reciprocal of the linear dimensions. So traffic density does not rise in full proportion to population density. The picture improves further if we understand "traffic" in terms of vehicles, especially *powered* vehicles: as the linear dimensions are reduced, more commuters can walk or cycle to their destinations, and it becomes feasible (even without the tax reforms proposed herein) to provide public transport within walking or cycling distance of a larger percentage of the population. As public transport carries more persons per vehicle than private transport and uses each vehicle for a larger fraction of the time, it causes less congestion per passenger-km, compounding the benefit of fewer passenger-km due to shorter distances and the options of walking and cycling.

Experience shows, however, that property owners invariably oppose higher density on the stated ground that it will overload the existing infrastructure. They do not seem to believe that the new infrastructure made "feasible" by higher density will actually materialize. And nor should they, as long as new infrastructure competes with other spending priorities in the struggle for a limited pool of public funds. If a promise of new infrastructure is to be believed, **new infrastructure must create the revenue that pays for it**, so that it can no longer be sidelined by "other spending priorities".

3 Self-funding infrastructure

The capital cost of new infrastructure is seldom recoverable through **user charges** (e.g. fares), because high user charges mean **low patronage**. While the *benefit* of an infrastructure project is worth whatever people decide to pay for it, user charges are only one component of what they pay. The other component is the price of access to *locations* where the infrastructure can be used, as opposed to locations where it cannot: "Location, location!" The latter component, which is the benefit *net of user charges*, is manifested as **uplifts in site values**—not values of buildings, which are limited by construction costs, but values of space, because space has location, and therefore locational value, even if no buildings yet occupy it. Hence the **cost-benefit ratio** of an infrastructure project, where the "cost" is also net of user charges, is simply the **cost-uplift ratio**. If the "tax" system claws back a certain fraction of every uplift in land values, any public infrastructure project whose cost-benefit ratio does not exceed that fraction is self-funding or better than self-funding. The remaining ("after-tax") portion of the uplift is a net windfall for the property owners—who should therefore be glad that the clawback enabled the project to proceed.

The existing "land tax", as far as it goes, is effective in clawing back uplifts in site values, provided of course that the rates and thresholds are left well alone, and are not modified every time property owners claim to be suffering because their assets have increased in value!

Other State taxes are *inefficient at clawing back uplifts in site values*. Even **development levies** and the **GAIC**, which are ostensibly levied for the purpose of financing infrastructure, and which are ostensibly justified by uplifts in property values due to rezoning and public provision of infrastructure, are not explicitly levied on or apportioned to the said uplifts. Development levies are per-lot. The GAIC is per-hectare. Neither is levied on *values*, let alone uplifts in values. Worse, the GAIC is payable by a land owner who sells to a developer, even if the owner must sell at a price fixed under an existing contract that did not allow for the GAIC. Thus the GAIC can amount to a retrospective tax on a past decision, and may not be paid by the party who actually benefits from the rezoning.

Capture of uplifts in site values would be much improved if all existing taxes on property trans-

fers, including stamp duty, development levies and the GAIC, were replaced by a single **site windfall charge** (**SWC**) payable by the vendor and proportional to the real increase in the site value since acquisition, with a deduction for any expenses incurred by the vendor in contributing to the uplift—e.g. infrastructure provided by developers *between* developed residential lots, contributing to the locational values of those lots.[6] The SWC would not only facilitate and encourage public investment in infrastructure, but, unlike existing transfer taxes, would be guaranteed not to turn an otherwise profitable purchase-resale cycle into a loss-maker. All this should appeal to property owners and their lobbyists. To avoid any element of retrospectivity, vendors who acquired their properties before the change should have the *option* of paying tax as if they had sold and bought back their properties on the last day before the change, so that the SWC would apply only to the uplift in the site value *since the change*; and any vendor who sells a site at a price fixed before the change should pay the SWC on that price, which would then be the base value for any SWC subsequently paid by the buyer.

A fraction of the SWC collected in each municipality should be refunded to the local council in recognition of its infrastructure responsibilities.

The initial replacement of existing taxes by the SWC could be revenue-neutral. But thereafter, expenditure on a wide variety of infrastructure would pay for itself by expanding the revenue *base* without further changes in "tax" rates or thresholds.

N.B.: Contrary to superficial appearances, the SWC would *not* amount to a shifting of the existing stamp duty from buyers to sellers. The *obvious* reason is that the seller will avoid tax on any subsequent purchase. But the *fundamental* reason is that any such "shifting" is done by the market. If a transfer charge is payable by the seller, the seller will want to add it to the price. If it is payable by the buyer, the buyer will want to subtract it from the price. Unless the charge is legislated after the price is agreed, the charge will be shared between the seller and buyer in inverse proportion to their bargaining power, regardless of who nominally "pays" it. But if the transfer charge depends on the increase in the site value since acquisition, it is convenient to make it payable by the seller, who already knows the value at the time of acquisition and has the cash with which to pay.

4 Is the UGB necessary?

A growth boundary is the economic equivalent of a **pressure vessel**; and when a pressure vessel **springs a leak**, it tends to do more damage than if one had never tried to contain the pressure in the first place. The UGB can indeed spring a leak—by ejecting satellite townships to such a distance that they are not considered part of Melbourne and therefore to not technically violate the UGB, but are still close enough to permit commuting. Thus the attempt to contain sprawl might only make it worse.

An alternative remedy, which is not liable to backfire in this way, is to *encourage infill growth* instead of trying to prohibit outward growth. If the municipal rating system were not hostile to infill development, and if the State revenue system were to capture a sufficient fraction of uplifts in land values to finance the infrastructure needed by increased density, thus overcoming the present opposition thereto, then further spreading of suburbia might be arrested *without the need for a UGB*.

But as long as the UGB is there, it is there to be enforced—not to be extended for the benefit of speculators who hold titles or options over land in certain locations just outside the present boundary, at the expense of others who hold titles or options over land inside it or in other locations just outside it. Developers should be rewarded for development, not for lobbying.

[6] In each estate to be subdivided, the initial value and the development cost would need to be notionally divided among the lots in order to calculate the SWC on each lot. The method of apportionment would not greatly matter, because it would not affect the *total* tax payable on the lots. But some method would need to be specified in the SWC legislation.

5 Livability and density

It is rightly said that the most important quality of real estate is location. But location is assessed chiefly in terms of **proximity** to work, shops, schools, etc. Everyone wants to be close to almost everything, including the CBD and the bush. These wants can be reconciled only by urban **compactness**. But if compactness is not to degenerate into congestion, it must be accompanied by **infrastructure**, including comprehensive coverage by **public transport** so as to minimize car-dependence. This is not to impugn anyone's right to own a car, but merely to admit that while *having* a car is an asset, *needing* one is a liability, especially when the roads are clogged because everyone else needs one.

The present tax system has no reasonable prospect of financing the necessary investment in infrastructure, because it fails to capture a significant fraction of uplifts in land values. This submission has offered a remedy in the form of the SWC. While the SWC is not the only possible remedy, and not necessarily the one that we would prefer, it is perhaps the one that most directly addresses the concerns of this Inquiry.

6 Conclusions addressing the Terms of Reference

We find it convenient to address the Terms of Reference in reverse order.

(f) Alternative options

Alternatives to the GAIC (and development levies and stamp duties): The only transfer charge on property should be a **site windfall charge** (**SWC**) payable by the vendor and proportional to the real increase in the site value since acquisition, with a deduction for any expense incurred by the vendor in contributing to the increase (e.g. infrastructure provided by developers between developed lots). The revenue collected from each transfer should be shared between the State and the local municipality. To avoid any element of retrospectivity, a vendor who acquired a site before the commencement of the new system ("**D-day**") should have the option of paying as if the site had been sold and bought back on the last day before D-day, so that the SWC will apply only to the uplift in the site value *since* D-day; and a vendor who sells a site at a price determined before D-day should pay the SWC on that price, which would then be the base value for any SWC subsequently paid by the purchaser.

Alternatives to the UGB: If local councils stop taxing infill development—i.e. if they levy rates on the **site value** only—and if infill development is made politically acceptable by infrastructure funded by the SWC, then Melbourne will start growing upward instead of outward, with or without any artificial constraint on outward growth.

(e) Any displacement or replacement of Government spending

If the introduction of the SWC in lieu of other transfer taxes is revenue-neutral, this will not of itself have any effect on spending. But if spending on infrastructure is subsequently increased, revenue from the SWC will automatically increase due to growth of the SWC base, i.e. uplifts in site values.

(d) Unintended consequences

Of the GAIC: Owners who have contracted to sell land to developers at fixed prices in the event that the land is included within the UGB will have done so on the assumption that any associated tax will be paid by the developer. If the GAIC is instead payable by the current owners, some of them will be

ruined, and in no case will the GAIC liability be reasonably apportioned to the benefit of the rezoning. The SWC, because of its anti-retrospectivity provisions, would avoid such perverse outcomes.

Of the UGB: If growth just outside the present urban fringe is prevented by the UGB, it will not necessarily be forced inside; it may be forced so far *outside* that it is no longer considered part of Melbourne, but is still within commuting distance. Thus the UGB might *increase* sprawl. This outcome can be avoided by *encouraging infill* growth instead of trying to prohibit outward growth.

(c) Impact on the housing and development industries

Because stamp duties, development levies and the GAIC are not apportioned to uplifts in site values, they can turn otherwise profitable resales into loss-makers, and thereby delay sales (and hence development and construction) until prices rise sufficiently to cover the taxes, and/or the litigation over contracts affected by tax changes is complete. Such outcomes obviously impede the supply of accommodation and damage affordability. The SWC would avoid such outcomes because it would not turn a capital gain into a capital loss or increase a loss.

(b) Ensure the contributions are directed only to the intended purposes

While the alleged *purpose* of the GAIC is to pay for infrastructure, the alleged *justification* for it is that the payer has received a windfall, in the form of an uplift in a site value, due to (*inter alia*) the promised infrastructure. From the viewpoint of the payer, what matters is whether the windfall is actually *received*; whether it is *caused* by infrastructure or by something else is irrelevant. Because the SWC as proposed herein is levied on the windfall, it is not payable unless the windfall is actually received. Stamp duties, development levies and the GAIC give no such guarantee.

(a) Quantum of the collections

The issue is whether the "collections" are sufficient to pay for the infrastructure made necessary by the development approvals giving rise to the collections. If the collections recover a certain fraction of each unearned uplift in site values, infrastructure projects whose cost-benefit ratios do not exceed that fraction will be self-funding. The SWC would indeed recover fractions of unearned uplifts in site values. Stamp duties, development levies and the GAIC are not so well targeted.

. . .

We thank Mr Sean Coley, Executive Officer of the Outer Suburban/Interface Services and Development Committee of the Parliament of Victoria, for the invitation to make this submission.

Yours sincerely,

(Dr) Gavin R. Putland
Director, Land Values Research Group
Prosper Australia
1/27 Hardware Lane
Melbourne, Vic 3000
Tel. (03) 9670 2754
Fax (03) 9670 3063