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Value capture through development licence fees

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Introduction

This paper argues that the oft-cited ‘windfall gains’ attaching to planning approvals are simply capitalised monopoly rents arising from warranted restrictions on competition in the market for development rights. While there are many in the literature calling for taxes on ‘planning gain’ or ‘betterment’, this paper suggests an alternative policy strategy involving charging proponents for privileged access to limited development rights. For the most part, we illustrate these arguments with examples from Victoria. However, they are generally applicable across all Australian jurisdictions.

Monopoly rents arising from limits competition

Restrictions on competitive access to markets inevitably create opportunities for extraction of super profits or ‘monopoly rents’.

These restrictions on competition may be ‘natural’. This can occur when the market in question can only support one (or a small number) of efficient suppliers, by virtue of the capital intensity of the business or simply the limited size of the market.

Restrictions on competition can also be deliberately constructed through state regulation. Historically, governments reserved, to themselves, access to trade in particular markets with a view to extracting the monopoly profits on offer. This could occur directly through state outlets or through the official sale of the trading rights¹.

This revenue objective aside, regulation of competition may be warranted in the interests of economic efficiency. While open competition and market access can generally be relied upon to produce a welfare-boosting outcome for the community, this is not always true, principally because of market externalities. Transactions among freely competing suppliers and their customers may cause unwanted side effects for third parties. These external welfare losses could outweigh or significantly dent the welfare gains made by market transactors.

Warranted restrictions on competition

Regulation of land use and development through planning schemes in Victoria and other Australian jurisdictions represents a restriction on competition warranted by this economic efficiency objective. A ‘free for all’ in, say, the development of traffic generating shops, noise emitting warehouses or sunlight robbing towers is likely to create inferior streets, neighbourhoods and cities in terms of overall community welfare.

The Harper Competition Policy Review² acknowledged that regulation of land use and development is needed, notwithstanding the implicit or explicit erection of barriers to entry in planning schemes.

Land can be used for a variety of purposes, including residential, industrial, commercial and conservation, which can include national parks. However, the unfettered market may not deliver an outcome across these various uses that is considered optimal for society as a whole. Hence, governments allocate land to particular uses through planning, zoning and development assessment.

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The Harper Report goes on to critique the way in which planning regulations constrain competition, particularly in the development of shopping centres. But, as might be expected in a policy review focused on economic efficiency, the Report fully accepts the requirement for regulation of where, when and how much and by what design proponents can develop land in the process of building the city.

The Harper committee further acknowledged that, where undertaken, past reviews have confirmed that planning regulation passes the net community benefit (i.e. economic efficiency) test, albeit that there is always room to better calibrate the restrictions on competition.

¹In some international jurisdictions, for example Norway and Sweden, Governments hold a monopoly over liquor retailing and directly own and operate a network of stores to address this market demand. Australian jurisdictions exploit this monopoly through liquor licencing fees. http://competitionpolicyreview.gov.au/files/2015/03/Competition-policy-review-report_online.pdf

²Harper, I., Anderson, P., McCluskey, S. and O’Byrne, M. (2015) **Competition Policy Review Final Report**, commissioned and published by the Australian Government

Value capture in the planning system

We therefore have deliberate and systematic restrictions on competition in planning regulations. Governments and communities sanction these because these restrictions are expected to generate a net community benefit compared to allowing urban development to proceed on a 'laissez faire' basis. However, by definition, they are also routinely creating opportunities for monopoly rent.

These opportunities for extraction of monopoly returns are attached to particular sites. Accordingly, they are capitalized into the value of the land. Other things equal, a piece of land which has latent or realised approval for the construction of a major shopping centre will be more valuable than land without this privileged access to retail centre development rights. Similarly, land approved for a multi-storey apartment building will be worth more than otherwise equivalent land designated for a single household dwelling.

This occurs because developers value candidate sites on a 'residual' basis. They will deduct from the gross proceeds of the sale of their finished products on a site all their delivery costs (approvals, site preparation, construction, marketing etc) plus a margin for profit and risk to arrive at the maximum price they would be prepared to pay for the land in question. Planning approvals which enable an expansion of gross proceeds will typically result in higher residual land values. This increase in land value is, in fact, a measure of the value of the additional development rights conferred by the planning approval (see figure 1).

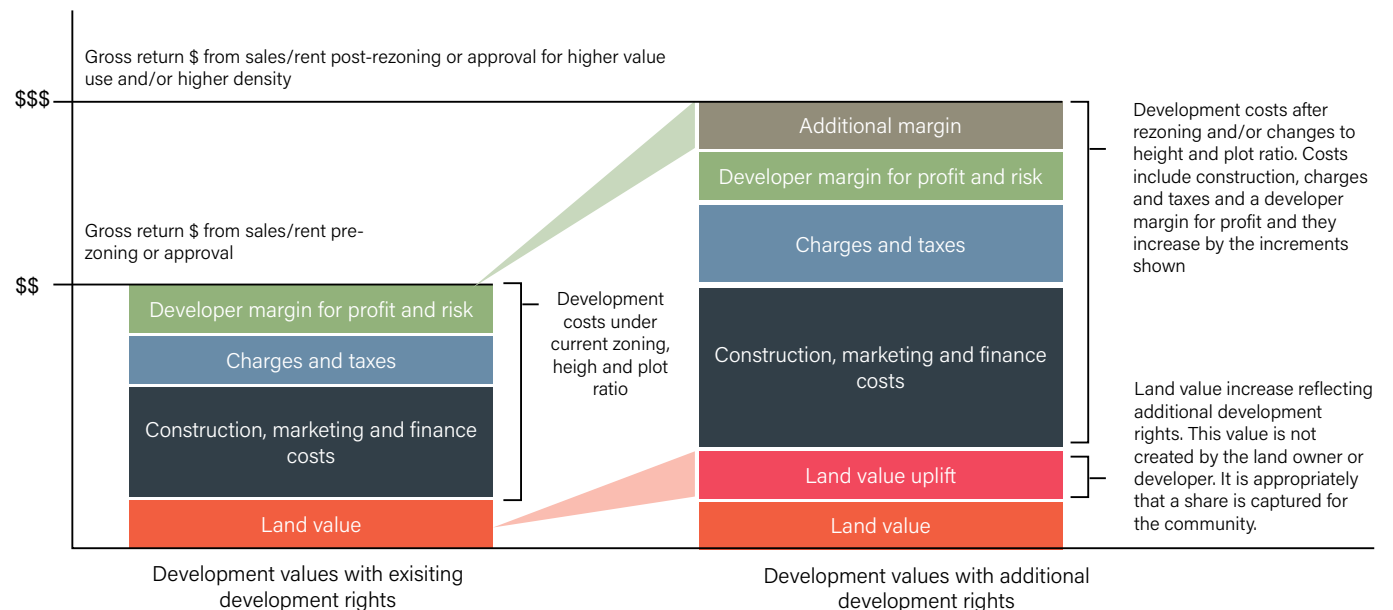
This boost to property value occasioned by variations in the competitive restrictions applying to different areas of land across the city has been recognized since the inception of planning schemes in Victoria and elsewhere. It has gone by many names including 'planning gain', 'betterment' and the rather pejorative 'windfall gains'.

Early versions of Victoria's planning legislation explicitly recognised the creation of betterment through the regulatory process and made provision for its partial capture. For example, the Town and Country Planning Act (1961) which was repealed in 1985 to make way for the current Planning and Environment Act included a specific head of power for taxation of value uplift brought about by planning scheme changes.

Even in Victoria's current planning legislation, the Growth Area Infrastructure Charge (GAIC) is, in effect, a betterment levy on the conversion of rural land for urban purposes on Melbourne's fringe.

From time to time, other jurisdictions have sought to capture part of the value uplift from planning regulations through various forms of taxation. Generally, these have been unsuccessful in no small part because of the difficulty of measuring betterment in relation to a particular transaction event. Taxing the value margin as measured 'before and after' (a planning approval or rezoning) has been problematic because of speculated pre-approval increases in value.

FIGURE 1. ESTIMATING THE VALUE OF PLANNING APPROVAL



In the absence of taxation mechanisms, approval authorities have devised less transparent ways of capturing a share of the betterment created through their planning schemes. This can include protracted negotiations to extract commitments to invest in the public domain, provide affordable housing or otherwise deliver a benefit to the local community. Some authorities have sought to regularise the extraction of community benefit by making access to additional development rights contingent on a 'bonus' system. Unfortunately, many of these innovations have had the damaging side effect of adding to a complex, inefficient and risk laden development assessment system that acts as a drag on worthwhile investment. Moreover, the granting of a bonus can connote that approval authorities are compromising environmental and design standards in order to achieve an unrelated public benefit.

Licensing rather than taxation

Rather than conceptualising betterment as a negative taxation issue – that is, the government *taking away* part of the wealth of a property owner – it can be seen as the *sale of development rights* to proponents granted privileged access to markets that must be regulated for the sake of economic efficiency. That is, the government is providing a positive asset to the proponent for a reasonable price linked to the monopoly rent on offer.

This perspective may be novel within the confines of the planning system, but it is conventional in other regulatory regimes where market access is necessarily restricted in the interests of efficiency. Access to commercial fisheries, broadcasting bands, logging in native forests and, as noted, liquor distribution are but some examples of where regulation is essential to manage natural monopolies and externalities in a sustainable and equitable way, and where those granted access to the limited trading rights must pay a licence fee to government for the privilege.

Australian precedents

Development proponents in the ACT are already required to pay a fee linked to the value of the land-use rights granted via the planning system. Since 1971, the Territory Government has imposed some form of licence fee where there is betterment as a result of a change in land use, additional floor space or both.

That this licence payment is straightforward and generally accepted in the national capital stems from the fact that the Territory has a leasehold rather than freehold land tenure system. Once proponents for more intense or higher value land uses have secured planning approval for the sites in question, the terms of their lease on the land must be varied to accommodate this approval. As the varied lease will be of higher value than the pre-planning approval lease, the Government extracts a proportional lease adjustment fee.

Originally, this lease variation charge was estimated on a case-by-case basis, using before and after valuations. The system is now being reformed to use codified or pre-notified standard per unit values for different types of development in the different suburbs of Canberra³.

The development licensing fee system in the ACT is made transparent by the leasehold arrangements unique to that jurisdiction. However, it is not dependent on that system of land tenure. A codified system of development licensing system identical to that of the ACT could be applied across Australia.

An operational model for development licence fees

A development licensing system of general applicability would compare the current use of a lot with the proposed use and apply a fee geared to the implied uplift enabled by the planning approval.

The before and after site *valuations* would not be estimated for this purpose. As noted, such valuations are likely to have been subject to pre-approval speculation. To circumvent this problem and to simplify administration, the uplift in land use value would be established using generalised residual land value figures for the suburb or precinct in question. These generalized figures would be empirically based in the sense that they would be derived from recent sales records.

³See Macroeconomics.com.au (2010) **Final Report on the Review of the Change of Use Charges System in the ACT**, commissioned by the ACT Treasury <http://www.treasury.act.gov.au/Change%20of%20Use%20Charge/CUC%20-%20Macroeconomics%20Nicholls%20report.pdf>

This approach has been applied in the recently approved Amendment C270 to the Melbourne Planning Scheme. Proponents of developments in the central city with a floor area ratio (FAR) greater than the adopted benchmark of 18:1 are required to pay an in kind licence fee geared to the generalised residual land value for each square metre of floorspace above the benchmark. These generalised residual land values are calculated as 10% of the gross realisation value, which itself, is a generalized or typical figure for each precinct in the central city (see table 1 and figure 2).

The gross realisation values adopted in Am C270 are shown in the following table. On this basis, a proponent of development for an additional 10,000 square metres of residential floorspace above the 18:1 FAR in, say, the 'Eastern Core' precinct must, firstly, meet all relevant design standards and, secondly, make a public benefit dedication on site to the value of $10,000 \times \$9,000 \times 10\% = \9 million.

This dedication must be made 'in kind' as agreed with the approval authority, and take the form of any of the items listed below:

- publicly accessible open areas on site
- publicly accessible enclosed areas within the proposed building
- affordable housing within the proposed building
- competitive design process for the design of proposed building, and
- strategically justified uses including office on site or within the proposed building.

TABLE 1. GROSS REALISATION VALUES PER SQUARE METRE BY USE AND PRECINCT

	Eastern Core	North Eastern	Civic	Flagstaff	Western Core	Spencer	Southbank	Docklands
Retail	\$17,000	\$14,000	\$16,000	\$15,000	\$17,000	\$14,000	\$12,000	\$14,000
Hospitality	\$9,000	\$8,000	\$8,000	\$7,000	\$7,500	\$6,500	\$6,500	\$6,500
Commercial	\$9,000	\$6,000	\$7,000	\$5,500	\$7,000	\$5,000	\$5,000	\$5,000
Residential	\$9,000	\$8,000	\$8,000	\$7,000	\$7,500	\$6,500	\$6,500	\$6,500

Source: SGS using EY data

FIGURE 2. GRV PRECINCTS MAP



Source: DELWP (2016), How to Calculate Floor Area Uplifts and Public Benefits

The 'value sharing' or development licensing principle established in the Melbourne Planning Scheme could be readily applied to all development across the State, although several refinements would assist in efficient administration. These include making allowance for cash instead of in-kind payments for development licences and establishing a standardized base line for the calculation of fees. The value of the additional development rights would be taken as the difference between the (standardized) residual land value of the proposed development and the (standardized) residual land value of existing use rights.

It would also be useful to separate collection of the licence fee from the planning assessment process, as occurs in the ACT. That is, a proponent would secure a development approval purely on the planning merits and then purchase the relevant licences at the scheduled fee from a separate agency of government. This would mitigate perceptions that planning outcomes are being compromised in pursuit of greater revenues.

As an illustration of how this expanded and codified development licensing system might work, refer to the table of nominal residual land values by hypothetical suburb below. Assume a proponent wants permission to replace four single family houses on four lots in

Suburb 3 with a residential tower of 100 dwellings comprising a total of 10,500 square metres of floorspace. In this case, the value of existing use rights will be $\$450,000 \times 4 = \$1,800,000$. The gross value of the development rights after the approval will be $10,500/100 \times \$80,000 = \$8,400,000$. The value uplift enabled by the development approval will therefore be $\$6,600,000$.

The percentage of this uplift taken as a licence fee is a matter for policy. In the ACT, it has ranged up to 75%. In a recently adopted de-facto licensing scheme, the Georges River Council in NSW seeks to recover 50% of the value of additional development rights granted through planning approvals⁴.

It is important to leave 'something on the table' in striking the fee rate. Too high a percentage could act as a disincentive to development.

A rate of up to 50% might be seen as reasonable, particularly if phased in over a long period (say 5 to 10 years) to allow currently embedded price expectations to work their way through the market. At 50%, our Suburb 3 proponent would be required to pay \$3.2 million for a development licence fee. This amounts to around 40% of the gross value of the development rights.

A development licence fee of this nature would generate significant revenues. If, for the purposes of illustration, we assume a residual land value of around \$50,000 per apartment in Victoria and approvals of around 30,000 such dwellings each year, revenue yield would be \$600 million per annum for that state. Development licence fees for commercial, retail, hospitality and other land uses would be in addition to this. So revenues could exceed \$1 billion per year in Victoria.

TABLE 2. NOMINAL RESIDUAL LAND VALUES

Land Use/ Development	Unit	Suburb 1	Suburb 2	Suburb 3
Low density residential	dwelling	\$380,000	\$500,000	\$450,000
Medium density residential	100 sq m NLA	\$62,500	\$70,500	\$65,000
High density residential	100 sq m NLA	\$75,000	\$85,000	\$80,000
Commercial - low rise	100 sq m NLA	\$70,000	\$79,000	\$74,000
Commercial - high rise	100 sq m NLA	\$63,000	\$71,100	\$66,600
Retail / Hospitality	100 sq m NLA	\$82,500	\$93,500	\$88,000
Industrial - intensive	100 sq m NLA	\$35,000	\$39,500	\$37,000
Industrial - low density	100 sq m NLA	\$23,100	\$26,070	\$24,420

⁴The value of these additional rights are also estimated on a codified, pre-notified basis along the lines of AmC270 in Melbourne. See <http://www.georgesriver.nsw.gov.au/GeorgesRiver/media/Documents/Building/Planning%20Agreements/Georges-River-Council-Policy-on-Planning-Agreements-effective-10-August-2016.PDF>



Collateral benefits

Capturing land value through development licence fees would bring a number of collateral benefits.

Revenues from licence fees could be shared between State and local government. This would give local communities and Councils an incentive to facilitate housing and other warranted development. This structural change in the way value created by development is shared could pave the way for liberalization of the land supply chain for housing construction, particularly in well serviced areas. This would work towards improved housing affordability.

Moreover, better data would be generated about the value (or loss of value) implied by proposed planning scheme changes. This would enable more efficient and accurate assessment of whether these changes will give rise to a net community benefit. It might also be expected that speculative bidding up of land values ahead of approvals may be dampened, leading to more rapid and efficient adjustments in local land markets.

Importantly, a development licence fee will be non-distortive if calibrated correctly. That is, a development licence fee would not deter development that would have occurred in the absence of such a scheme. Proponents will be indifferent as to whether they pay the full value of the development rights secured through a planning approval to the private owner of the site, or whether this amount is shared between the private owner and government. On the land owners' part, they can be expected to continue to release the sites in question for redevelopment for as long as there is a sufficient price premium on offer compared to the value of the sites in their current use.

Coverage of value uplift

This paper has focused on land value uplift arising from the granting of development rights via the planning system. There are two other sources of value uplift. One relates to the unpriced, off-site benefits generated by public investment in infrastructure, such as parks, public transport and other services provided in whole or part at the taxpayer's expense. Properties will enjoy this lift in value regardless of whether additional development rights are secured.

A further source of value uplift relates to the general health of the city economy which is a reflection of

sound urban management as well as historic and natural resource endowments. Property values in healthy, growing, well managed cities will be higher, other things equal, compared to a poorly managed declining city. Again, this would hold regardless of the granting of development rights or investment in new infrastructure.

These three 'engines' of value uplift are conceptually separate and should be kept so for policy making purposes (see SGS Economics & Planning Pty Ltd, 2016)⁵. Different tools for value sharing will be appropriate for the different engines. For example, the

Land Tax regimes operated by most State Governments would be suitable for the third of the sources described above. Meanwhile, special purpose 'benefitted area levies' or the like might be suitable to capture part of the uplift associated with infrastructure investments that have a localized catchment of prime beneficiaries.

Licence fees could then be secured from recipients of ad hoc development approvals. To the extent that land taxes and/or benefitted area levies affect gross realisation values and/or development costs, the size of the required licence fee would adjust automatically.

⁵SGS Economics & Planning Pty Ltd (2016) Technical paper on value capture; Final report, prepared for, and published by, Infrastructure Australia http://infrastructureaustralia.gov.au/policy-publications/publications/files/SGS_Technical_paper_on_value_capture-September_2016.pdf



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