prosper australia

BRIEFING NOTE:
REZONING WINDFALL GAINS TAX

This brief is for policymakers to better understand the issues surrounding the Victorian government's proposed tax on rezoning windfall gains, and includes the following sections:

1. Overview and rationale for the tax
2. Comment on stakeholder concerns
3. Overview of tax design considerations
4. Side-by-side comparison of ACT Lease Variation Charge, the model under development by Victoria DTF, and the alternative scheme proposed by the Urban Development Institute of Australia.

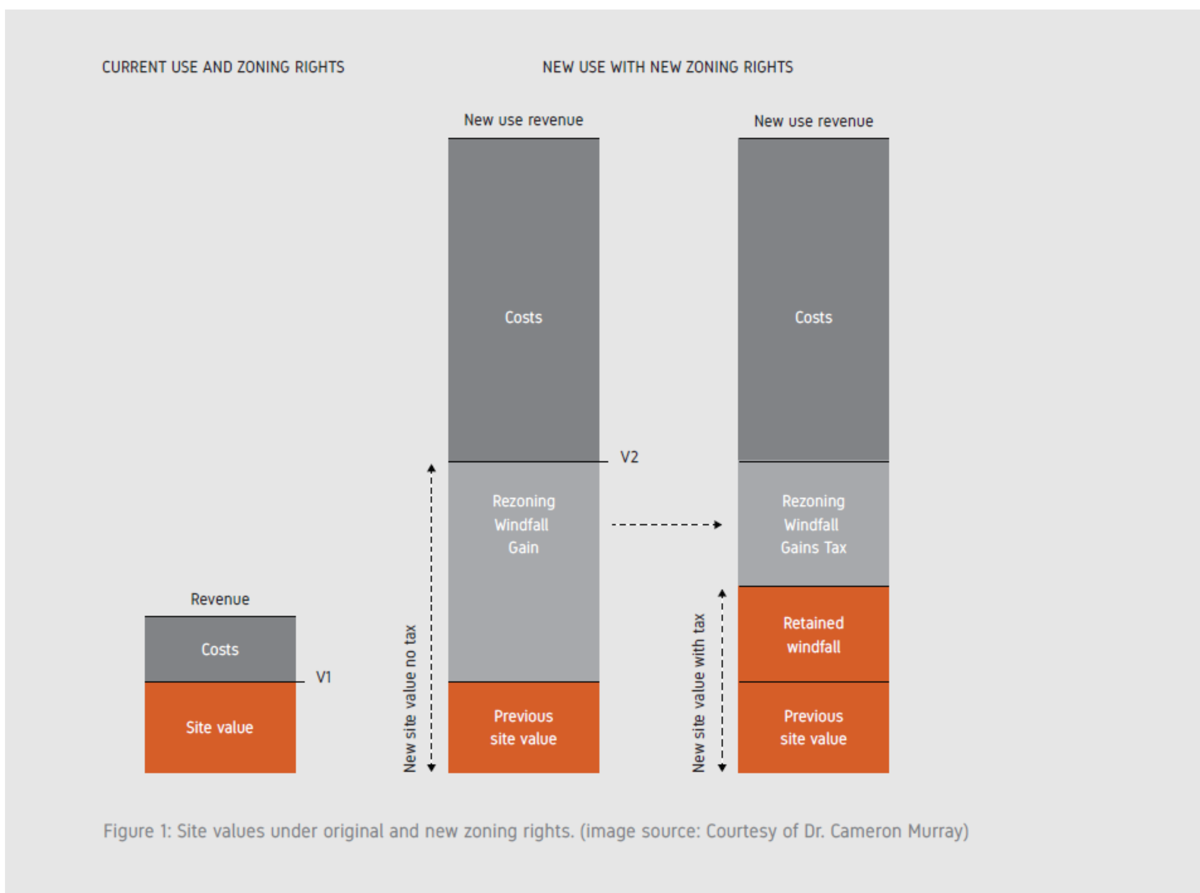

Figure 1: Site values under original and new zoning rights. (image source: Courtesy of Dr. Cameron Murray)

REZONING WINDFALLS ARE **GIVEN, NOT EARNED**

Land obtains its value by what you can do with it. To achieve public interest objectives, planning regulations limit what can and cannot be done on a given site. When governments change what can be done on a site through rezoning, it can drastically increase the value of the land. This is a reflection of the greater profitability of newly permitted uses. In figure 1 below we see how a rezoning affects land value, and what could be taxed.

This change in land value is created by a public planning decision. It does not come from any inherent investment of the landholder. These windfall gains from rezoning are subsequently available to whomever owns the land at the time.

SHARING REZONING WINDFALLS IS **FAIR AND EFFICIENT**

Tax is usually paid from activity that creates jobs and improves our living standards. A rezoning tax is different. It taxes free giveaways that would otherwise go into a few lucky or well-connected pockets, enabling their use for public purposes. .

This is inherently fairer - we don't need to give away something for nothing. A rezoning tax doesn't hurt economic activity. It cannot be avoided. It cannot change behaviour. Building higher density developments remains just as profitable. But property development and speculation becomes less of a lucrative lottery.

SHARING REZONING WINDFALLS **SUPPORTS URBAN GROWTH**

Rezoning is part of the way we coordinate urban growth and development. Growth requires additional infrastructure and public investment to support larger populations without reducing living standards. Additional public spending needs funds to support it.

Rezoning windfalls occur in the process of regulatory change to enable growth and development. Recovering these publicly created windfalls can help meet the funding needs of that same development, ensuring living standards improve and other taxpayers are not worse-off.

Hypothecation of funds raised ensures that windfalls support a virtuous investment cycle in a localised growth area. However, there are instances where public investment in other locations has higher impact. Excessive hypothecation can prevent valuable regional level cross-subsidy. General revenue can be more suitable for allocating windfall revenues. Especially where there is a shortfall of funds for regional transport initiatives, or inadequate infrastructure provision in high-growth corridors.

REZONING WINDFALLS TAX IS A **DISINCENTIVE TO CORRUPTION**

Large windfalls from rezoning come with little effort. If given freely to landholders, an incentive exists to acquire land and lobby for rezoning. This gives rise to grey corruption, whereby well connected insiders game the planning system to benefit from rezoning windfalls.

If the public recovers rezoning windfalls, there is less easy money available.This disincentivises lobbying for favourable rezoning.

Land will be rezoned by planning authorities when and where there is strategic justification. A key rationale for taxing rezoning windfalls is to remove a private incentive that can undermine public confidence in the strategic planning process (as was the case in the City of Casey and the John Woodman corruption saga).

Many members of the Victorian cross-bench are supportive of taxing rezoning gains in part due to their experiences in local government where council-led strategic processes were regularly trumped by a Ministerial "call-in."

Planners often debate the merits of Ministerial powers to grant a rezone without notice. At least with a rezoning windfalls tax we will remove an obvious, corrosive incentive to lobby.

It shifts the parameters of the debate, and may lead to greater community acceptance of urban densification, which is currently a huge barrier.

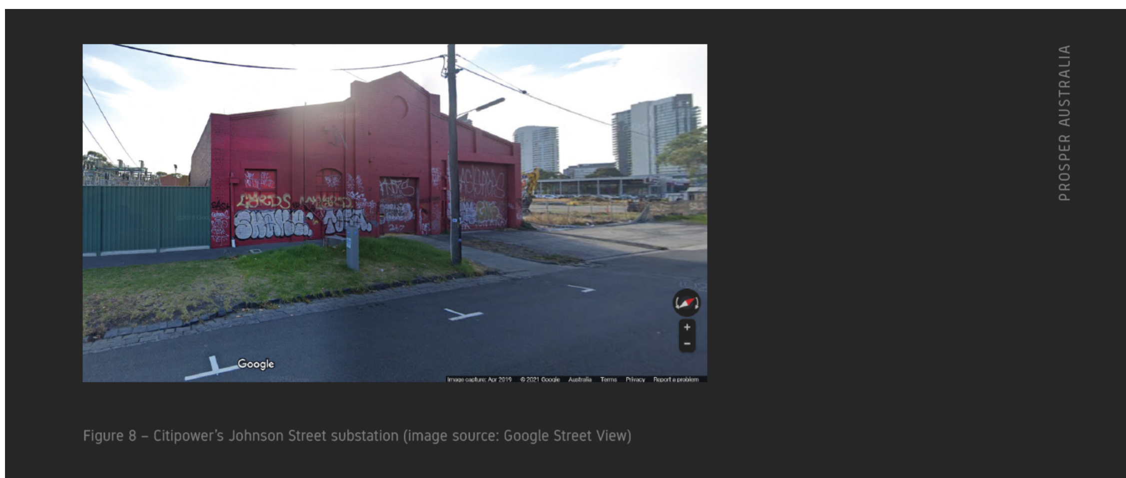

Figure 8 – Citipower's Johnson Street substation (image source: Google Street View)

Example: 90-96 Johnson Street. South Melbourne

Prosper's recent report, *The Rezoning Honeypot: Evidence from Fishermans Bend*, contains several case studies of land value uplift in the Fishermans Bend precinct.

This property, 90-96 Johnson Street has been an electricity substation since 1965. The former State Electricity Commission sold the site in 1991 as part of the rationalisation of the Victorian electricity grid, relying on its then zoning to protect its future use. This zoning was not protected when Minister Guy rezoned the whole area Capital City Zone. Yet, the substation played a critical role in power supply throughout the inner south east suburbs.

The private owner continued to lease the site to CitiPower. In the ten years prior to the rezone the annual rental had been around $168,000 per annum. After 2012, the private landholder demanded much higher rent based on the appreciation in land values due to the rezone. The property was subsequently marketed as a development site with a significant holding income.

The operator, CitiPower, was forced to purchase the property in 2016 in order to secure permanent use of the site for electricity purposes. The rezoning uplift on this site was the highest in our sample, returning 11 times the $469p/sqm average for properties without planning permits. We calculated the rezoning windfall at $22million.

ADDRESSING **INDUSTRY STAKEHOLDER CONCERNS**

In media reports and submissions to government, industry stakeholders such as the Urban Development Institute of Australia and the Property Council of Australia have flagged concerns about the proposed tax.

The UDIA has made specific recommendations that are addressed below. We also speak to more general concerns and claims that have been made.

A rezoning windfall tax should not be described as a "developer contribution". There is no nexus with development. A rezoning does not translate into additional development. What rezoning secures is additional development *rights*; an option to increase the number of dwellings, for example.

Nor is it a contribution. It is a fair payment for additional value received. In some places, such as São Paulo, Brasil, these additional rights are auctioned at market. In Victoria, they are given away.

The nomenclature Rezoning Windfall Gains Tax accurately reflects the nature of the benefit being taxed and should not be obscured.

The supply of developable land is within the remit of government. Strategic planners will seek planning scheme amendments notwithstanding the preferences of existing landholders. Planners do not rely on the private sector to initiate planning scheme amendments. Nor should they.

In Victoria, rezonings (planning scheme amendments) are usually initiated by the Victorian Planning Authority, or by local government.

Proponent-led rezonings are also a feature of our planning system. In these cases, the planning scheme amendment is initiated and sponsored by a private landowner on behalf of the local government. The associated costs, such as private planning consultants, are borne by the proponent. This is sometimes characterised as a cost to development - deductible from the unearned uplifts associated with rezoning.

We understand that there are a few contexts where private-led rezonings are the predominant means by which new development sites are added to supply. Arguably, where there is a strong market signal for land-use change in these contexts (e.g. rural shires with shallow housing markets and limited council resources), a 50% share of rezoning uplift will be a sufficient incentive for landowners to act.

Where there is strong strategic justification, but weak markets, councils must be adequately resourced to undertake necessary strategic planning.

The concept of "net uplift" as opposed to "gross uplift" is misleading. All the costs of developing land are reflected in what developers pay for it. The change in market value of land before and after rezoning *is* net of project costs (see figure 1 above).

The Government's proposal includes a generous tax-free threshold of $100k. This is a considerable subsidy to proponent-led rezonings. Furthermore, the tax leaves 50% of the windfall on the table.

Distinction between developers and speculators is not meaningful. In some instances, the beneficiaries of rezoning are not developers, but land speculators who flip rezoned land to developers. In some instances, the beneficiaries of rezoning are developers. The tax shares rezoning windfall gains irrespective of the beneficiary.

Rezoning windfall gains tax is unlikely to be passed through to higher house prices. Developers operate in a competitive market. Industry admits that passing on the rezoning tax in higher prices "*...is not possible as the market will not bear the higher prices*…"[1]. However, they predict a new tax on rezoning windfalls will reduce the viability of development projects. Fewer projects mean fewer dwellings or commercial properties available. This lost supply *could* increase prices.

It is difficult to gauge the magnitude of this effect.

It is important to reiterate that strategic land supply is within the remit of government. Increased land supply is a result of rezoning, regardless of whether there is a windfall gain to the landholder.

Developers do not need rezoning windfalls in order to make development profitable on rezoned land. Consider the sale of public land to private developers. If the government sells public land for housing development, charging developers the market price for land does not "render developments unviable."

If public land was given to private-sector developers for free (as is currently the case with additional development rights from rezonings), it would not make viable projects "more viable." A rational operator would not build fewer dwellings if they paid the market price. Nor would they build additional dwellings if land acquisition was free. The windfall gain is divorced from the viability of a development.

Another concern for supply-crimping relates to acquisition. Vendor expectations have been shaped by big windfalls. Developers initiating rezonings would need to factor in windfall gains tax obligations into their feasibility and willingness to pay for pre-rezoned land. Some vendors may be unwilling to accept a developer's adjusted acquisition offer.

It is important to note that when industry reports vendors 'walking away from deals', they are walking away from risky and uncertain efforts to secure the *right* to develop.

[1] *UDIA Victoria Rezoning Tax Proposal*, p. 4

Transition issues can largely be ameliorated with good tax design. It is well established that land prices can rise ahead of a rezoning. Where there is reasonable confidence that a parcel will be rezoned, the market will trade “as if” that land has been rezoned.

Developers may have paid a speculative price for land. In this scenario, the beneficiary has already been paid. The rezoning uplift was dissipated in the speculative ‘run up’.This results in an unfair, unavoidable sunk cost.

From the perspective of the individual developer, the tax may significantly impact their balance sheet and profitability, irrespective of whether they choose to develop a project. Losses cannot be reduced by refusing to build.

This is a transition issue that can largely be ameliorated in the tax design**.** A valuation methodology that captures recent comparable sales will measure any new uplift due to the rezoning. Other transition measures to consider include time-limited exemptions via grandfathering provision, or exemption of precincts where the rezoning process is well advanced.

There is some contention that an unintended consequence of the tax --as announced-- is to make GAIC areas more attractive vis-a-vis urban infill. This is due to the difference between the rate of the GAIC and the rate of the proposed rezoning windfall gains tax.

The issue is reduced profitability for urban infill that *requires a rezoning to be developable* vis-a-vis greenfield development in a GAIC area that has an existing Urban Growth Zone designation.

The reasons why Victoria is falling short of Plan Melbourne’s vision for 70% of new development in established areas are many and complex. Urban renewal faces existing challenges: slimmer margins, riskier, and more capital intensive projects, heterogeneity of infill sites and their relative scarcity etc.

We cannot have any confidence that by giving away rezoning rights we are improving infill feasibility. We may simply be giving away rezoning rights to landholders whose “business” is flipping strategic, scarce and heterogenous development sites.

To reiterate, a rezoning does not translate into additional development. What a rezoning secures is additional development *rights*; an option to increase the number of dwellings or change land use.

Please refer to our website for further FAQS.

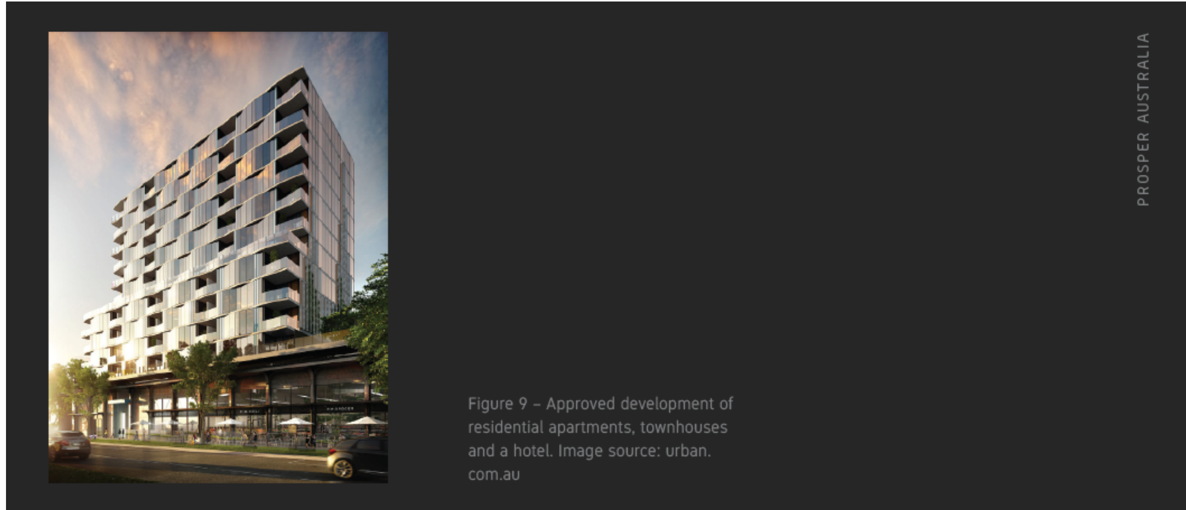

Figure 9 – Approved development of residential apartments, townhouses and a hotel. Image source: urban.com.au

Example: 320 Plummer Street, Port Melbourne

320 Plummer Street, Port Melbourne is a 7,468m2 site formerly used as the Rootes (Chrysler) factory. The property sold in 2009 at a low price of $1.7 million ($230 per square metre).

Subsequent to rezoning, an application for a large mixed-use development was submitted to the Metropolitan Planning Authority (MPA) in 2014. The application proposed a large podium covering the entire site, with three residential towers located above. A permit was granted in August 2015 by the Victorian Civil and Administrative Tribunal (VCAT).

Architectural renders depict the permitted development of 443 dwellings including a mixture of apartments and townhouses, and 908m2 of commercial floor area.

The property was subsequently purchased for more than $11 million by a local developer who substantially reworked the design proposal. An amended permit increased the yield to 547 dwellings including a residential hotel. Commercial floor space increased to 1305sq/m with the plans indicating a supermarket, and other retail.

We estimated the rezoning windfall at an adjusted value of $7.7m. The property developer who eventually delivered the project was not the beneficiary of the rezoning uplift.

Under the proposed rezoning tax, $3.85m of that $7.7m could have been collected to help pay for the transport links needed in Fishermans Bend.

TAX DESIGN CONSIDERATIONS

If not done right, poor tax design can lead to poor outcomes for government, industry, and the public. These are the most important considerations for the rezoning windfall gains tax:

Tax Base - What is taxed
Different types of taxes can be levied on property to capture windfalls, and windfalls can crystalise at different points in the planning process e.g. rezoning, development permit. There are also variables around geographical jurisdiction, qualifying land use categories, deductions, and how much to tax.

Tax incidence - Who pays
Who is required to legally pay the tax has important political economy applications. Potential taxpayers include landowners, developers and purchasers. Legal incidence usually has little effect on the economic incidence of the tax.

Hypothecation - Who receives benefits
Tax revenue once collected will inevitably be spent. There is potential for hypothecation of tax revenue to infrastructure etc. for areas where revenue is collected. This competes with the option to engage in cross-subsidy.

When - Timing taxation
Taxes have a number of temporal factors. A tax is triggered at a point in time after some specified action. There must be a time period of valuation assessment to determine the tax base. Eventually the final tax bill must come due after another action, potentially after deferral mechanisms have been used.

How- Method of assessment
How the tax is levied affects how much revenue is collected. Differing assessment methodologies affect the estimated tax base. Differing indexation rates result in different amounts paid after deferral, as well as changes in timing sales.

Transition issues - Fairness and certainty
Different transition models impact on revenue collected. It also affects tax burdens faced by industry, the equity of changing the rules after investment decisions have already been made.

Windfall Tax Models - Comparisons

	ACT Model	Proposed Vic Model	UDIA (Industry) Model
WHAT IS TAXED			
Tax Rate	75% of uplift	First $100k exempt, up to 50% of total uplift above $500k	GAIC equivalent
Deductions	Affordable housing & energy efficiency	TBC	50% discount for regional Vic
Tax Type	Lease Variation (with development application)	Upon rezoning (zone type or zone)	Developer contribution on a per hectare basis
Whole state?	✔	Excludes GAIC areas & public land	Excludes GAIC areas & public land
All land use?	✔	✔	✔
WHEN			
Tax Trigger	Upon granting of lease variation	Upon rezoning (zone type or zone)	Set up after rezoning - GAIC type treasure
Tax Due	Deferral for up to 4 years or until certificate of occupancy/sale	TBC	Same as GAIC
WHO			
Landholder pays?	✔	✔	Like the GAIC potentially deferred and shifted to the developer
Tax to general revenue?	✔	✔	Hypothecation to local infrastructure, maybe limited amount for general revenue
HOW			
Assessment Timing	On the day lease variation is granted	Upon rezoning	Contribution liability placed after rezoning
Assessment Methodology	Market localised fixed schedules for single use. Before & after valuation for mixed uses.	Statutory valuations from year of rezoning. Hypothetical post-rezoning value applied retrospectively	Same as GAIC - applied tax schedules to different categories of land
Indexation	Market rate + 1.8% compounding on the full amount until fully paid	10Y Vic Govt bond rate	Not specified
Transition	When annual leasehold fees were made annual fees	TBC	No retrospective applications to existing commercial arrangements
Notes	Gold standard. Limited application to Vic in some respects due to planning system differences	Good framing, broad rezoning tax base, corrects most egregious rezoning. Limited revenue base given it excludes permit issuance, low indexation rate, difficulty in applying to owner-occupier residential land.	Simple admin, similar to GAIC levy. Divorced from windfalls gains to new development rights, requires ad got discounts for regional areas. Developers still get windfalls and can potentially deduct other taxes allowing them to speculate on land. Incentives for corruption subsidised through "net uplift"