

**Reforming the Change of Use Charges (CUC) in the ACT:
An independent economic assessment**

John Piggott

November 25 2010

This report has been prepared for Macroeconomics. I am grateful to several organizations and individuals for their input to the preparation of this document. All opinions and analysis are the author's own. Also, the document is not to be reproduced or distributed without express permission from the author. Further, while every effort has been made to ensure the accuracy of this document and any attachments, the author makes no warranty as to the accuracy or completeness of this document, nor accepts any liability for any errors or omission, or for statements, opinions, information or matters arising out of, contained in or derived from this document, or related communications, or for any actions taken on such a basis.

Executive Summary

This report aims to provide economic context to the impact of the adoption of recommendations concerning the Change of Use Charge (CUC) contained in a study prepared for the ACT Government by Macroeconomics, a Canberra-based consultancy, the Draft Final Report On the Review of the Change of Use Charges System in the ACT (hereafter “the Review”). The centrepiece of the Review is a recommended schedule of codification of values, which form the base for calculating the CUC. These vary with the nature of the CUC application and the location of the property in question.

There is widespread agreement that the move to codification will improve the operation of the CUC, and this consensus accords with common sense tax administration.

There is less agreement over the magnitude of the charges. Partly this results from the complex transition triggered by the move, first from recent practice to rectification, and then from rectification to codification. Compared with recent practice, full implementation of the recommended codified CUC at a 75% levy rate (or a 25% remission rate) would lead to substantial increases in liabilities and revenues. Compared with a fully functioning “rectified” system, the Review makes recommendations which, so far as one can judge, imply a much smaller increase. Both the rectified and codified systems rely on valuation rather than fixed fees for administering the CUC. But the rectified system has only been operating for a few months, and this comparison is therefore necessarily tentative. Because the implementation of the CUC, up to May 2010, involved very different liabilities and revenues from the rectified system, or the new proposed codified system, it is important that this independent economic assessment take account of the increases in charges from the practice of the last several years, as well as codification *per se*.

The Review recommends various other departures from current practice, beyond codification *per se*. The most important of these relate to treatment of improvements and the offsetting of both onsite and offsite user charges against the CUC. These will also have some impact on revenues and liabilities.

Data limitations at this time make it impossible to reliably gauge the impact of the CUC on development activity at different levy rates. But the impacts of the CUC at a low levy rate are unlikely to be major. If decision makers take a cautious and phased approach, beginning with low levy rates, then experience in the market will provide the best guide to future increases. There will likely be a tipping point, where higher rates impact development activity, and may compromise overall revenue collections, although it is impossible, on current experience, to determine where that might lie. This suggests that, consistent with the Review, increases to the levy rate should be phased in over several years, and be mandated in the light of experience gained with the initial rate.

The Review recommends a three year timeframe to reach a 75% levy rate. It may be better not to commit to a timeline for increasing the levy rate in advance, or a target long term levy rate. As experience accumulates, an appropriate long term levy rate can be set. It is possible that future experience will indicate that it is sensible to vary increases in the levy rate across the various sectors of the property investment market, and to set the levy rates with regard to the overall economic outlook. Attention should be paid to possible inconsistencies of valuation stemming from differences in the wording of individual leases.

The industrial and commercial sectors will be affected less from the move to codification because the regime operating over the last several years is more in line with the codified regime. The Review emphasises that on average, revenue increases from codification are likely to be small, although increased revenue will be generated from the removal of site improvements from the “before” valuation. In some areas, case-by-case valuation is currently undertaken because of short term volatility in the market. In addition, the ACT Government has the right to reduce or waive the CUC liability where there are good reasons for doing so. Based on this information, it seems reasonable to expect that the impact of codification on these sectors will be minor, especially if phased in.

This report finds that in line with the recommendations of the Review, allowances for mandatory infrastructure should be separated from the CUC for reasons of transparency, and that valuations themselves should be transparent: these recommendations make eminent sense. The motivation for having the developer undertake necessary infrastructure is cost efficiency – much of the necessary means for development are already set up. But for these savings to be passed back to the community, costings should be undertaken on a marginal basis, rather than on the basis of how much it would cost the government authorities to provide equivalent infrastructure. This principle should be incorporated into the protocols underlying the transparency of costings for mandatory infrastructure under the new regime. But developers should not be financially penalised through this separation, and payments should be scheduled to avoid this outcome.

Similarly, and in line with the Review’s recommendations, market value of land forms the best basis for the estimation of betterment. Particularly in the case of commercial development, allowing improvements in the “before” valuation will have the effect of encouraging premature redevelopment of sites. In those cases where the authorities wish to encourage early redevelopment, for example with a retail development that is likely to create positive amenity for the surrounding community, adequate provisions exist for reducing or waiving the CUC to generate the desired outcome. Relatedly, costs of demolition should not be allowed – these are better seen as a cost of construction.

Independent Economic Assessment of the Impact of Reforming the Change of Use Charges (CUC) in the ACT

1. Introduction

This report aims to provide economic context to the impact of the adoption of recommendations concerning the Change of Use Charge (CUC) contained in a study prepared for the ACT Government by Macroeconomics, a Canberra-based consultancy. The Draft Final Report On the Review of the Change of Use Charges System in the ACT, prepared by Professor Des Nicholls and Dr Stephen Anthony (hereafter the Review¹), makes various recommendations which would, if adopted, constitute a major departure from current practice. The centrepiece of the Review is a recommended schedule of codification of values, which form the base for calculating the CUC, depending on the nature of the CUC application and the location of the property in question. Various other departures from current practice, especially in relation to treatment of improvements and the offsetting of both onsite and offsite user charges against the CUC are recommended as well (page 83).

The proposed codification sets specified base values for various types of lease variation, and suggests that various rates should be applied to that base. In the case of residential development a cost per unit dependent on locality and size of development is specified; for commercial and industrial development a charge per square metre of gross floor area is charged according to location. These are cast either as a positive levy rate on the codified base, or as a rate of remission on a presumed full value surrender of the charge. In this document, this rate will generally be expressed as a positive rate of levy on the codified value. A 25% levy means that a quarter of the codified value is payable.

The Terms of Reference of the current report are to consider the impact of the Change of Use charge and its codification on:

- Housing affordability across the Territory and the inner city
- Private property investment in the ACT
- The cost of business and profit levels in the property industry; and
- Returns to government revenue.

The Recommendations of the Review will, if adopted, result in a codified system replacing the CUC system where charges are determined based on an assessment of 'before' and 'after' values. A complication is that for the past several years, the practice had grown up of charging a fixed fee for residential lease variations under the CUC (the "fixed fee" system). This has been rectified from May 2010 (the "rectified" system). Because the rectified system has only been operational for a few months, its impact is not yet known. Any assessment of the impact of the adoption of the Review recommendations is complicated because these

¹ References to The Review in this report mostly refer to the April version.

two changes are conflated. Comparing the rectified system with that proposed in the Review is difficult because it has been in operation for only a few months, although it should be noted that both the rectified and codified system are based on valuation, and are therefore closer in principle than the pre-rectified system, which was formulaic. On the other hand, comparing the system in operation until May 2010 with the Review proposals is misleading, since the actual change, if the recommendations are adopted, will be as a departure from the rectified system.

Quantitative analysis, in the sense of econometric analysis, is not feasible in the present context, as the Review acknowledges (page 52). A subsequent report (Dungey 2010) confirms this view. What can be offered is some insight into what the potential effect of the Review recommendations might be, in comparison with both the “fixed fee” CUC and the “rectified” CUC, on the above dimensions of impact, by appeal to qualitative economic analysis. By far the most important part of the change relates to residential development, and the report will mostly focus on this aspect of the proposed change.

In preparing this report, meetings took place with representatives of the Property Council, the Housing Industry Association, and the Master Builders Association. All offered valuable insights into the workings of the charge, and the property industry in the ACT. In addition, ACT Government and Australian Valuation Office officials provided helpful advice.

2. Brief Description of the CUC

The CUC, or, in the recommended new terminology, the Lease Variation Charge (LVC), is a payment for a lease variation which results in increased rights to be associated with the lease.² Its rationale is that it is appropriate to return to the community a significant proportion of an accretion in capital value of a property where that has been generated through changed development opportunity. The value of this “betterment” forms a natural tax base. The application for a variation of the lease to permit alternative or expanded uses provides a convenient trigger for tax collection, one which is available in the ACT because of the leasehold basis for land tenure.³

3. The ACT context

The ACT is a vibrant economy in its own right. While the public sector is important, various light industries flourish, as well as retailing, and services for its population of more than 350,000 residents. Critical among these are housing services. Together with commercial property development, residential property development is a major contributor to the ACT

² Review, page 22. We will use the traditional title and acronym in this report.

³ It should be noted that because each property is subject to a separate lease, wording differences can impact on the reliability of the lease variation application as a mechanism for tax collection.

economy, as well as providing the necessary infrastructure for the Territory’s continued growth.

The impacts of the new CUC will depend in part on the nature of population growth, household formation, and commercial development. This might be thought of as the demand side of the market on which the CUC impinges.

Residential Development

Dwelling supply in the ACT lies more in the hands of government than is the case for most other jurisdictions in Australia. Greenfield sites are released by the ACT Planning and Land Authority on a regular basis, and the flow of these has been increasing in recent years. Between 2007 and 2010, the actual number of dwelling sites released in each fiscal year exceeded the original target as shown in Table 1. The land release targets specified in the *Australian Capital Territory Indicative Land Release Programs 2010-2011 to 2013-2014* released in June 2010 show that planned flow of government released dwelling sites in the next two years remains strong. There is a two to three year delay in converting raw land releases into building completions.

Table 1: ACT Residential Land Release Program

Fiscal Year	Original Target	Actual Number of Dwelling Sites Released
2007-2008	2200	3470
2008-2009	4200	4339
2009-2010	3014	4061
2010 -2011	5000	
2011-2012	5000	
2012-2013	3500	
2013-2014	3500	

Source: Department of Land and Property Services, *Australian Capital Territory Indicative Land Release Programs 2010-2011 to 2013-2014*, June 2010.

The substantial targets set for 2010 – 2012 reflect current market demand which in part is fuelled by growth in overseas immigration. In 2009-10 alone a record net gain of over 2,500 migrants generated an estimated demand for an additional 1000 dwellings in the ACT. Increased demand is also expected to be generated as a result of increased housing affordability under the *ACT Government’s Land Rent Scheme* which will enable more people on low to moderate incomes to enter the market.

Over the last two decades there has also been a shift towards construction of higher density dwellings, such as townhouses, apartments and flats. *The Canberra Spatial Plan* states that ‘between 1991 and 2001 there was a 4 per cent decrease in the stock of separate houses in

the ACT (as a percentage of total housing) and a 4 per cent increase in other types of houses. This trend away from detached housing is expected to continue over time.’ It predicts that falling household sizes and an ageing population will affect both future housing needs and preferences.

In Table 2, we track population growth and the rate of dwelling increase over the last 10 years. Table 3 reports increase in prices for both houses and units over the same period.

Table 2: Population Growth and New Residences: ACT: 2001 – 2010

Fiscal Year	ACT Population (June quarter) ('000)	ACT Building Completions (original)
2000-2001	314.2	2047
2001-2002	323.6	1878
2002-2003	322.9	2437
2003-2004	324.0	2572
2004-2005	325.2	1966
2005-2006	328.8	2445
2006-2007	339.9	2376
2007-2008	344.2	2309
2008-2009	351.2	2503

Sources:

ACT Population: Australian Bureau of Statistics Cat No 3101.0 - Australian Demographic Statistics, 2001-2009

ACT Building Completions: Australian Bureau of Statistics Cat No 8752, Building Activity, Table 38.

Table 3. ACT Residential Prices 2000 – 2009

Fiscal Year	Median Prices (Averaged over the year)	
	Houses (\$'000)	Units (\$'000)
2000-2001	185.8	142.3
2001-2002	213.8	167.1
2002-2003	244.2	211
2003-2004	348.8	275.7
2004-2005	361.3	295.5
2005-2006	358.1	305.8
2006-2007	400.8	315.4
2007-2008	453.5	354.3
2008-2009	449.2	363.2
2009 (to Dec Quarter only)	468.7	387.3

Source:

Median Prices: REIA Median Prices Housing Indicators

Over this period, the median price of a house has increased from \$185,800 to \$468,700, a 152% increase, compared with a CPI increase of 29%. Median unit prices have increased at an even greater rate, with 172% growth over the same period. Real prices have therefore outstripped inflation and earnings over this period, and this indicates the importance of securing an on-going supply stream of dwellings.

Current ACT policy emphasises the importance of infill, or redevelopment of existing sites with higher density housing, as an important plank in its overall development policy. To achieve the goal of a more sustainable and diverse city, *The Draft Greater Canberra City Area Coordinated Action Plan 2010 – 2016*, specifies a number of targets to be achieved by 2016 including a doubling of the number of people living in the Greater City Area to about 10,400. *The Canberra Spatial Plan* sets a target of up to 50% of future urban growth in the ACT occurring within the existing urban area of Canberra to facilitate reductions in the consumption of land, water and energy. At the moment, between 10 and 15% of new dwelling completions are of this type.

Infill takes place primarily through redevelopment of residential or commercial sites, and in this way the CUC interacts with development policy. Submissions from the Property Council of Australia, Housing Industry Association and the Master Builders Association of Australia in response to the Draft Final Report all make the point that much of the impact of the CUC will be experienced in the inner urban centres which may have the effect of acting as a disincentive to Brownfield development and increase demand for Greenfield development.

Commercial Development

Commercial development attracts a CUC through a lease variation, such as increasing gross floor area. While commercial development is important in the ACT, and the CUC may be a significant charge, various regulatory and legislative mechanisms exist to help ensure that the CUC will not thwart commercial developments which the ACT Government sees as desirable (Review, page 68).

4. Comparing the features of the three systems

It was foreshadowed in the Introduction that this report pertains to three separate regimes of the CUC. The first, which is better characterised as a practice than a policy, we refer to as the “pre-rectification” system; the second, currently in force but still in the process of becoming operational, is the “rectified” system; finally, we have the “codified” system, which is the term used to denote the system recommended in the Review. Table 4 at Attachment A summarises these differences.

The existing method for calculating the CUC charge (referred to as Method H in the Review) was introduced in September 1999 and was based on the calculation of ‘before’ and ‘after’ values as detailed in Table 4. Over the last several years, the practice had grown up of applying a series of “fixed fees” per unit or townhouse in a development irrespective of location, instead of the statutory formula. The “rectified” system requires site by site valuations to be undertaken. The system recommended in the Review, the “codified” system, uses valuations (based on the market value of land) as the basis for codified charges which vary by area and intensity of use, as well as by unit.

There are several other important differences between the rectified and the codified system. The current arrangements involve offsets for offsite infrastructure. The Review recommends that where mandatory infrastructure is to be compensated by the ACT authorities, this should be accounted for independently of the CUC, for reasons of transparency. The Review also suggests that the process of valuation of mandatory infrastructure be made more transparent (page 23). Market value of land is to be used, regardless of current use. For example, if an existing commercial development has an office building, the value of that building should not be taken into account in calculating the “before betterment” valuation. Similarly, costs of demolition should not be allowed against the market value of land.

The remission rate of 25%, or a levy rate of 75% of the betterment value is expected to result in substantial increases in payments for residential developments, relative to recent practice. As indicated in Table 4, for a residential unit development, the standard charge per unit has been set at \$1125 (75% of \$1500) per unit, regardless of location. In contrast, betterment is valued as much as \$60,000 per unit under the codified system (e.g. a 3 unit development in Barton attracts a charge of \$80,000 per unit less 25% remission). In these circumstances, a 75% levy would be a dramatic increase, and for that reason, a phase-in has been suggested (Review, page76).

Data on CUC levies for commercial developments suggest much smaller increases. Macroeconomics, in its Review, estimates that overall, there will be only a small net revenue gain in these segments, although the adoption of land value as the basis for valuation will have some impact on revenue. In some areas, case-by-case valuation is undertaken because of short term volatility in the market. In addition, the ACT Government has the right to reduce or waive the CUC liability where there are good reasons for doing so. Based on this information, it seems reasonable to expect that the impact of codification on these sectors will be minor.

Industry reaction to these various changes is mixed. First, there is wide acceptance that a codified system is superior, in principle, providing certainty and transparency, and reducing mediation. Not unexpectedly, questions arise around valuation. Second, industry representatives argue that mandatory infrastructure sometimes includes remote infrastructure, for example a set of traffic lights hundreds of metres from the site, which should really be the responsibility of the ACT authorities. (It is understood that the practice of mandating remote infrastructure has now ceased.) Third, some industry representatives thought that demolition costs should be allowable, and that valuation of commercial property should encompass improvements permitting existing use. Finally, the idea of a phase-in to the new system was welcomed.

An indication that these systems will have very different impacts may be drawn from estimates of CUC revenue collections detailed in Table 4. The pre-rectification value of \$21 million, an estimate of revenue collections over the 4 years between 2010-2011 and 2013-

2014, were that regime to continue, compares with \$89 million over the same period under the codified system. The Review estimates that most of this increase comes from rectification, with relatively minor increases consequent on codification *per se*.

Comment on offsite valuation recommendations:

The recommendations of the Review, that allowances for mandatory infrastructure be separated from the CUC for reasons of transparency, and that valuations themselves should be transparent, make eminent sense. The motivation for having the developer undertake necessary infrastructure is cost efficiency – much of the necessary means for development are already set up. But for these savings to be passed back to the community, costings should be undertaken on a marginal basis, rather than on the basis of how much it would cost the government authorities to provide equivalent infrastructure. This principle should be incorporated into the protocols underlying the transparency of costings for mandatory infrastructure under the new regime.

Industry representatives argue that with long gestation periods between the payment of the CUC and works completion, this change of practice will penalise them financially by the delay in being compensated for the infrastructure works, relative to the current arrangements. There is merit to this claim: administration should be arranged so that there is no implicit financial penalty from this source.

Comment on use of market value of land as the basis for valuation, and the allowance of demolition costs:

Market value of land forms the best basis for the estimation of betterment, and should be used. Particularly in the case of commercial development, allowing improvements in the “before” valuation will have the effect of encouraging premature redevelopment of sites. In those cases where the authorities wish to encourage early redevelopment, for example with a retail development that is likely to create positive externalities, adequate provisions under Sections 175-177 of the Planning and Development Regulation exist for reducing or waiving the CUC to generate the desired outcome (Review, page 69). There will, however, be revenue impacts from adopting this convention, supporting the argument for adopting a phased approach to the levy rate.

Relatedly, demolition costs should be seen simply as part of construction costs, and not separately allowable.

5. Economic Impacts of the CUC Change

Any extraction of revenue from the development process must impact on at least one of the site price, developers’ profits, and sale price, as is pointed out in the Review (page 72). In all probability, it impacts on all three. The extent to which each of these three variables is impacted will depend upon how responsive each is to the introduction of the charge. As a

general rule, the burden of a tax will fall more heavily, the less room there is for quantity response. In what follows, we will mainly focus on the impact of the CUC on residential developments. We will divide the discussion into Demand and Supply side factors.

Factors influencing demand

It is tempting to view demand for housing as entirely determined by population growth. But while population growth and household formation are clearly related, there is far from a one-to-one correspondence. Significant household formation in the ACT stems from children leaving the parental home. The timing of this change of circumstance is often discretionary, as is its form. Young people can share accommodation or live alone, and this decision will be influenced by the price and availability of suitable housing. At other stages in the life cycle, people in relationships may choose to live together or maintain separate residences, and home owners may choose to sublet part of their premises or not. These options combine to deliver considerable short to medium term price elasticity of demand for housing. In the longer term, life decisions, such as work location and even family size, drive demand responsiveness. Specific programs such as the “Affordable Housing Action Plan”, which allows purchase of the house while renting the land, are further influences on overall demand.

The segment of the market directly affected by the CUC, which we are considering here, comprises only about 10% of new dwellings each year. Buyers have a ready substitute at hand - an established home, or a new residence on a Greenfield site. This suggests a high elasticity of demand for the CUC-affected market segment.

Factors influencing supply

In line with the observations already made in relation to the demand side, there are several supply channels for residential housing: established dwellings, Greenfield sites, and new higher density development. Again, it is the latter category which is directly affected by the CUC. Of interest here is the impact of the new CUC on the supply of higher density development.

Table 5, which provides the major public data on the operation of the ACT residential development industry, suggests that the industry may be stylistically characterised as having two segments. The first represents major development activity, of more than 20 units, which we will denote segment A; the other is a catch-all for minor developments, from dual occupancies to smaller developments of less than 20 units (Segment B).

In reality, of course, there is a continuum of such developments, but this dichotomy may provide insight. This characterisation of the overall market is consistent with the recent history of developments in the ACT. There were only 6 developments involving more than 20 units over 2007-8 and 2008-9, which attracted a CUC, while many developments,

including 111 dual occupancies and 47 smaller developments over the same two year period, fell into segment B of the market.⁴

Table 5: Frequency and scale of CUC-affected developments in the ACT 2007 – 2009*

2007-8		2008-9	
Classification	Frequency	Classification	Frequency
Dual Occupancy	33	Dual Occupancy	78
3-5 units	8	3-5 units	10
6-10 units	5	6-10 units	9
11-20 units	5	11-20 units	10
21-50 units	4	21-50 units	1
51-100 units	0	51-100 units	0
100+ units	0	100+ units	1
Total	55	Total	109

*Source: ACT Planning and Land Authority

Segment A has the following characteristics. First, there are relatively few developers in the ACT who take on projects of this magnitude. This segment of the market is potentially contestable and new entry is possible, but the capital required to secure the multi-million dollar borrowing necessary for such an undertaking, and the detailed knowledge of the development approval and change of use processes, are sufficiently scarce, that new entry is quite difficult. Second, the blocks of land suitable for such developments are limited in number, at least within the current territory plan. Only a small number of such developments are undertaken each year. On both counts, the supply of new units in segment A is probably not very responsive to a change to a codified CUC with a low levy rate.

Segment B of the market is rather different. A typical development might be a dual occupancy, although, because the impact of new regulations may dramatically reduce the number of such developments, we may imagine instead a 6 unit block of townhouses, built across three residential blocks where single residences are currently sited.

While some major developers active in segment A of the market may also operate in segment B, segment B is also open to much smaller players, for example a builder. Here, the

⁴ The ACT Planning and Land Authority have indicated that in the ACT, under the Territory Plan, a number of commercial and residential zones are not liable for the Change of Use Charge if the construction of residential redevelopments is permissible under their current lease conditions. These redevelopments have not been included in Table 5, as no Change of Use Charge was paid.

chance of a major quantity response to a large increase in the CUC levy is much higher. While at any one time, only a limited number of contiguous blocks come up for sale, in the longer term, under the current application of regulations, single residences can be converted into smaller developments of this type fairly readily. So the supply of units from such developments is likely quite sensitive to price. A substantial CUC is likely to inhibit such developments, impacting on the supply of dwellings overall.

When a higher CUC is imposed, which we think of here as comprising both rectification and codification, consistent with Table 8 of the Review, the unit CUC is split between the price received by the seller and that paid by the buyer. Relative to the pre-change situation, the above considerations suggest that most of the levy is borne by the seller, with a smaller proportion passed on in higher prices. The quantity of units developed is lower than it would have been in the absence of an increase in the charge. In order for the CUC to have the same proportional impact on both segments of the market, a smaller CUC would have to be levied in segment B than in segment A. To keep both segments vibrant, a strategy of this kind may need to be considered. This is further explored in section 6, where some implementation issues are raised.

This analysis is developed diagrammatically at Attachment B. While helpful, it does not provide an answer to the question of the extent of supply reduction which might follow from the introduction of the new CUC, or at what levy rate the market might show significant response. This question, and the related issue of business and profitability, must await experience of market activity under some form of codified CUC regime, before any answers can be formulated.

Implications for Terms of Reference:

Housing affordability: The above analysis and earlier commentary suggests that housing affordability will be affected in only a minor way by the imposition of the CUC. While new dwellings generated through re-developments are significant, they represent only about 10-15% of all new dwellings in the ACT. Further increase in Greenfield development would have the potential to completely offset price increase, although it is not clear whether an increase in the rate of development is feasible or desirable on other social grounds. (ACT policy emphasises infill development [see page 5 above]). Certainly, the possibility of substitution between Greenfield sites and redevelopment sites increases the elasticity of demand for re-development dwellings.

It should also be noted that housing affordability in the ACT is by far the highest across all capital cities. Table 6 indicates that as of the December quarter 2009, the ratio of repayments to income in the ACT stood at 17.7%, compared with a national average of 30.7%. The Real Estate Institute of Australia's Home Loan Affordability Indicator (HLAI), which is the ratio of median family income to average loan payments, for the 2009

December quarter calculates home loan affordability in the ACT to be 56.5%, significantly above the national average of 32.6%.

The high HLAI reflects the high median weekly family income of ACT residents. In the December 2009 quarter, the median weekly family income for ACT residents was \$2516 compared to the national average of \$1397. 2009 December quarter figures for median houses prices indicate that the Canberra median price of \$458,000 is the same as the quarterly Australian weighted median house price. Further, various ACT government initiatives, such as the Land Rent Scheme (where land is rented rather than purchased), renders housing even more affordable to families on low to moderate incomes.

Table 6: Proportion of family income needed to meet loan repayments*

	Dec qtr 2009	Sept qtr 2009	Dec qtr 2008
NSW	33.6%	31.2%	34.3%
VIC	29.5%	28.2%	32.1%
QLD	29.6%	28.5%	33.2%
SA	29.3%	28.1%	31.9%
WA	26.0%	26.4%	27.9%
TAS	26.2%	26.0%	30.6%
NT	22.8%	21.7%	24.6%
ACT	17.7%	17.2%	18.6%
AUS	30.7%	29.0%	32.4%

*Reproduced from Real Estate Institute of Australia's *Housing Affordability Report, December Quarter 2009*

Private property investment; Cost of business and profit levels

The industrial and commercial sectors will be affected less from the move to codification because the regime operating over the last several years is more in line with the codified regime. The Review emphasises that the revenue impact of commercial/industrial codification is likely to be small. There will, however be some impact on revenues and liabilities consequent upon adopting the market value of land convention for valuation. In some areas, case-by-case valuation is undertaken because of short term volatility in the market. In addition, the ACT Government has the right to reduce or waive the CUC liability where there are good reasons for doing so. Based on this information, it seems reasonable to expect that the impact of codification on these sectors will be minor.

Government revenues

Residential development: The overall impact on government revenues will be positive. The pre-rectified (fixed fee) system and the current rectified system will have very different budgetary impacts. The 2010-2011 ACT Budget included a significant increase in revenue estimates going forward, from both rectification and codification. For example, in 2011-2012, \$5.4 million was already in the budget base; rectification and codification added \$17

million to total \$22.4 million. In total, \$68 million was added over the 4 year period from 2010-2011.

But the impact of the increased CUC on other tax bases needs to be taken into account. One way to think about this is to calculate what the present value of other taxes associated with a dwelling might be. If one less dwelling is produced because of the CUC, then that is the amount which should be subtracted from the gross CUC revenue to calculate its net revenue contribution. Once the codified CUC is in place, then the comparison is between marginal CUC revenue raised from increasing the levy rate, and the revenues forgone through the impact of the increased CUC on the supply of units. Revenues from the sale of Greenfield sites, which may marginally increase if dwelling prices increase, are ignored here, as are the costs of servicing new units. A more complex calculation could take these into account.

The magnitudes of these taxes suggest that for low levy rates, the CUC revenues dominate any revenue reduction from other taxes. But the market response to increases in the CUC is probably not linear. It is more likely that some increase in the charge will have almost no impact on supply, but that beyond some point, the impact rapidly becomes substantial. This again points to the importance of a phase-in of the levy rate, allowing experience with market response to accumulate, and setting the final levy rate in light of that experience.

Commercial development: According to estimates in the Review, there will be little overall revenue gain from the codification of the CUC for commercial development, although the removal of the value of improvements from the “before” valuation will have a revenue impact.

6. Implications for implementation

This report has sought to provide an economic perspective on the proposed introduction of the “codified” CUC. Because the rectified CUC is so new in its application, comparisons with rectification are not possible. But some insights are available into the impact of the CUC. This section summarises the policy implications of the analysis for codification.

Perhaps the most important implication of the analysis is that the introduction of the codified system should be phased. The proposed 25% levy rate is a reasonable starting point. This report recommends that the timeframe on subsequent increases should be flexible, if the aim is to introduce the codified system without risk to the dynamic property sector which currently exists in the ACT, and that the long term rate be kept open. As experience with the codified system and its impacts accumulates, the feasibility and impacts of increases in the levy rate will become clearer. In the residential sector, this is especially important in light of the ACT government’s desire to encourage infill development. Developments of this kind are directly impacted by the CUC.

1. The phase-in process might be differentiated between residential and commercial developments, and between low unit and high unit residential developments. It makes sense to begin with a single low levy rate. But over time, as experience is gained, consideration should be given to distinguishing between increases in the levy rates for different kinds of developments. This may be helpful in minimising impact while retaining revenue.
2. The time schedule of CUC payments should be arranged to respond to the legitimate claims by developers that the separation of the CUC from infrastructure compensation, while sensible on transparency grounds, disadvantages them relative to the current system because of the long time period between the payment of the CUC and the completion of works and repayment of the levy. For example, a system where half the CUC is payable on application, with the other half payable at completion of the project, may help overcome this concern without seriously compromising government revenue streams.
3. Overall, the codified system should be monitored. The codified schedules will need to be tested and, where necessary, revised, as new information becomes available. There should also be awareness of the imperfections of using the lease variation as a means of collecting the betterment levy. It has been pointed out that differences in wording across individual leases mean that differential CUCs could be payable in effectively identical economic circumstances. No administrative system of taxation collection is entirely free from such imperfections. But if substantially increased revenue is to be raised from this source, and wording differences lead to widespread variations in revenue collections and a perception of capriciousness in the system, then the tax base will be compromised. This is potentially quite important in commercial developments, where, for example, a sub-optimal re-development may be chosen simply because it avoids the necessity of a charge-triggering lease variation requirement associated with the best development option.
4. Macroeconomics, and the Review confirms that overall, there will be little net increase in revenue from codification of the CUC as it applies to commercial developments, although the adoption of market value of land as a valuation base will have some revenue impact. Further, there appears to be considerable discretion given to the application of the CUC on commercial development. All these factors combine to suggest that there will be little overall impact on the commercial sector of the new codified regime, provided phase-in is applied.
5. The analysis of the impact on Revenues suggests that overall, more revenue may be collected by settling on a low to moderate levy rate, whose appropriate value may be more precisely determined in the light of experience with the new system. Quantitative analysis is not possible, but again, this speaks to a careful and measured phase-in of the levy rate.

7. Conclusion

This report aims to provide economic context to the impact of the adoption of recommendations concerning the Change of Use Charge (CUC) contained in a study prepared for the ACT Government by Macroeconomics, a Canberra-based consultancy. The centrepiece of the Review is a recommended schedule of codification of values. These form the base for calculating the CUC, depending on the nature of the CUC application and the location of the property in question.

The rationale of the CUC is that it is appropriate to return to the community a significant proportion of an accretion in capital value of a property where that has been generated through changed development opportunity. The value of this “betterment” forms a natural tax base.

Because of the low liabilities associated with recent practice, the Review recommended that the levy rate be increased over three years. Compared with recent practice, full implementation of the recommended CUC at a 75% levy rate (or a 25% remission rate) would lead to substantial increases in liabilities and revenues. Various other departures from current practice, especially in relation to treatment of improvements and the offsetting of both onsite and offsite user charges against the CUC are recommended in the Review as well.

This report concludes that while lack of experiential data precludes definite answers, the economic impacts of the CUC using low levy rates are unlikely to be major. Higher rates may impact development activity, and may compromise overall revenue collections.

It is therefore recommended that subsequent increases to the levy rate be phased in over several years, and be mandated in the light of experience gained with the initial rate. It may be better not to commit to a schedule of levy increases, but instead introduce these as experience with the market accumulates. While this leads to some industry uncertainty, this should be limited if it is clearly indicated that incremental increases will not be large. In recent years, changes have been made to the CUC levy rate in light of the financial crisis without introducing significant disruption. It is possible that future experience will indicate that it is sensible to vary increases in the levy rate across the various sectors of the property investment market, and to set the levy rates with regard to the overall economic outlook. The valuation schedules will require adjustment over time, and attention should be paid to possible inconsistencies of valuation stemming from differences in the wording of individual leases.

This report finds that in line with the recommendations of the Review, allowances for mandatory infrastructure should be separated from the CUC for reasons of transparency, and that valuations themselves should be transparent: these recommendations make

eminent sense. The motivation for having the developer undertake necessary infrastructure is cost efficiency – much of the necessary means for development are already set up. But for these savings to be passed back to the community, costings should be undertaken on a marginal basis, rather than on the basis of how much it would cost the government authorities to provide equivalent infrastructure. This principle should be incorporated into the protocols underlying the transparency of costings for mandatory infrastructure under the new regime. But developers should not be financially penalised through this separation, and payments should be scheduled to avoid this outcome.

Similarly, and in line with the Review's recommendations, market value of land forms the best basis for the estimation of betterment. Particularly in the case of commercial development, allowing improvements in the "before" valuation has the effect of encouraging premature redevelopment of sites. In those cases where the authorities wish to encourage early redevelopment, for example with a retail development that is likely to create positive externalities, adequate provisions exist for reducing or waiving the CUC to generate the desired outcome. Relatedly, costs of demolition should not be allowed – these are better seen as a cost of construction. Account should be taken of the revenue and liability implications of these changes, through appropriate phase-in.

The most important finding of this report is that the phase-in of the levy rate should be gradual, and flexibly introduced, and that the long term rate or rates should be set in light of the experience with the impact of the CUC as it accrues.

References

- Australian Bureau of Statistics, Australian Demographic Statistics, June Quarters 2001 -2009
- ACT Chief Minister's Department, Greater Canberra City Area (Haig Park to Lake Burley Griffin) Coordinated Action Plan 2010 – 2016 Draft for public consultation, February 2010
- ACT Department of Land and Property Services, Australian Capital Territory Indicative Land Release Programs 2010-2011 to 2013-2014, June 2010
- ACT Planning and Land Authority, The Canberra Spatial Plan, available at <http://apps.actpla.act.gov.au/spatialplan/index.html> (last updated September 2007)
- ACT Planning and Land Authority, Planning System Reform Project, Technical Paper 1, Leasehold Administration in the ACT: Its Role in the Planning System, Canberra, 2005
- ACT Treasury, 2010-11 Budget Paper No. 3, Revenue and Forward Estimates
- ACT Treasury, Affordable Housing Implementation Group Working Paper, 'Do House Prices Fall Over Time,' August 2008, Housing Industry Association, Submission on Draft Report on Review of the Change of Use Charges System in the ACT, April 2010
- Dungey, M (2010), Review of Empirical Estimation of the effects of Change of Use Charges (CUC) in the ACT, Report prepared for Macroeconomics.
- Macroeconomics.com.au, The Final Report on the Review of the Change of Use Charges System in the ACT, April 2010, revised November 2010.
- Master Builders Association of the ACT, Submission on Discussion Paper: A Codification Framework for the Change of Use Charge, December 2009
- Property Council of Australia, Submission on Draft Report on Review of the Change of Use Charges System in the ACT, April 2010
- Real Estate Institute of Australia, Housing Affordability Report, *Joint Quarterly Survey 101, December Quarter 2009*
- Real Estate Institute of Australia, Real Estate Market Facts, A Quarterly Review of Major Property Markets in Australia, June Quarter 2009

Attachment A: Table 4. The three systems compared

	Pre-rectification System	Rectified System	Codification (Lease Variation Charge)
Valuation basis	The specific property referred to in the DA	The specific property referred to in the DA	A public register of fixed charges for different, and permitted, land uses in different ACT regions or suburbs ⁵
Method	<p>The difference between the value of the land before and after the lease variation is used as the basis for the determination of the amount paid.</p> <p>Statutory formula is $CUC=(V1 - V2) \times 75\%$</p> <p>Where V1 means the capital sum the lease might be expected to realise if a lease were varied as proposed and then sold immediately afterwards and V2 means the capital sum the lease might be expected to realise if the lease were not varied but still sold immediately afterwards</p> <p>Note: A practice of charging fixed fees for dual occupancy,</p>	<p>The difference between the value of the land before and after the lease variation is used as the basis for the determination of the amount paid.</p> <p>Statutory formula is $CUC=(V1 - V2) \times 75\%$</p>	<p>Residential sites: Schedule of fees will apply for all ACT suburbs calculated using a market rate index based on land values calculated by the Australian Valuation Office (AVO) averaged over 3 yrs; fees categorized according to dual occupancy developments and medium/high density developments.</p> <p>A percentage of this value represents the LVC payable</p> <p>Commercial and industrial sites: Market rate index value based on a rate per square metre of gross floor area for each zoned land use category by suburb.</p> <p>A percentage of this value represents the LVC payable</p>

⁵ Particular cases where codification does not apply will require either the input of a certified practising valuer, to determine the 'before' and 'after' values (excluding any structural improvements and any onsite or offsite costs) to determine the amount of LVC payable or a fixed fee will apply

	townhouse and multi-unit developments in defiance of the legislation was in operation until rectification.		
Dual Occupancy	Fixed CUC charge of \$3750 (75% of \$5000) irrespective of location	Statutory formula applied as detailed above	Codified fee applicable for the suburb
Townhouse sites	Fixed CUC charge of \$1885 (75% of \$2500) irrespective of location	Statutory formula applied as detailed above	Codified fee applicable for the suburb dependent on the number of units to be constructed
Multi-unit developments	Fixed CUC charge of \$1125 (75% of \$1500) irrespective of location	Statutory formula applied as detailed above	Codified fee applicable for the suburb dependent on the number of units to be constructed
Remission	ACT Government has right to remit all or part of charge	ACT Government has right to remit all or part of charge	ACT Government has right to remit all or part of charge
Improvements	Before and after values are based on the value of the land and improvements	Before and after values are based on the value of the land and improvements	Value of improvements excluded
Onsite capital costs (demolition and remediation)	Offset against CUC charge	Offset against CUC charge	Not taken into account in determining LVC
Mandated offsite costs (required irrespective of development type)	Offset against CUC charge	Offset against CUC charge	<ul style="list-style-type: none"> • Treated separately from the calculation of LVC • Process to be established to identify, verify and where appropriate fund mandatory offsite infrastructure. • Govt to develop an appropriate admin structure to oversee this. • Once costs confirmed, developer to invoice Govt according to agreed cost share on completion (for large scale

			works consideration should be given to progress payments being made)
Offsite costs (development specific)	Offset against CUC charge	Offset against CUC charge	Not taken into account in determining LVC
Mediation	Available when there is disagreement between AVO and applicant over before and after values	Available when there is disagreement between AVO and applicant over before and after values	Applicable only in cases where codification does not apply and 'before' and 'after' values are used. Formalization of current mediation process before a dispute proceeds to ACAT. API to appoint an independent valuer to make an expert determination on disputed valuations
Appeals Process	If agreement not reached via mediation , case proceeds to appeal phase in the ACAT	If agreement not reached via mediation , case proceeds to appeal phase in the ACAT	No right of appeal except in special cases where codification does not apply (p 33, p44)
Revenue Estimates (2010-2011 – 2013-2014) [†]	\$21 million		\$89 million

Sources

* Macroeconomics.com. au, *Final Report on the Review of the Change of Use Charges System in the ACT*, p 58, Table 8

†Correspondence from ACT Treasury, October 14 2010.

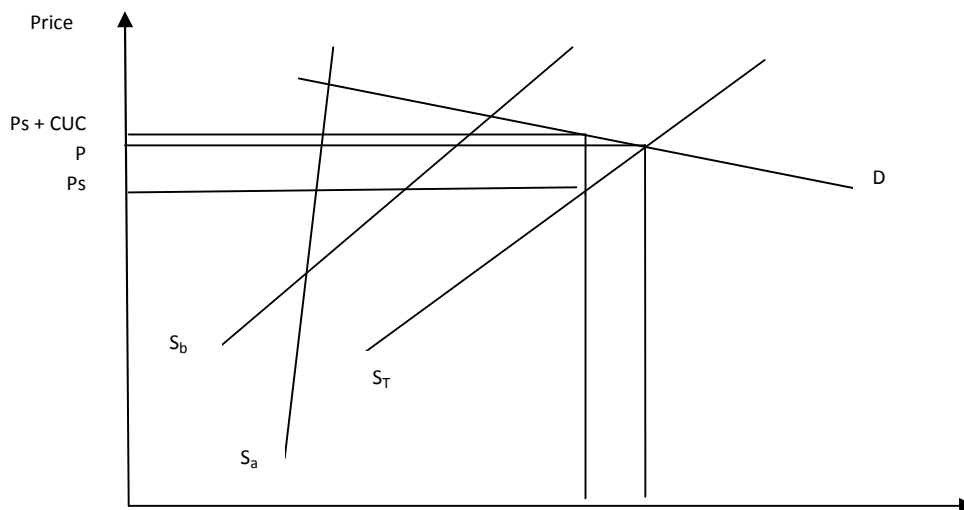
Attachment B: Diagrammatic analysis of the Impact of the CUC on the Residential Property Market

This attachment systematises the material in Section 5. While econometric estimation is difficult and is not attempted here, qualitative analysis can be helpful. Sorting out the relative responsiveness of the demand and supply sides of the market will provide insights into which parties might bear (as opposed to pay) the tax, and what the nature, if not the scale, of quantitative impacts might be.

Figure 1 presents a simple stylised model which allows the interactions of the market to be analysed. It is cast and described in static terms, for example, reduction in supply. But this may be interpreted as lower growth in supply – the basis for analysis is comparative to some pre-change situation.

The supply curve S_a represents segment A of the market. It is not very responsive to supply price, which will be a function of the level of the CUC. Segment B of the market, represented by supply curve S_b , is rather different. Here, greater responsiveness to an increased CUC might be expected. These two components of supply must be aggregated to understand the overall CUC-affected market, represented by S_T . Combining the two segments suggests that supply of development units is unlikely to be highly elastic, but will have some responsiveness. This is in sharp contrast to the demand curve, D , which is likely to be very elastic.

Figure 1: A simple model of the ACT redevelopment dwelling market



When a higher CUC is imposed, which we think of as comprising both rectification and codification, consistent with Table 8 of the R... t CUC is split between the seller and the buyer. Relative to the pre-change situation, the above analysis implies that most of the levy is borne by the seller, with a smaller proportion passed on in higher prices. This is represented in Figure 1 by the relatively small difference

between P , the pre-CUC price, and the post-CUC price paid by the buyer, comprising P_s (the price received by the seller) and the CUC, the price paid by the buyer. P_s has declined by most of the CUC value. The supplier can be thought of as both the original seller of the land, who will likely receive a lower price for the land he holds, and the developer, who will likely face some reduction in profits. The proportional split between these two stakeholders is impossible to determine in advance, but some experience with the levy should generate evidence on which an assessment might be made. But one observation is that with respect to segment B, the effective floor on land price is the market value of the existing dwelling, which may be traded without incurring the CUC.

The quantity of units developed is less than before the imposition of the charge. This is represented in Figure 1 by the reduction in supply from Q to Q' . Further, it is clear that the supply of units in segment B is more sensitive to the imposition of the levy than in segment A. In order for the CUC to have the same proportional impact on both segments of the market, a smaller CUC would have to be levied in segment B than in segment A. To keep both segments vibrant, a strategy of this kind may need to be considered. This is further explored in section 6, where some implementation issues are raised.