



A BETTER WAY

FINANCING URBAN INFRASTRUCTURE

UDIA NSW Discussion Paper
2007 Update

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Introduction

A *Better Way* proposes a highly transparent and accountable infrastructure financing mechanism to deliver quality services in a timely manner. This paper is intended to stimulate discussion towards the development of equitable solutions to the provision of public infrastructure in support of urban development.

The report examines the potential for a ***Pre-Tax Collection Financing*** approach where tax collections projected to be generated from the development are identified ahead and applied by the developer, in whole or part, directly to pre-determined infrastructure as the development (and occupation) progresses. Full cost recovery may be provided for expenditure as 'approved' infrastructure is constructed. This can be achieved via GST Business Activity Statements and development certification processes.

Step One will involve the undertaking of economic analysis to ensure the new release area generates a positive community benefit, especially after all inputs are costed and all outputs are accurately valued.

These valuations act as the control that would be expected to reflect community values and determine whether a project or release area achieves an economic benefit over an agreed time period (between 10 – 25 years).

In addition, the new release area's upper limit budget is set by funds generated through taxes.

Step Two in the process will involve the identification of existing infrastructure capacity and the need for new and upgraded infrastructure. Relevant infrastructure could include works, services and other public benefits such as environmental facilities that may be valued by the community.

Agreements would be made between the State Government (on behalf of all relevant state agencies), local councils, and the developer or consortium involved. The agreement would establish a delivery and cost recovery program, as well as the obligations of all parties to the agreement. The obligations would be in relation to approvals, standards, and on-going responsibilities.

More specific agreement detail would ensure infrastructure valuation and the delivery program is prepared for each locality or sub-region in line with demand generated by residents and users, and GST liabilities generated through sales.

Step Three involves the construction phase and the provision of services.

Step Four would enable cost recovery. Cost recovery arrangements would be made through the creation of tax credits against GST Business Activity Statements. The cost recovery process would see a private certifier valuing work in progress, a Certificate of Financier for the cost of finance, agreed project management charges applied, and certificates and the project management claims submitted as part of the Business Activity Statements generating credit.

UDIA NSW's proposal is for a fairer more cost effective method of financing and delivering public infrastructure in support of urban development.

Part A

1. The NSW Legacy of Public Infrastructure Provision

In the earliest stages of settlement in NSW, urban infrastructure was basic, more likely to follow housing settlements and generally seen to be the responsibility of the colonial government. As the colonial government became more established, the provision of most public infrastructure came under dominant government control.

The practical consequences were that areas established in the first 100-150 years of the colony were relatively well serviced by public infrastructure such as roads, transport, hospitals, public halls, libraries and other facilities and services. However, those suburbs established in the decades following WW2 were mostly poorly served at their creation and most have remained so since.

This is a consequence of successive governments' inability to keep pace with population growth and urban expansion. Infrastructure for water and sewerage services, public roads, rail, bus and water transport, and to a lesser extent schools and hospitals were now the sole prerogative of the state government. Meanwhile a range of social and community services were gradually being passed to local government to provide.

By the 1970's and 1980's state and local governments' had acquired a huge backlog of major infrastructure requirements. At the same time, they were limiting borrowings that they had previously relied upon to finance infrastructure to new areas.

Essential infrastructure such as water and sewerage was now to be funded partly, and in time fully, by the new development. Legislative powers were introduced to allow water and sewerage authorities and councils to link contributions for infrastructure to zoning and development approvals. These powers added to the traditional powers of such authorities to require reservation of land for public purposes, such as open space, major roads and services corridors.

2. Financing Sydney's Public Infrastructure – Recent and Current Practice

The trend to direct, up-front charging and full-cost recovery of infrastructure in new development areas has been increasing for some time. At the local level, the definition of local infrastructure to be provided by the council (but funded by new development), has expanded from just the reservation of land for public purposes to include the costs of developing the land for that purpose. Examples include embellishment for recreational use, provision of community buildings, child-care centres, traffic management, regional recreational facilities such as aquatic centres, and a variety of other facilities and environmental improvements. Such facilities and improvements frequently serve a wider population or area than is within the levied developments ('s.94 contributions').

Within the development area, roads and works installed by the developer now regularly include roundabouts, landscaping, lighting, cycle-ways, underground services, naturalised water cycle systems with ponds and lakes, and additional facilities serving the wider public such as community centres, crèches, sports centres, and catteries. Extensive land may also be set aside for native vegetation conservation and wetlands.

3. Infrastructure Costs for the New Homebuyer in 2007

What is the total current dollar cost of these levies that are inevitably passed on to the homebuyer?

Work undertaken by ACIL Consulting for UDIA NSW in 2001 found that the costs of developing new residential land and housing varied significantly across Australia's capital cities, with Sydney being by far the most costly, both in terms of land and in the levies applied by state and local governments. These figures have been updated by UDIA NSW in 2007.

The research found that for a typical house and land package in a new estate (2001) in Blacktown in Sydney's west: (Updated 2007 figures are in **Bold**)

- Public authority infrastructure charges amounted to \$31,750 – now **\$93,000**.
- Works within the subdivision (roads, drainage, etc) on a per lot basis were calculated at another \$25,250 – now **\$62,000**.
- These are all public infrastructure costs applied to a new home with an end price of \$338,000 – now **\$550,000** (median price of a house & land package).
- Of this, just over \$203,000 – now **\$255,000** covered land purchase (100,000), development and servicing (155,000 inclusive of contributions),
- The cost of the standard house constructed on the small lot \$135,000 – now **\$200,000**.
- The GST collected by Government expand on the inputs and services added from the acquisition phase through the development process and on to the final housing product. This can be readily calculated at around one eleventh of the final cost, or approximately \$33,800 – now **\$50,000** payable by the homebuyer.
- The transaction for a \$550,000 home would have attracted stamp duty of almost **\$30,000** as composite of charges paid by the developer and homebuyer. Land Tax is not included but is also a cost of development that is passed on.

It should be noted the transfer duty on the sale of vacant land or a new home is greater than the duty payable on an established home. This is because transfer duty is calculated on the GST inclusive purchase price, effectively as a tax on tax. The transfer duty payable by a developer when it acquires broad acre land will therefore vary depending on the GST treatment of its acquisition of that land.

The combination of taxes – land tax, GST, stamp duty, and contributions on new property development total around \$173,000 on a \$550,000 house and land package. The financing of public infrastructure is a significant burden being carried by the buyers and occupiers of new development in NSW. However, this infrastructure generally benefits a wider community that often has a greater capacity to pay and has more often than not, failed to contribute through fortunate timing of their purchase.

4. Trends in Public Infrastructure

The figures calculated by ACIL for UDIA at the end of 2001 have been overtaken in currently developing areas where there are growing environmental, amenity and social service expectations (see bold updated figures in previous section).

Whilst it may be considered prohibitively costly to introduce these standards in urban areas already developed and settled there is a view that for new developing areas, all these higher standards can be achieved. Higher standards of infrastructure provision in new release areas, if appropriately sized or extended, can provide benefits to nearby existing areas and/or redress past environmental errors. All or most costs are charged to the new development through the incoming population – those with the least capacity to pay.

At any point in time, new development is only a small part of the total urban footprint and will accommodate only a fraction of Sydney's population. The incoming population is not represented and unlikely to receive fair treatment when funding decisions are taken.

The questions that must be asked are what standards are affordable and who should reasonably and equitably pay. These questions receive limited attention in the drive to redress the city's public infrastructure and related environmental deficit; a deficit built up over most of its history.

5. Current Means of Public Infrastructure Provision

The occupants of new development, at least in areas being urbanised on the fringes of Sydney, are already being increasingly levied for local infrastructure. This trend is being expanded to infrastructure with sub-regional dimensions.

In future land releases, particularly the proposed Land Release Program for the South West and North West Sectors, proposals are also being put forward for regional transport infrastructure to be funded from new development. The benefits are far more widely dispersed than the development areas in question and extend throughout the entire Sydney Region.

UDIA NSW believes that the capacity of new development to absorb the costs of infrastructure extensions and improvements has already been thoroughly exhausted. There must be better ways of raising the standard of our public infrastructure; in particular that infrastructure that is presently delivered and/or controlled by public authorities. This should include raising finance for the capital costs.

No single solution will be right or best for all circumstances. Governments everywhere are entering new arrangements with private sector interests for the provision and financing of a range of major public infrastructure, including ongoing management. These initiatives may deliver process improvements and efficiencies, but they do not fundamentally address the funding question.

6. Integration of Urban Land Releases with Regional Infrastructure Provision

A recent factor in the public infrastructure debate in relation to new land releases in the Sydney Region has major implications for development costs. The Government has established a clear policy linkage between regional infrastructure (particularly transport) and urban development – it therefore establishes ***a new contributions revenue stream to government through new urban development.***

The State Government has thereby established its own responsibility to repatriate that revenue stream to the costs of providing the required public transport, and indeed, to the provision of other public infrastructure and environmental improvements where it establishes a policy linkage to the new development generating the revenue. The new contribution is \$485,500 per hectare for residential development or an average of \$33,000 per lot which will still fund 75% of the infrastructure expenses incurred in the Growth Centres. It is understood that a proportional level of contributions may be extended to regional areas such as the Illawarra and Hunter where they will continue to create a disincentive for investment.

Part B

A Better Way – Financing Public Infrastructure in Urban Areas

1. Metropolitan Housing Stress, Prices and Deficits in the Infrastructure Spend

Metropolitan urban growth and development takes place today in an environment where the traditional expectation of Australians of being able to achieve adequate and secure housing is under threat, and where the majority of aspiring and new homeowners are under extreme financial stress. The NSW Government now appears to acknowledge that the fundamental causes of this situation, stems from a decade of restricted new land releases and the absence of a comprehensive, Sydney-wide strategy to manage and support metropolitan and population growth.

Sydney's growth in population has exceeded forecasts and the supply of housing and services to the region has fallen spectacularly behind that growth in demand. Homebuyer stress has already been exacerbated by the introduction of the GST on housing. The GST has already been transferred through to the cost of purchasing and renting residential development but the money collected by the Government is not being specifically repatriated back to developing areas.

2. Funding Options

UDIA NSW has identified three possible funding options for broad-based infrastructure provision in new urban development areas. The three options are:

- *Private Sector Contributions*, where purchasers (homebuyers and businesses) fund infrastructure provision through charges against development at the zoning or approval stage;
- *Broad-based Funding derived from general taxation (post-tax collection)*, directed through government service authority or regional and local budget allocations; and,
- *Pre-tax collection Financing* approach where tax collections projected to be generated from the development are identified ahead and applied by the developer, in whole or part, directly to pre-determined infrastructure as the development (and occupation) progresses. Full cost recovery for expenditure as 'approved' infrastructure is achieved through the GST Business Activity Statements and development certification processes.

3. Customary Approaches

Private Sector Contributions are not a desirable funding option. Private Sector Contributions add to the cost of production, transfer directly to higher market prices, increase GST liability and further erode affordability. In addition, contributions of this type are inequitable as they penalise current homebuyers while allowing existing residents and the wider community to reap the benefits of improved and new infrastructure, at the expense of new residents.

Government funding through post-tax collection does not add to the cost of development, increase GST liability, or erode affordability and therefore, current homebuyers are not penalised.

However, the post-tax collection approach requires infrastructure funding to compete directly against other government priorities for funding. Experience informs us that under these circumstances, infrastructure required as a consequence of long term strategic planning may lose

out to the day-to-day immediacy of the political or bureaucratic demand. The infrastructure intended to support urban growth in either a timely or integrated manner is “lost” to the system.

In addition, the post-tax approach keeps the delivery process in the hands of those government authorities that have to date far failed to deliver infrastructure, not only when it has been needed, but as effectively or efficiently as it could be. This approach has demonstrated significant deficiencies.

4. Pre-Tax Collection Financing

Pre-Tax Collection Financing is the name UDIA NSW has given to a system where tax liabilities that would be generated from the development are recorded as credits against work carried out by the developer in providing approved infrastructure projects. The funding for these approved infrastructure projects is initially sourced from the developer’s financier and is undertaken in a normal financing project environment. The tax credits allow the developer to treat the cost as a funding transfer rather than as permanent cost upon which he must apply his margin.

Both the cost and the tax revenue are generated by the development and would not arise without the development and accordingly it cannot be counted in general revenue projections and expenditure for unrelated government priorities. Further, the work is done at the time it is needed and the pre-tax collection credit recovered upon sales revenue being realized. This approach will not permit funds to be diverted to other priorities before the work is completed. The government establishes a system that guarantees that the money spent on infrastructure by the developer (including finance costs) is recovered over the passage of time from GST.

Pre-Tax Collection Finance will put delivery under the control of those with the greatest incentive to make efficient use of time and capital. It *will* require federal and state co-operation and may require legislative change.

The Pre-Tax Collection approach to funding new or upgraded regional public infrastructure is premised on linking infrastructure provision to the timely generation of GST revenue from the development. A number of distinct stages or processes are envisaged to ensure proper planning, management, and accountability throughout.

- At the outset, an *Urban Capability Study* would be undertaken to establish a planning rationale and to identify major infrastructure works at a project (individual developer), local (Section 73 & 94) and regional (GST and other directly-linked taxes) level.
- Economic Analysis would then be carried out to establish costs, identify and value all benefits and recognize available tax income. This analysis would identify infrastructure required to service the development, from subdivision to sub-regional, catchment level or regional level, as *Approved Infrastructure Works* which would then be the program identified in a *Decision to Proceed*, formed between the relevant level of government and the developer.
- Once a determination has been made, developers would proceed to construct Approved Infrastructure Works, including services. The process and approach, backed up by the allocation of Tax Credits, would be applied so as to encourage development in preferred locations and configurations that support the provision and viability of favoured infrastructure and services. This proposal should generate a reasonable, predetermined return to government for its investment of management expertise and to allow an overall revenue gain to NSW.

- Tax income will be generated from GST (from land and housing and related flow-on activities), Stamp Duty and Land tax (particularly from developers). Developers will achieve full cost recovery through credits against monthly, quarterly or annual GST liabilities through the Business Activity Statements.

The MDP production target can be used to provide an example of the revenue created by this proposed pre-tax approach. The MDP target is to achieve production of 8,000 lots per annum. Assuming an average lot sale value of \$250,000, average dwelling sale value of \$200,000, and \$50,000 for household fit-out, estimated GST revenue generated solely by the fact that development proceeds is around \$360 million. Calculated by $1/11$ of $\$500,000 \times 8,000$.

Assuming a further \$100 million generated by stamp duty on the end land value alone, around \$460million will be generated annually. This amount is automatically indexed over time

In Sydney's Growth Centres the forecast expenditure on state infrastructure is \$7.8 billion over 25 years. Target dwelling production in the Growth Centres is 160,000 dwellings over the same period. The average complete house and land package of \$500,000 will therefore generate \$50,000 in GST. Multiplied by 160,000 new dwellings in the Growth Centres this equates to GST revenue of \$8.0 billion, more than sufficient to cover the state infrastructure costs.

Returning the GST revenue to facilitate the activity which generates the tax is a transparent and equitable method of financing infrastructure. This substantial contribution will both service the new growth and deliver significant benefits to the metropolitan region, its people and economy.

5. How Would it Work?

Before examining how this infrastructure financing approach will operate, it is important to note two overriding assumptions. The first assumption is that the community values the social, environmental and economic benefits of affordable housing, and the need for balance in supply and demand, efficiency in all delivery processes and certainty in investment. The second assumption is that state and local government understand and appreciate the need to reduce the direct effects that process delays and inefficiencies have on housing affordability.

This infrastructure financing approach will operate in four distinct steps.

Step One will involve the undertaking of economic analysis to ensure the new release area generates a positive community benefit, especially after all inputs are costed and all outputs are accurately valued.

These valuations act as the control that would be expected to reflect community values and determine whether a project or release area achieves an economic benefit over an agreed time period (between 10 – 25 years).

In addition, the new release area's upper limit budget is set by funds generated through taxes.

Step Two in the process will involve the identification of existing infrastructure capacity and the need for new and upgraded infrastructure. Relevant infrastructure could include works, services and other public benefits such as environmental facilities that may be valued by the community.

Agreements would be made between the State Government (on behalf of all relevant state agencies), local councils, and the developer or consortium involved. The agreement would establish a delivery and cost recovery program, as well as the obligations of all parties to the agreement. The obligations would be in relation to approvals, standards, and on-going responsibilities.

More specific agreement detail would ensure infrastructure valuation and the delivery program is prepared for each locality or sub-region in line with demand generated by residents and users, and GST liabilities generated through sales.

Step Three involves the construction phase and the provision of services.

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6. The Result

The State Government will necessarily need to establish investment and return criteria to assess new release area proposals against social, environmental and economic outcomes. Ultimately, governments will be able to balance the relative value of an adequate supply of affordable housing against community demands for social and environmental outcomes.

The budget for infrastructure will be informed by strategic planning with rezonings and dwelling forecasts determining projected revenue. Approval for new infrastructure projects will be judged against a potential development area's dedicated revenue stream and infrastructure will be acquired by credits against revenue as it is being generated. Only viable projects will proceed and the State Government will manage the revenue and policy.

Accordingly, the infrastructure burden will be shared equitably from existing revenue collection that is generated from the decision to proceed to release the land. Otherwise, the revenue is not available to the government anyway, and should not be included as part of its overall state budget.

This infrastructure financing proposal will also ensure Local government does not pick up the cost of regional infrastructure issues. Local government will be locked by agreement into a process of delivery with a predetermined approval process.

Developers will act as a partner with and supplier to government. Developers will deliver in line with demand, expenditure will be secured against revenues, and the full cost of the infrastructure-provision activity will be recovered. The proposal will mean on-site project management will be achieved by those who have the greatest incentive to deliver effectively and efficiently.

Finally, the consumer will not have to assume the entire burden of the cost of infrastructure that is demanded by others or benefits the wider community. The consumer will acquire a home at a more affordable price, determined indirectly by community standards and the broader community will achieve significant triple bottom line outcomes.

Conclusion

NSW demands quality and timely infrastructure financed in a manner that does not exceed the developer's funding envelope. The provision and financing of public infrastructure for urban communities has been an issue of continued importance throughout Sydney's growth and history. By the 1970's and 1980's, state and local governments had acquired a huge backlog of major infrastructure requirements, and new development was first asked to partly fund essential infrastructure such as water and sewerage, before a direct, full-cost up-front charging infrastructure charging system was introduced.

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Returning the GST revenue to facilitate the activity which generates the tax is a transparent and equitable method of financing infrastructure. This substantial contribution will both service the new growth and deliver significant benefits to the metropolitan region, its people and economy.

The capacity of new development to absorb the costs of infrastructure extensions and improvements has been thoroughly exhausted. We must find new and better ways of raising the quality and service standards of our public infrastructure.

A *Better Way* is a pre-tax collection financing approach where taxes that would be generated during and by the development recorded as credits against future tax liabilities. The pre-tax collection methodology is an innovative financing approach to funding new or upgraded infrastructure, particularly regional or catchment-based public infrastructure. It links required infrastructure provision to the timely generation of additional revenue streams directly by and from the development.

Further, pre-tax collection will avoid funds collected from the purchase of new housing being diverted to other priorities over time. The revenue will be collected and directly applied to providing services, by those with the greatest incentive for providing infrastructure as quickly and efficiently as possible.

Greater confidence in planning and enhanced co-operation in the planning process between government, developers and the community will be additional outcomes of this approach. There will be a greater incentive for developers to provide infrastructure in the most efficient and timely way, rather than forcing residents to wait.

Infrastructure and development will occur as a collaborative exercise, with each participant doing what they are best placed and equipped to do. There will also be opportunities for infrastructure providers to take advantage of the wider market to ensure an efficient market-determined price, rather than the public and consumers having to wear the state-agencies monopoly price based on their own cost-plus formulae.

Throughout the proposed process, the developer will act as the agent of the government, state agency and community. Government and the community will still set standards, determine policy and co-ordinate the planning process. Our approach will ensure a more equitable funding of new and upgraded urban infrastructure, both in terms of inter-regional and inter-generational requirements. It is simply *A Better Way*.