

**Submission
No 113**

INQUIRY INTO LAND VALUATION SYSTEM

Organisation: University of Western Sydney
Name: Assoc Prof John Macfarlane
Date Received: 14/03/2013

Submission to the Inquiry into the Land Valuation System

conducted by the

Parliament of New South Wales

**Joint Standing Committee on the Office of the Valuer
General**

from

Associate Professor John MacFarlane

University of Western Sydney

March, 2013.

Background

The current Inquiry has a focus on valuation issues and not taxation ones. Inevitably, though, it is via State land tax or local government rates that these matters impact on business and the community and it is via this taxation prism that statutory land values are scrutinised in relation to “ad valorem” taxes. It should therefore not be surprising that criticism and objections to the land values issued by the Valuer General come largely from those who are required to pay significant amounts in land tax and rates. For income producing properties, these taxes and charges arise from the ownership of the land. There are no costs/charges comparable to land tax, rates and transfer duties on some other alternative investment options (bonds and equities, for example), and it may well be the case that these additional costs cannot be recouped from the tenant or extra income derived from the property ownership. To some extent, these considerations may impact on investment decisions when property is being considered against other asset classes. Inevitably, it can be difficult at times to separate taxation and valuation issues, such as the question raised in the Committee’s discussion paper in relation to strata property.

NSW Land Valuation System

It is not my intention to give a detailed description of the NSW land valuation system. However, a few key points are relevant.

1. The system is based on land (site) values.
2. There is no mandated valuation methodology but, I believe, all current contractors use a methodology based on groups of similar parcels of land (called “components”). Components comprise properties which are of the same land use zoning within a Local Government Area (LGA) and whose land values are expected to move similarly over time.
3. All mass valuation systems require some form of grouping of properties so that the movement in value of properties which sell in a given time period can be inferred to those properties which have not been sold. This is a wider grouping of properties than would be the case for identifying comparable properties in the traditional valuation of a subject property.
4. In NSW, the component system dates back at least to the late 1980s. While the component system is not mandated, it is the default valuation method and all contractors are required to provide at least annual data which allow the

component method to be maintained and applied (for example, if another contractor took over the contract for that LGA).

5. The component method is a simple approach operating similarly to a price or commodity index. It is based on percentage changes in land values. This basic idea of land value movements is generally well understood by the public.
6. The concept of site value is essentially that of market value of transacted land parcels. This is a critical consideration so that market transactions of property are the basis for determining land values. Analysing the sale of an improved property to a land value as at a particular date is a standard valuation exercise.
7. Over time, the component method is largely self-correcting as it uses market transactions as its basis. Information on property transactions (sale prices) is available not only to valuers but also to the general public. There are regular newspaper articles discussing residential property values so that it is an area in which the general public is moderately well informed.
8. At all times, it needs to be recognised that this is largely a mass valuation system. I believe the system works extremely well where there is a reasonable amount of current market evidence.
9. The use of mass valuation approaches for the vast majority of land parcels (85-90%) permits the allocation of valuation resources to allow much closer scrutiny of those properties where mass valuation methods are not appropriate due to limited or no (market) sales evidence.
10. The NSW Ombudsman conducted a thorough review of the NSW land valuation system in 2005. He concluded that: "Mass valuation systems are used throughout the world and are an economic and logistical necessity. The component system of mass valuation is capable of producing estimates of value within a reasonable margin of error for the majority of properties, and is theoretically a self-correcting system so that it should converge to the true values over time. The investigation was also satisfied that the quality assurance framework in place, including the objection process, was reasonable, however, it has a number of weaknesses in its current implementation most of which are the product of resourcing and scheduling issues. These contribute to the system currently producing some values that have unacceptable margins of error".

Since that time, I believe the recommendations of the Ombudsman have largely been implemented and, with the increased focus on quality assurance, the overall quality of land values has improved significantly.

Quality Assurance

There has been a considerable focus on quality assurance of the land valuation system over the last decade and the following observations are relevant.

1. Prior to 2003, there were only limited quality assurance processes in place. Over the period 2005-08, I developed a considerable number of QA tools which have subsequently been incorporated into VALNET so that the analysis and information which arises from it, is available to LPI staff the day after values are provided by contractors. The QA reports feature relevant statistical summaries together with exception reports of properties and components requiring closer examination. These statistical summaries and exception reports are a tool to help identify possible problems in the land valuation process. They are not a substitute for valuations themselves.
2. The NSW mass valuation system uses internationally recognised QA standards and compares favourably with other Australian and comparable overseas jurisdictions. These QA standards specifically measure the consistency of valuations (the coefficient of dispersion or COD), the accuracy of valuations (the mean value price ratio or MVP) and a measure of vertical equity (the price related differential or PRD) which checks that valuations in high and low dollar brackets are equitable.
3. Valuation tends to be a conservative art/science and the MVP statistical standard indicates that land valuations are consistently around 95% of market value across all land use zones. The MVP standard requires that valuations are in the range 90-100% of market value which indicates, contrary to some public opinion, that the mass valuation system does not deliberately inflate property land values. The process tries to ensure that over-valuation is avoided and that properties are not knowingly over-valued.
4. Analysis of the mass valuation outcomes over the period 2007-2012 indicates that there has been improvement in consistency and equity in most land use zones and a consistent level of valuation accuracy (about 95% of market value) over this period. I can supply the Committee with relevant statistical reports as required. However, the internationally accepted statistics used for mass appraisal are almost unique to this application and would possibly require additional background and explanation.

5. There is a considerable international literature on valuation accuracy. The Ombudsman in his 2005 report gives attention to the acceptable standards for valuation accuracy. He noted that variation in values can be up to 15 to 20% for standard valuations for some property types and that, by its nature, mass valuation is less precise than direct valuation of a subject property. I would content, however, that mass valuation methods can produce very acceptable levels of consistency and accuracy for those classes of property where there is good market evidence available and it is then a question of resource allocation to ensure that there is sufficient attention given to those properties types where market evidence is very limited or not available at all.
6. There also need to be sufficient resources available to maintain the basic infrastructure of the mass valuation system (the make-up of components, benchmark properties, etc) and regular examination of the value relativities within a component and across an LGA. This maintenance is the responsibility of the contracted (private sector) valuers with oversight by LPI staff.

Discussion and Conclusions

In conclusion, I would like to provide a number of additional comments some of which relate to some of the specific issues raised in the Inquiry's terms of reference.

1. The existing NSW mass land valuation process is not a complex one but is based on the idea of movement in land values over time. These are basic ideas which largely reflect the way the general public consider land and property values.
2. The process has been made much more transparent in recent years with access to relevant valuation information provided via the LPI website.
3. Many automated valuation models (AVMs) are now available on the web. These purport to give "accurate" valuations on individual properties. These AVMs are largely "black box" using regression and neural network models which are much more complex and far less transparent than the current land valuation system. Valuations produced by these AVMs are of dubious consistency and accuracy and are likely to be much more volatile from one time period to the next than the existing NSW land valuation methods.
4. For land tax, there is a single threshold and rates in 2 bands which apply to all classes (zonings) of liable property. On the other hand, local councils can, and a number do, apply differential rates to different categories (zonings) of properties, so that properties with the same land value in the same LGA in

different differential categories can have different rate assessments. Further, properties with the same statutory land value and the same zoning in different LGAs can have very different council rate assessments even in adjoining LGAs.

5. Objection rates in NSW are approximately 2 objections per 1000 valuations issued annually by the Valuer General (only properties subject to land tax and those LGAs in which notices of valuation are released on a normal 3-year cycle are issued each year; which amounts to approximately one million assessments released annually). This is a considerably lower rate of objection than in many other jurisdictions.
6. The objection process has been a focus of attention within LPI so that the bulk of objections are finalised before the next round of annual valuations are completed. This is an important consideration to ensure that all relevant information is available for each valuation round (July 1 base date).
7. Movements in land values should reflect movements in the property market and I do not believe that currently produced statutory land valuations are more volatile than the market. If the market is in steady growth, then this should be reflected in relevant land value movements rather than leaving values unchanged for a period of time and then having to move them more drastically in order to “catch up”. This “catch up” can be disconcerting to the public if there is a moderate to large increase in land value in a period when property values have not increased at such a rate. The general public may not focus as much on the absolute land value, and the fact that this is still below the market value; but rather on the percentage change in value since the previous assessment.
8. The evidence indicates that for those properties where “mass” valuation processes are used – based on available market evidence of the movement in land values – the rates of objection and successful objection are lower than for those properties where “mass” methods are not used. This might seem to be contrary to expectation but “mass” methods are used on “easier” properties where there is adequate market evidence. Properties which do not fall into this category are exactly those which give rise to valid disagreement as to the appropriate valuation between competent valuers (as identified earlier on issues of valuation accuracy). Adequate resources need to be available for the valuation of these more unique properties but competent valuers may still arrive at different valuations for such properties.
9. There is a very reasonable community expectation that under an “ad valorem” system of rates and taxes, everyone should make an appropriate contribution. Values should, where possible, relate to market evidence. I am not a legal expert but it may be that the Valuation of Land Act requires attention to

ensure that “fair” valuations are imposed on all properties and that this is reflective of market evidence where that is available. This can be problematic for those groups of properties where there is little or no market evidence.

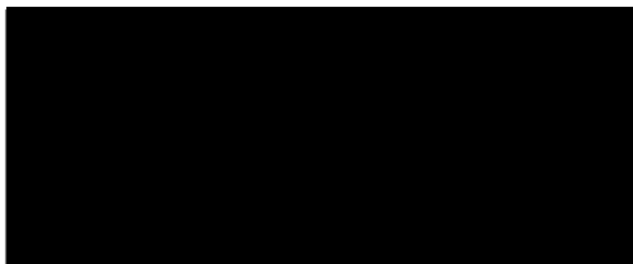
10. The Issues Paper released by the Committee raises the question of equity in relation to strata holdings. This is more a question in relation to Land Tax than to Council rates where strata units are often subject to a minimum level of rates as determined by the Council. I think this is largely a question of philosophical approach (encouragement of medium density development, for example) but I would indicate that a system based on land values has considerable merit given that:

- taxes on land values do not act as a disincentive to development whereas taxes on improved values might well do so;
- movements in property values are largely associated with movements in the value of land rather than to any improvement which may sit on that land;
- improved properties vary much more than does the land on which they are built; so that a mass valuation process is considerably more difficult to implement if applied to improved values rather than to land values; and
- in some jurisdictions which use improved values (New Zealand, for example) there is quite intense scrutiny of government assessments by potential property vendors and purchasers. This is not an intended use for these valuations but may well give rise to an unnecessarily increased level of objections.

11. During my several years of direct involvement in the NSW land valuation process, including running workshops on quality assurance methods for both contractors and LPI staff, I have noted the strong desire of both groups not to cut corners but to “get it right”. While there are financial imperatives for contractors, they are very aware that the renewal of contracts and reducing costs associated with enquiries and objections can best be achieved by producing a good quality set of valuations in the first place. While resourcing is an issue for LPI, I have also been impressed by the focus on quality outcomes and a commitment to quality improvement and transparency by senior LPI staff.

12. Finally, I believe there has been significant improvement in the land valuation system and the land values which arise from it, since the Ombudsman’s Inquiry in 2005. This is borne out by analysis of the valuation outcomes. There is still room for improvement in the system but this should be achieved through further incremental development of the existing system rather than by seeking to develop an alternative process.

I am happy to provide additional information and/or statistical reports to the Inquiry or to appear before the Inquiry as the Committee may feel is appropriate.



Associate Professor John MacFarlane
School of Computing, Engineering and Mathematics
University of Western Sydney

March, 2013.