Land Governance in an Interconnected World
ANNUAL WORLD BANK CONFERENCE ON LAND AND POVERTY
WASHINGTON DC, MARCH 19-23, 2018

EVALUATING VALUE CAPTURE INSTRUMENTS

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Paper prepared for presentation at the
"2018 WORLD BANK CONFERENCE ON LAND AND POVERTY"
The World Bank - Washington DC, March 19-23, 2018

Abstract

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Since Henry George's *Poverty and Progress* governments have developed a series of value capture instruments to extract increases in land values. These can be seen as alternatives to taxes. Whereas the taxes explicitly extract value from the owner or developer many of the other instruments can be argued to do this by stealth. This stands in the way of evaluating the effectiveness of such instruments and whether their use is the most effective way of achieving the desired objective or whether explicit taxation might be more effective. The paper applies some standard measures of the efficiency of taxes to evaluate the value capture instruments, including equity, certainty of liability, administrative efficiency, transparency, convenience, neutrality, and fairness. It compares their performance against these to those property taxes that can be used as means of value capture.

Key Words: building norms, developer exactions, Floor Area Ratio (FAR), planning gain**,** value capture

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Introduction

Henry George in his book *Poverty and Progress* (1880) famously argued that landowners contribute nothing to the creation of land. The value of land was the result of its exchange value as a monopoly and does not express its reward in production. In essence the value of land is determined by its demand. This could increase as a result of economic or population growth or urbanisation. He argued that "[Value] is not in any case the creation of the individual who owns the land; it is created by the growth of the community. Hence the community can take it all without in any way lessening the incentive to improvement or in the slightest degree lessening the production of wealth". A distinction should be drawn between improvements, such as buildings, drainage, and the provision of infrastructure, which result from landowners applying capital to the land and the land itself. Land in the words of David Ricardo, can be regarded as the "original and indestructible elements of the soil". He was critical of his near contemporary Adam Smith for conflating rent, the reward for supplying the original and indestructible element in the soil, and rent as paid by a tenant to a landlord, which is a combination of the reward for supplying land but also fixed capital, the reward for which should, in his definition, be interest on capital. Landowners should be entitled to a fair return from their investments in improvements to reward them for the capital invested and bearing the risks involved. Such rewards can be taxed through the normal channels of income and profits taxes. In benefitting from increases in the value of land generated by society, landowners are the beneficiaries of something to which they have not contributed, as distinct from increases that have resulted from improvements. This philosophy had led governments to search for ways in which part of any increase in land values can be captured on behalf of the communities that generated it.

In some cities, such as Hong Kong and Amsterdam, governments own land, and so are able to extract value increases through granting leases at market rents that reflect rising values. Otherwise governments must devise instruments that can do this. The most obvious way is through the imposition of taxes on increases in value. A variety of taxes are, in principle, capable of capturing part of land value increases. Property transfer taxes can be imposed on the price paid for land and they increase as prices increase with each new transaction. Capital gains taxes fall on the difference between the price paid for an asset and the price at which it is sold less any expenditure on improvements. Betterment taxes can be levied on increases in the value of land, for instance, when consent is granted for a change of use to a more profitable activity or for development. Recurrent property taxes that are revalued periodically can also tax increases in value since the fundamental characteristics of most properties normally change little between revaluations. These taxes explicitly extract value from the owner or developer.

Value capture taxes may not be available to local governments seeking to capture value increases on behalf of their communities. This may be because the law does not permit them to levy them. It can also be because of the poor performance in collecting taxes so that value capture instruments are seen as a pragmatic substitute (Smolka, 2013). Alternatively, the value capture taxes imposed are ones for which the proceeds go to central government rather than the communities that have generated the value increases. Central government may collect the revenue generated by value increases through property transfer or capital gains taxes that are not shared with local governments. This can result in the creation of other instruments by local governments designed to capture value on behalf of the local communities that created it. Sometimes this is done by stealth, with a charge being extracted that is purported to be in return for some service. Often the language is used is opaque, talking in terms of charges or fees for a service being granted or a charge for the right to do something rather than the instrument being described as a tax or exaction that has to be paid. This lack of clarity in language is unhelpful and confusing as it stands in the way of evaluating the efficiency of such instruments and whether their use is the most effective way of achieving the desired objective, particularly in comparison to explicit taxation of increases in value. The paper puts forward the argument than in considering their efficiency, reference should be made to the criteria by which taxes are judged. By evaluating value capture instruments in this way, it is possible to judge whether or not they are superior or inferior to explicit value capture taxes and, therefore, the desirability of their use.

Determining When Value Capture Taxes Have Been Imposed

A tax can be defined as being any payment to the public sector that is not in direct exchange for goods or services received. Thus, the purchase of a stamp from a state-owned postal service cannot be regarded as a tax unless the charge is set at a level that provides the government with an excess profit beyond the normal costs of providing such a service, including a fair return on the capital employed. Governments commonly supply utility services. Politicians may prefer to impose a higher charge than is necessary to provide an economic return on the resources used for, say, electricity in order to generate revenue to support the general government budget. Such measures conceal the true tax burden compared with charging the market price for electricity and imposing, say, a value added tax. Such a move would make the tax element explicit but either approach is, in effect, imposing a tax on consumers of electricity.

It is reasonable to impose a charge on landowners seeking permission for a change in the use of their property or to undertake development. There are costs involved in reviewing such applications, including technical work that has to be undertaken by expensive professionals. A case can be made for charging the user of such services rather than providing them free at the point of consumption, with the cost being met by taxpayers in general. However, if the charge goes beyond reimbursing the government for the reasonable costs involved in undertaking this work, one can argue that the additional levy should be regarded as a tax. If the costs of making utility connections or links to infrastructure reflect the direct costs of doing so, then the case can be made for these to be met by the landowner or developer since he will be the beneficiary rather than them being provided free at a cost to the community or utility users in general. A charge in excess of these costs, though, can reasonably be regarded as tax on the increase in value that such a connection brings.

The argument is that many of the instruments imposed to capture land value increases, particularly by local governments, are, in reality, taxes. They may be given a different name, such as a charge, fee, levy, or contribution but the reality is that they are often a tax by any other name. The revenue generated may not appear amongst tax revenues in government accounts but this does not stop them from being taxes. The exaction can take the form of a payment in kind, such as infrastructure being constructed at the developer's expense or land being transferred by a developer to a local government. Sometimes the revenue does not appear in government accounts because the charge in cash or kind is received by a beneficiary nominated by the government rather than the government itself, such as a provider of social housing. We should examine the reality of impositions rather than how they are accounted for as accounting policies are sometimes used as a way of concealing the true nature of a transaction.

Criteria for Evaluating Taxes

In 1776, the Scottish economist and moral philosopher Adam Smith published *The Wealth of Nations,* which included a series of principles as to what makes for a good tax. He argued that citizens of every state ought to contribute to the support of the government in proportion to the income that they enjoy under the protection of the state. Smith argued that the taxes to be paid by an individual should be certain and not arbitrary and that the time and manner of payment should be that which is most convenient to the taxpayer. Taxes should cost as little as possible to collect and should not "obstruct the industry of the people".

Ever since the *Wealth of Nations* was published economists have debated Smith's criteria, often putting forward alternatives, though without reaching universal agreement. However, there are certain key principles of the economic efficiency of taxes that can be argued to enjoy widespread support and against which any tax can be judged.

- **Equity.** Those who are equal should pay an equal tax burden. This is known as horizontal equity. Some economists would go further and argue the case for progressive taxation, meaning that those with the greatest income or wealth should pay a higher rate of tax than those with lesser resources. In other words, that those who are unequal should be taxed unequally. This is known as vertical equity. There is widespread support for the notion that taxes should not be regressive and should not therefore be levied at a higher rate on those with lower incomes or wealth than on the more affluent.

- **Certainty of liability.** The taxes people are expected to pay should be obvious and determined by clearly stated rules. They should not to be arbitrary or uncertain. Where there is discretion in applying rules or in the valuation of the tax base, there is potential for abuse of process and corruption. If liability is certain, then taxpayers can plan on this basis and order their affairs in such a way as to minimise the impact of tax on these. They will be able to plan to have the funds available when the tax is due. Governments also benefit from certainty of liability as they can predict with confidence the revenue they are likely to receive.
- **Administrative efficiency.** The administrative costs of a tax should be as low as possible. Inputs devoted to taxation take productive resources away from other objectives and so should be minimised. Taxes that are easy to avoid or evade are likely to be expensive to administer because of the efforts that have to be put into their collection. Exemptions and allowances increase the cost of administering a tax, although they can also enable the tax burden to be made more equitable.
- **Transparency.** Taxpayers should be able to understand how a tax works. This implies that the rules under which taxes are levied are published and readily accessible, and should be in a form and language that taxpayers can understand. Some taxes are imposed by stealth so that the tax burden is not obvious to taxpayers. This prevents taxpayers from making judgements about the balance of advantage between taxation and public expenditure. Taxpayers should be able to find out what other taxpayers are liable to pay so that they can check whether their own assessments are fair.
- **Convenience.** Taxes should be levied in a way that is easy for the taxpayer to pay them. Ideally taxes should be payable when taxpayers have the cash available or taxpayers should have the ability to pay them in instalments. Taxes should not impose significant compliance costs on taxpayers over and above the tax burden itself. For instance, taxpayers should not be obliged to spend significant amounts of money on accounting systems they do not require for their own affairs in order to satisfy the demands of the tax system, or have to employ lawyers, accountants or valuers just to make sure that they do not break the rules even if the end result is little or no tax liability.
- **Neutrality.** Taxes should not discourage legitimate economic activity. Taxes can distort economic behaviour, and choices about consumption, savings, investment, or employment may be changed in response to taxation. Such distortions can result in losses of welfare and productive resources. Although neutrality is generally desirable, some taxes are imposed in order to discourage activities that are harmful. For instance, some countries impose taxes on tobacco in order to discourage smoking for health reasons. Property taxes may also be imposed to meet social objectives, for instance, to discourage land speculation.
- **Fairness**. The procedures should be fair and avoid discrimination. It must be recognised that taxpayers are not always cooperative. No matter how fair and well-designed the tax, there will be some taxpayers who will seek to evade it, avoid paying it, or delay their payments. The tax system must contain suitable penalties to discourage such behaviour, for instance fines for the late or non submission of tax assessments or declarations. The principle is that these must be applied fairly with opportunities to appeal to an independent tribunal against assessments and the imposition of penalties. A distinction may be drawn between behaviour that is unacceptable but not undertaken with malicious intent, such as failure to adhere to a deadline for payment or returning information or failure to understand rules, and that which is carried out with the intention of evading legitimate charges. The former may be punished by an administrative penalty, whereas the latter is more properly subject to criminal sanctions.

It is argued that these criteria should also be applied to value capture instruments to evaluate their efficiency. As argued above, such instruments may be imposed out of expediency because, for instance, the law does not permit local governments to impose value capture taxes or the taxes which are imposed generate revenue for central rather than local government budgets. Just because value capture instruments may tax by stealth rather than explicitly, is not a reason why they should not satisfy the principles for economic efficiency of taxes. If value capture instruments are evaluated in the same way that taxes are, then it is possible to judge which policies maximise economic efficiency so that policy makers can make rational choices between alternatives.

Developer Exactions and Charges for Building Rights

These can go under a number of different names, including planning obligations, planning gain, development charges, and developer exactions. The key is that the developer contributes in cash or kind and receives in return the right to undertake a development. Town planning or zoning policies restrict the development that can take place without obtaining permission from the relevant planning authority. Zoning policies identify the permitted land uses within an area or for a parcel. Consent is needed for changes of use other than those permitted under zoning plans. In return for the relevant permissions the planning authority takes an exaction from the developer. A widely used device is that the developer hands over some of the land for public facilities, such as streets, schools, and parks. In Latin America it is commonly 15 to 35 per cent (Smolka, 2013) and in Turkey 40 per cent. The granting of consent for development or a change of use is likely to increase the value of the land for which such permission is given, for instance to change the permitted use from farmland to housing or to grant more intensive development. The increase in value can be significant. For instance in the UK, farmland with a value of, say, £22,000 per hectare might be worth £2.5 million per hectare as housing development land once permission for change of use is granted. The increased value of the land can only be realised if the development is provided with the necessary infrastructure and facilities. Since these are of direct benefit to the developer and the developer benefits from the capital growth that carrying out the development realises, it is reasonable that the costs of providing these should be factored into the costs of development. Either the developer can assume responsibility for constructing facilities like roads and the costs of infrastructure connections or he can hand over cash or land to the local authority to do so.

The justification for exactions that go beyond the provision of services and facilities for the development is that developments often give rise to externalities. For instance, the building of a new retail park may result in congestion in neighbouring areas, increasing journey times and transport costs for road users who make no use of the retail park itself. Under these circumstances, the local planning authority may seek apply the "polluter pays" principle and require the developer, at his own expense, to provide mitigation measures. This could include, for instance, the construction of a by-pass or flyover so that the traffic generated by the development is accommodated or of a bus interchange or railway station to enable users to make better use of public transport when accessing the development. Loss of amenities to a local community might be compensated by the provision of, say, a library, community centre, or doctors' surgery. The argument is that through these means any externalities are internalised by the developer who generated them. For instance, in the UK, section 106 of the Town and Country Act, 1990 provides the legal basis whereby an owner can agree to provide a facility of public benefit to offset the impact of his development on a community. This permits a local planning authority to enter into an agreement with any person with an interest in land in their area for the purpose of restricting or regulating the development or use of land. The agreement can be enforced of against the owners of the land and there is a charge placed on the land. These are private agreements between the local authority and a developer by which the developer agrees to undertake works or make a contribution to offset the detrimental effects of his development.

This raises the question of at what point does the planning obligation or planning gain extracted as compensation go beyond reasonable mitigation of the impact of a development and, in effect, become an instrument for value capture. In Serbia a development fee is charged for infrastructure triggered by development. It is based on the cost of construction and varies according to the use of the property and the zone in which it is located (Rašković et. al., 2016). The use of different zones has raised questions about why the rates are often higher in city centres where infrastructure is already in place, than greenfield sites, where the costs of connection can be expected to be greater. As a result, there is the belief that the development fee is a value capture device rather than being for cost recovery, and its use as such is advocated by local government bodies (Žerjav, 2013). The suspicion that this is the case is the fact that the development fee forms a significant part of the incomes of many Serbian municipalities, particularly in the larger urban areas. Not all governments are happy with the notion of developer exactions being used as value capture devices rather than to mitigate adverse effects of development. In the UK a planning circular issued by the government in 2005 introduced constraints on the use of planning obligations. It made it clear that the obligations were required to be necessary and directly relevant to the development and "fairly and reasonably related in scale and kind to the proposed development". They "should never be used purely as a means of securing for the local community a share in the profits of development, i.e. as a means of securing a "betterment levy"" (Office of Deputy Prime Minister, 2005). The National Planning Policy Framework (2012, paragraphs 203- 204) reinforced the idea that planning obligations should be sought only where they were necessary to make the development acceptable in planning terms and they should be directly related to the development, and fairly and reasonably related in scale and kind to it. The tests were given statutory form by the Community Infrastructure Levy Regulation 2010 (paragraph 122).

Although the UK government has a policy that such planning gains or planning obligations should not be used by local authorities as value capture devices, clearly they could be in other circumstances, and, in any case, this does raise questions about the nature and extent of the impositions. The mitigation measures are negotiated between the local planning authority and the developer, which raises issues about the certainty of liability. Neither the developer nor the local planning authority can be sure what the outcome of the negotiations will be. The negotiations are likely to be asymmetrical since the developer possesses information on the likely costs of the development and the impact of mitigation measures on his profit, which the local authority does not possess. Local authority staff, who are likely to be expert planners, are pitched into negotiations with skilled commercial managers, for whom negotiation is one of their day-to-day functions. This can also raise questions of equity since the outcome of the negotiations may reflect the skill and knowledge of the respective parties, with scope for different developers and local residents to be treated in a differential fashion.

There is a lack of transparency in the negotiations since developers are likely to insist on commercial confidentiality, resulting in it being difficult for outsiders to examine how the outcome was arrived at and whether it was fair to all parties. A further complication is when a number of developers benefit from to infrastructure improvements, such as a railway line, as to how contributions should be apportioned between them, particularly when there is also a significant public sector investment. The evidence from London, which has had several major railway schemes in recent years, including Crossrail and the Jubilee line extension, is that "existing value capture mechanisms extract only a small fraction of land value gains from transport investment, in an ad hoc and poorly-targeted manner" (London Finance Commission, 2017, p. 63). Much of the land value extracted in this case was done by national taxes, such as stamp duty land tax, the UK's tax on property transfers, and went into the coffers of the national government rather than to the local governments serving the communities affected. The developments contributing to these schemes not only benefitted from infrastructure investment but generated significant congestion that could only be mitigated through improved public transport. For instance, the construction of major office schemes increased the numbers of commuters, adding to the congestion of existing public transport facilities and the road network.

A further issue is the utility of the mitigation measures generated by such planning obligations and developer exactions. Typically, the measures involve the construction of something, whether this is a new school, doctors' surgery, park, community centre, or library. The community may gain an asset but also acquires a liability in the form of the on-going running costs of the new facility. Really an endowment fund is needed from the developer to provide for these. The facility may not necessarily be one that delivers the greatest utility to the community. It is what the developer has offered rather than what the community wants, and is likely to be something that involves him in least cost. If the money spent could have been divided into a number of packets applied to different mitigation factors, the overall level of satisfaction might be improved. There is therefore an issue as to whether planning obligations result in distortions that a tax on development would avoid.

The problems of inflexible planning obligations in kind has led in the UK to an alternative cash-based solution that has greater flexibility as to how contributions are used. The Community Infrastructure Levy (CIL) was introduced by the Planning Act 2008 as a charge that local authorities in England and Wales could use to fund infrastructure. Planning obligations continue to be used to mitigate the specific impacts of new developments but, once a local authority has adopted a levy, planning obligations cannot be used to provide infrastructure intended to be funded by the levy. Section 106 agreements can result in a facility being provided in mitigation of the impact of a development that ignores the wider impacts that result from it. For instance, new housing developments bring extra traffic on to roads, but also additional demands for school places, medical facilities, and leisure facilities amongst others. A developer agreeing to fund a primary school under a planning agreement ignores the impact on other facilities that may become congested as a result. The advantage that CILs have over planning obligations is their certainty. There is a clear statement of the exact amount that a developer will have to pay per dwelling or per square metre of office, retail, or industrial space. The local authority knows the revenue that will be generated when it grants planning consent for a development. Unlike planning agreements, there is flexibility which enables the funds to be used in a number of different ways. There is transparency as the rates are published and are not subject to uncertainty in asymmetrical negotiations between local authority staff and developers. However, there are problems. CILs may not bear any relationship to the viability of development and may be unrelated to ability to pay or the value uplift from planning consents. Where levied per unit, as in housing developments, the response by developers can be to build fewer but larger units so that CIL is reduced as a proportion of the value of each unit. Although it may be argued that the contribution ought to be related to the number of households, as this determines the requirement for public services, a community might want to secure smaller and more affordable housing for its population but the incentive to developers is to minimise contributions. Although the intentions behind CIL may have been to rein in the use of planning obligations as a means of securing betterment, they have not been problem-free, the UK's regulations having been amended five times since their introduction in 2010.

Changes in Building Norms

One way in which value can be captured by a local government is through setting a building norm that developers can pay to have relaxed. The way in which this can be done is to set a restrictive Floor Area Ratio (FAR) or plot ratio, which limits the intensity of development as measured by the floor space relative to the footprint. Such a restriction has no impact on existing development as the buildings already exist, but does affect new development. Developers are faced with either having to build at a lower density, which may be unprofitable, or purchasing the right to build at a higher density. Thus, for instance, the FAR might be set at 3 but because this is an area suitable for high rise development, consent might be granted for construction with a FAR of up to 6. This type of policy can be used to achieve social objectives rather than just to raise cash. Thus, developers may be able to secure a higher FAR if they construct social housing or are willing to contribute finances to the construction of social housing elsewhere, or it can be used to permit developers to gentrify an area providing they re-house the existing residents (Smolka, 2013).

Such an approach would at first sight appear to be equitable. All landowners seeking to develop at a density above the maximum permitted FAR are obliged to pay to do so. There are two fundament problems with the approach. Firstly, there is a divergence between the FAR which should be set on town planning grounds and that which is set on fiscal ones. If a FAR of 6 is acceptable or even desirable on town planning grounds, then there is the risk that setting a maximum FAR of 3 will produce sub-optimal development. Urban sprawl may be encouraged with densities of development that are too low to support public transport, businesses, or public or private services. There is also the risk that a cash-strapped municipality may be prepared to accept a higher FAR than is desirable on town planning grounds in order to generate needed revenue. The approach fails to recognise that instruments like FARs are designed to be part of the process of securing design, environmental, and social objectives rather than fiscal ones. Secondly, it is unclear what the financial consequences of the policy are. There is no simple relationship between FAR and the profitability of development. It is true that in cities the most valuable locations tend to be those that are developed most intensively and tend to have high rise buildings. But not every location is capable of absorbing a supply of high rise developments. Greater intensity of development can be secured through achieving smaller sub-divisions, each with lower floorspace, rather than increasing FAR. Areas with low FARs may command higher prices per square metre of floorspace and be capable of producing higher profits than those with higher FARs. Indeed one can argue that this is a characteristic of areas in which the rich tend to live. It is not clear that a policy of charging for additional FARs produces an equitable system of taxation in which those paying the charge do so at a similar rate relative to the value of their assets or that municipalities have a clear understanding of what the effective rate of tax is.

It is a small step from charging for FARs to using them to finance a range of policy objectives by offering them as compensation. There are examples of municipalities using FARs to compensate landowners whose properties are acquired for schemes like roads and transit systems or flood prevention. Rather than owners receiving financial compensation for the loss of their land, they receive certificates which can be sold to developers which will allow them to increase FARs and develop more intensively. The key problem with this approach is that the value of the compensation given is uncertain. Owners who receive them can only realise the compensation on offer by selling them to developers or undertaking development themselves in permitted areas. A municipality can try to create demand for these certificates by imposing low FARs to artificially generate a market for the certificates. The value of the compensation could be wiped out if there is no market for the certificates.

A similar approach is applied to the Transfer of Development Rights (TDRs). Typically TDRs are used to protect environmentally sensitive areas and historical buildings from development (Nelson et. al., 2012). Owners receive certificates that can be sold to developers that permit more intensive development in designated receiving areas. Owners voluntarily agree to restrictions on their property rights through easements or covenants on their properties to protect them from development or demolition. As with certificates received as compensation for expropriation, the value of the compensation varies according to the market for development rights. Local authorities using such policies need to create a market for them by artificially depressing permitted development in the designated receiving area in which the certificates can be utilised so that development cannot take place profitably without acquiring them. In some cases banks have been established which can purchase the certificates, effectively establishing a buyer of last resort. What is often overlooked is that the policy is financed through what is in effect a tax on owners and occupiers in the designated receiving areas. The same also applies where certificates are used as compensation for expropriation. However, this is not a free policy. It involves restricting the ability of owners in receiving areas to undertake development so that they are obliged to purchase certificates. This in turn results in higher rents having to be paid by business and residential occupiers of the developments thus constructed. It raises questions about why those owning or seeking to occupy properties in receiving areas should finance policies that can be argued to benefit the whole population when these policies could be financed through property taxes on the whole jurisdiction.

Conclusions

There are many reasons why a policy that is technically inferior may be preferred to one that can be argued to be more efficient and effective. In taxation or any other instrument that generates revenue for a level of government, it may be desirable from the perspective of governance that citizens should be aware of how great the burden is and where it falls so that they can form a judgement about the relative costs and benefits that result. In reality, politicians and policy makers may be quite happy for this not to be explicit and for something that is a tax by any other name, should be described as a charge or obligation for pragmatic reasons of minimising opposition. This may also be the only way in which a local community is able to share in any increase in land values to which it has contributed through demographic or economic growth in the absence of the capability to levy local value capture taxes or because this value is being extracted by national taxes. Nonetheless, it is still important to be aware of any deadweight costs that may result from the pursuit of such an option. The alternative policies to value capture taxes as means of capturing increases in land value have been divided into two main groups, developer exactions and changes in building norms. There are issues that arise with each of these but these types of policies are not normally subjected to the same rigour of analysis as tax policies. If they were, it is likely that in some cases tax policies might be preferred as alternatives to them.

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