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Productivity Commission Inquiry Into Better Urban Planning – Revenue Funding Options.

Executive Summary

This paper has been prepared for the New Zealand Productivity Commission to assist it with its inquiry into ways of improving New Zealand's urban planning system.

There is an apparent paradox in that urban development seems to produce clear economic benefits but such development imposes significant costs on councils in terms of infrastructure spending. Councils should be able to fund the required investment out of the economic benefits flowing from the development but many argue that "growth does not pay" – councils and existing ratepayers seem to have to meet the extra development costs while the benefits of development often seem to flow to developers and existing land owners. Councils thus become reluctant to fund the required infrastructure investment and urban development is hindered resulting in an overall loss in national welfare.

A marginal property development should provide a return in terms of an increase in the unimproved value of affected land that meets the costs and risks borne by the developer/existing land owner and the council. The issue is ensuring that councils can capture enough of this benefit (through value capture) so as to fund their costs and risks.

The issues here are complex reflecting the complexity of the impact of urban development. There does not seem to be one solution and nor is there a perfect answer to be found in a suite of responses.

The paper concludes that councils should first apply user charges on the services they provide to the extent feasible. Arguably, user charges properly applied could be employed to ensure that required infrastructure investment can be funded. While there seems to be more room to use such charging (e.g. for water services), as the Commission has previously outlined there are limitations in the extent to which urban development can be funded out of such charges.

The Rating Act empowers councils to levy rates (or property taxes) in a reasonably flexible way. Urban development can create windfall gains for existing land owners. By targeted and differential rating of the unimproved land value of property that should benefit from urban development, councils should be able to capture some of that gain which in reality is in part merely the return on the council's infrastructure investment.

The benefits from urban development are nevertheless reflected in increases in unimproved land prices in diverse and uncertain ways. Councils may also face high marginal infrastructure costs overcoming capacity constraints. As a practical matter some of the benefits of urban development are likely to be spread unevenly through the community. If a proportion of these benefits cannot be

used by councils to help fund infrastructure spending then it is quite likely that there could be a shortfall in sources of funding. "Growth will not pay".

There thus may be a need for a revenue source that more closely matches the wider community benefits of urban development. A new rating base measured by above-average increases in the unimproved land value is suggested as being worthy of further consideration.

In all cases as a way of funding infrastructure investment, a base of the unimproved value of land (land value as opposed to capital value which also taxes the value of improvements to the land) is the only base that can be seen as matching the benefits of urban development with its costs. This is also in economic literature the most efficient tax base. Taxing capital value, on the other hand, is not so closely related to the benefits flowing from council infrastructure investment and penalises investment in improvements. As a way of funding urban growth rating based on improved value has major drawbacks in that it encourages land banking and other activities detrimental to efficient urban development.

The paper canvasses alternative tax bases other than property including those now used by central government – mainly income tax and GST. The paper sees little merit in these as a source of funding infrastructure spending. A cash flow type tax on property is considered but rejected on the basis that it would be excessively complex and costly.

The objective is, to the extent feasible, to fund infrastructure investment in a manner that aligns the costs of the investment with the benefits. The main issue is the practical one of being able to identify what specifically gives rise to the need for the new spending and who specifically benefits from it. The decision framework suggested is:

- Apply user charges where costs and benefits are readily identifiable and attributable to users.
- Use development contributions and the like to the extent users cannot readily be identified but developments benefiting from the infrastructure can be identified.
- Use targeted/differential rating on land values where the benefits of the investment are likely to be reflected in an increase in unimproved land value over a specific geographic area.
- Use betterment taxes on the **increase** in land value if that can reasonably capture the value created by the investment.
- Consider other tax bases that may be proxies for aligning costs and benefits.
- Use general rates/government grants as now to the extent that infrastructure investment cannot be funded from the above.

Introduction

The Government has asked the Productivity Commission to look at ways of improving New Zealand's urban planning system.

This inquiry follows on from the Commission's investigation of how councils make land available for housing – Using Land for Housing (the 2015 report"), which found that New Zealand's urban

planning laws and processes were unnecessarily complicated, slow to respond to change and did not meet the needs of cities.

The Commission has been asked to identify the most appropriate system for allocating land use in cities to achieve positive social, economic, environmental and cultural outcomes. This includes the processes that are currently undertaken through the Resource Management Act, the Local Government Act and the Land Transport Management Act. The inquiry is looking beyond the existing planning system and considering whether a fundamentally different approach to urban planning is needed.

The Commission published an "issues paper" in December 2015 and a draft report in August 2016 ("the 2016 draft report"). The Commission gathered submissions on the draft report from interested parties and is continuing to consult broadly to help inform and ground its analysis. The final report to the Government is due in the new year.

A key facet of the inquiry is how urban planning can be improved so that it reduces any current barriers to an adequate supply of housing in response to increased housing demand.

In this context, the Commission has identified the potential for local government revenue constraints to act as a barrier by limiting investment in infrastructure by councils which in turn limits housing development and urban growth more generally. Ideally local government planning should accommodate an increase in housing supply where the increase is economically justified. However, it has been argued that the revenue raising options available to local government mean that councils find it difficult to fund infrastructure for new development without placing a burden on existing residents in the form of either higher rates or higher council debt. If we assume that a housing development and the associated infrastructure spend by a local council is economically justified, it is desirable that council can fund this spending. A council will be able to fund part of the required spending from the increase in the rating base that the development generates, from development contributions and other fees and charges. However, should this funding be insufficient, as many councils argue, there is an argument that the return to the development that is captured as economic rents by land owners should be considered as an additional revenue source. But this may not be legally possible under the current rating system.

With the above in mind this paper explores whether there is a politically and practically viable tax base and mechanism to raise revenue from such a base that would:

- allow councils adequately to fund the investment councils have to make to allow for urban development,
- reflect council costs attributable to a development or relate to the economic rents arising from such development, and
- better align the costs and benefits of urban development.

Such a tax would be economically efficient since it would either be an appropriate and necessary return on council investment or a tax on pure economic rents. Conversely, and possibly equally importantly, it is a good thing if councils are dissuaded from investing in infrastructure for projects

that have a negative economic return. We note that by using taxes with no or low efficiency costs, councils are likely to enhance overall welfare of their respective communities.

The focus of this paper is on options to fund infrastructure investment required for urban development. Councils undertake numerous functions for their communities. Infrastructure investment is just one of those functions. Infrastructure investment is defined to mean investment in:

- Roading
- The three waters
- Community amenities such as parks.

The level of council capital expenditure in these areas is significant. It is estimated that in 2012 council capital expenditure amounted to about $3.5 billion of which $1.2 billion was for water and $1.1 billion on transport. (Local Government New Zealand, 2015 Local Government Funding Review - "the 2015 Local Government Funding Review" - page 19).

This paper's focus is thus on options to fund just one of a council's activities. It is possible, and even likely, that options to fund infrastructure investment are not best suited to funding all other council activities. That is because an ideal funding option for infrastructure investment closely aligns funding with the benefit that flows from the investment. The premise is that this should best ensure that infrastructure investment is undertaken where the benefits exceed the costs. For other council activities a revenue raising option that tries to align costs with benefits attributable to individual ratepayers may be less appropriate.

This paper's focus is also on infrastructure investment required for urban growth. This is largely investment required to fund growth in the 10 territorial authorities identified by the Productivity Commission in its inquiry report *Using Land for Housing* September 2015 ("the 2015 Report") at page 20 (upper North Island, Wellington, Christchurch and Queenstown). This is not to deny that other councils can face significant challenges in funding infrastructure requirements. For example, small rural communities can face significant costs upgrading sewage treatment facilities. Arguably that is at least in part for the benefit of the national environment. Again the desirable funding options identified in this paper may not be an appropriate response to funding challenges not arising from urban growth.

Given the paper's focus on funding infrastructure investment and urban growth, the general approach adopted is to look for options that best align the costs of such investment with its benefit so that investments are likely to proceed where benefits exceed costs but not be undertaken where costs exceed benefits. In general terms costs seem best aligned with benefits where one of the following applies:

- **User pays funding**. The recipient of the goods or services meets the costs through user charges; or
- **Value capture funding**. The investment is funded by way of councils capturing some of the value created by the investment that would otherwise accrue to individual ratepayers. As explained in a recent policy paper released by Infrastructure Victoria, *Value Capture – Options, Challenges and Opportunities for Victoria, October 2016 "The Victoria Policy Paper*

> *2016",* value capture funding involves "seeking a funding contribution from individuals or business that benefit privately form government investment or planning decisions, rather than relying solely on finding by general taxpayers. These contributions 'capture', 'recover' or 'share' a portion of the extra value created for individuals or business from government decisions." (At page 14).

Both user pays funding and value capture funding help to align the cost of infrastructure with those who benefit. The difference is that user pays funding seeks a contribution from those using the goods or services councils provide whereas value capture funding seeks a contribution from those who benefit even if they do not actually use the goods or services provided.

An objection often raised against user pays and value capture funding is that it may pay inadequate regard to ability to pay, who causes or creates the need for infrastructure spending and other fairness concerns. There is, however, an innate fairness in those who benefit from council activities paying at least part of the cost of the activity. This is in addition to the efficiency advantage of encouraging infrastructure investments whose benefits outweigh their costs.

It is nevertheless recognised that rating and other funding decisions made by councils are inherently political in nature. In making these decisions councils should reflect the often conflicting views and values of their specific communities. Councils that do not adequately reflect the balance of community views are likely to be voted out of office. This may mean that a decision to fund infrastructure investment efficiently by better aligning cost with benefits may not always be sustainable. Revenue mechanisms that are subject to change (because they are politically unsustainable) are themselves inefficient especially given the capitalisation of funding decisions into land prices. Councils should nevertheless be aware that when funding options do not align costs with benefits this is likely to lead to under- or over-investment in infrastructure to the detriment of overall welfare.

It should also be noted at this point that there can be significant practical difficulties with measuring who benefits from particular infrastructure spending and in implementing mechanisms that apply a user charge or value capture funding approach. For this and other reasons, it is unlikely that such an approach can ever fund all council infrastructure needs. There is unlikely to be one funding solution and solutions are likely to differ between different local authority areas. The remainder of the paper explores what funding options are currently available and used by councils and what other options might be considered.

Funding Options Currently Available to Councils to Meet Infrastructure Investment Requirements

Urban development can require significant levels of investment in new or enhanced infrastructure – transport, water and waste disposal services, community facilities, hospitals, schools, electricity/energy, communications such as telephone and internet access, and the investment in retail, recreational and the myriad requirements expected to be available in a modern city. In New

Zealand much of this investment is provided by the private sector including much investment that once was provided by government or its agencies (electricity/energy, communications such as telephone and internet access). Such private sector investment is generally forthcoming through the operation of efficient markets. The service and facility providers have an incentive to make the required level of investment (and assume any risks with such an investment) because they are able to cover the investment costs (and an economic return) by charging users and beneficiaries of the services and facilities.

In New Zealand a considerable part of the infrastructure investment required by urban development is met by central government – hospitals, schools, policing and so on.

Local government bears a significant proportion of infrastructure costs. As previously noted it is estimated that in 2012 local government capital expenditure (mostly on infrastructure) amounted to some $3.5 billion and between 40% and 45% of council operating expenditure over the period 2003 to 2012 was spent in relation to infrastructure – (2015 Local Government Funding Review, pages 18 and 19).

User Charges

Councils are required to provide investment in areas such as the "three waters", transport, and various community facilities (parks, libraries etc.). To the extent that councils could charge users and beneficiaries for providing this investment on a user pays basis, it could be expected that the required investment would be forthcoming on the same basis as say electricity/energy and communications investment can be expected to be provided by the private sector.

The other main options available to councils under current law are the local government tax base (rates) and contributions from developers (development contributions).

Rates

Rating is the main tax raising option provided to councils under current law. The powers and limitations on councils in setting rates are set out in the Local Government Act 2002 ("the Local Government Act") and the Local Government (Rating) Act 2002 "(the Rating Act").

The Rating Act allows for various types of rates (water rates are viewed as a form of user charge rather than a tax).

General rates. These are a general land tax imposed on the rating units (broadly those holding property titles) across the community. Rates are set as a percentage of the value of the property being its:

- land value – the unimproved market value of the land.
- capital value – the improved market value of the land excluding chattels, stock plant or machinery.
- annual value – the estimated annual rental value if the property were rented on the open market. More specifically annual value is statutorily defined as the greater of

- (a) the annual rental value of the property less 10% for bare land and 20% for other property, and
- (b) 5% of the capital value.

In economic terms the main distinction is between rates levied on land value (the unimproved value of land or the value of bare land) and rates levied on capital/annual value which taxes the value of bare land but also improvements to the land made by property owners.

Targeted rates. While general rates are designed to fund council activities generally, targeted rates are used to fund designated council functions or group of functions. As well as land/capital/annual value, targeted rates can be based on:

- the value of land improvements.
- land area.
- area of land paved, sealed, built upon or protected.
- area of floor space of buildings on the land.
- number of connections to the local authority reticulation system.
- number of water closets and urinals.
- number of separately used or inhabited parts of the land.
- extent of services provided to the land occupier.

Differential rates. General and targeted rates can be levied on a differential basis taking into account property values, location, area, use to which the land is put, and activities allowed for on the land. Thus different ratepayers can face different levels of rates and targeted rates can apply to all ratepayers or only a section of ratepayers such as those that are seen as benefiting from the activities funded by the targeted rates.

General rates fund general council activities. Targeted rates fund specific council activities. Rates that apply to all properties in the area on the same rating basis are non-differential whereas differential rates vary according to the location or characteristic of the property.

Uniform annual general charges ("UAGC"). These are a fixed charge levied on rating units irrespective of the value of the property. A targeted rate can also be a fixed amount per rating unit but a council cannot collect more than 30% of its total rates by way of a combination of such fixed targeted rates and uniform annual general charges. This means that most rates by value must be related to property value in some form.

The Rating Act does provide councils with flexibility as to how to raise revenue including revenue to fund necessary infrastructure investment. However, councils must raise rates within the ambit of the powers conferred by the Rating Act and must do so in a reasonable manner. On a number of occasions the courts have considered the breadth of the Rating Act powers.

The leading decisions in this areas are full Court of Appeal decisions in *McKenzie District Council v Electricorp* [1992] 3 NZLR 41 and *Wellington City Council v Woolworths NZ Ltd (No 2)* [1996] 2 NZLR 537. Richardson gave the judgment of the Court in both cases.

In *McKenzie* the Court of Appeal ruled that the rate struck was invalid. This was on the basis that the District Council set rates at a level producing revenue beyond any reasonable need and the statutory process requires councils to first establish revenue requirements.

In *Woolworths* the Court of Appeal upheld the rate and noted that Mackenzie was an extreme case. *Woolworths* concerned the rating differential between commercial and residential ratepayers set by the Wellington City Council. The judge at first instance held that Wellington City Council acted unreasonably and unfairly towards the commercial ratepayers in setting the rate.

The lower court decision was overturned by the Court of Appeal. In giving the judgment of the full Court Richardson P stated that the legal principles were well settled and had been discussed in the Court of Appeal decision in *McKenzie*. Essentially, it is a matter of statutory interpretation. The local authority must act within the powers conferred on it under the legislation. Rate fixing decisions are also amenable to review on the Wednesbury unreasonableness ground (*Associated Provincial Picture Houses Ltd v Wednesbury Corporation* [1948] 1 KB 23).

Richardson P cited Lord Diplock in Council of *Civil Service Unions v Minister of Civil Services* [1985] AC 374 as describing the test as applying:

> "to a decision which is so outrageous in its defiance of logic or of accepted moral standards that no sensible person who has applied his mind to the question to be decided would have arrived at it."

The relevant points that arise from *McKenzie* and *Woolworths* and the other relevant cases are:

- A council has a fiduciary duty to ratepayers to have regard to their interests (*McKenzie*) but that "does not open up a route by which the court can investigate and if thought appropriate interfere with every exercise by local authorities of their discretionary powers." (*Woolworths*).
- The local authority must have regard to the levels of services provided to ratepayers and categories of ratepayers but is not obliged to adopt a narrow user pays approach (*McKenzie*). This approach does not require a close correlation between benefits provided to a particular sector and rates levied on that sector (*Woolworths*)
- Councils can set a range of rates from general rates, through separate rates and uniform charges to user pay charges. Subject to statutory maximums and percentage limits "the choice is unrestrained." (*Woolworths*)
- The legislation imposes significant process obligations on councils but the substantive judgments on rating are made by "popularly elected representatives exercising a broad political assessment" (*Woolworths*).
- The differential system cannot be applied to the land value system for the purpose of achieving the same result as would have been achieved if the Council could have adopted the capital value system (*ECNZ v The Waimate District Council*).
- A differential rate does not have to be calculated using a fixed percentage difference. There can be other methods - e.g., "to calculate the differential on the basis of roading needs within the group" (see *Barton v Masterton District Council* 1991 unreported). See also a differential rate that imposed a differential for multi-

unit apartments and for buildings over 6 stories (*Norfolk Flats Ltd v WCC* [1989] 2 NZLR 614).

Woolworths and *Mackenzie w*ere decided under the previous legislation - section 81 of the Rating Powers Act 1988. This and the Rating Act both set out the matters to be taken into account in defining categories of rateable land. But schedule 2 of the current Act does not contain the equivalent of "such other distinctions in relation to the characteristics of the property as the local authority thinks fit" as was contained in section 81 of the Rating Powers Act 1988.

Nevertheless the above tests seem to still apply. Cases as recently as last year have cited them as the relevant authority - see, e.g. *Mangawhai Ratepayers and Residents Association Incorporated v Kaipara District Council* (at para 90).

Subpart 3 of Part 6 of the Local Government Act imposes financial management requirements on local authorities. A local authority is required to have a balanced operating budget (section 100). It must also undertake quite detailed financial planning including an annual and long term financial plan, a financial strategy, and an infrastructure strategy. It must also have funding and financial policies that include how expenditure is to be funded from borrowings, fees and charges and rates etc. (section 103). Importantly, section 101 requires a local authority to meet its funding in relation to each activity it undertakes following appropriate consideration of a number of factors including consideration of:

- Community outcomes to which the activity primarily contributes and the distribution of the benefits of those outcomes. This has been described as an equity or benefits approach – who benefits from council expenditure, should pay for it.
- The extent to which actions or inactions of individuals or groups contribute to the need to undertake the activity and thus incur the expenditure. This has been described as a causation approach – who causes expenditure should pay for it.

Arguably this is a restraint on council rating powers. In *Neil Construction Limited v North Shore City Council (*2006 CIV 2005-4040-4690) Potter J in the High Court (on a matter relating to powers to require development contributions rather than rating powers) concluded that subpart 3 and section 101 in particular requires councils to consider for each specific activity (defined as each good or service provided by a council including the provision of facilities and amenities) how it is to be funded taking into account each factor listed in section 101. Having considered each of the community wellbeing factors in section 101 the council must consider the overall impact of each funding sources “as part of its broad role and purpose in promoting” community welfare as set out in the Act (at para 213). What was considered invalid was a council setting development contributions on the basis of a policy that singled out and adopted a causation approach (at para 217).

As noted above *Neil Construction* is a decision on the validity of development contribution policy not rating powers. Nevertheless, rating powers are also subject to the same provisions in subpart 3 and section 101 in particular. Given the inherent difficulties with measuring who benefits from infrastructure spending and who causes it and how much different ratepayers benefit and cause such expenditure needs, it would be understandable if councils took a cautious approach to using targeted rates to meet infrastructure costs.

That said, the *Woolworths* decision seems to be authority for the view that councils have a wide authority to levy rates on land values. McKenzie marks a limit to that flexibility, but mainly seems to highlight the importance of proper process in making rating decisions. To the extent that land values reflect the benefits from urban development, this provides councils with wide powers to fund spending requirements using the rating base. However, some caution is required. Different judges can come to different conclusions on the facts based even on the test in *Woolworths* which emphasises the political nature of rating decisions and the flexibility inherently required by such decision making. See for example, the *Lovelock* case where the High Court held that the rates were set on an unreasonable basis and the rate was invalid. This was overturned by a 3 judge Court of Appeal bench which included Richardson P and one other judge from *Woolworths*.

If a new rating approach is adopted under existing legislation there is risk that it will be challenged. This brings uncertainty and also some risk that the challenge might succeed, albeit that the Courts have set the bar high. Given this, introducing a novel rating approach under the existing legislation would seem quite risky and specific legislation would be preferable.

Financial and Development Contributions

Instead of the council meeting the costs of development infrastructure, and funding this through rates, there are statutory provisions under which the developer pays more directly for some of these costs through financial or development contributions. Financial contributions are under the Resource Management Act 1991 whereas development contributions are under the Local Government Act.

Section 108 of the Resource Management Act 1991 empowers a local authority to impose conditions on a resource consent issue under that Act requiring a developer to pay a financial contribution to the local authority. A financial contribution can only be imposed if its purpose is to remedy or mitigate the adverse effect on the environment arising from the particular development authorised by the resource consent. This can be, and often has been, to meet the additional demand for infrastructure generated by a development. The conditions have to fairly and reasonably relate to the development permitted by the consent to which the conditions attached. This requires a clear causal nexus between the particular development for which the consent is being granted and the demand on the infrastructure created by the development for which the financial contribution is required.

Financial contributions can be subject to an objection or an appeal to the Environmental Court meaning that financial contributions were an uncertain source of infrastructure funding. As a result Subpart 5 of Part 8 of the Local Government Act was enacted. This provides for development contributions. The appeal rights under the Resource Management Act do not apply (see sections 198(3) and (4)). However, objections are allowed and heard by development contributions commissioners appointed by the Minister and development contribution policies are of course subject to judicial review. Development contributions are also governed by Part 4A of the Rating Act.

Under these provisions a council can get developers to help bear the costs of new subdivisions and similar developments (such as reserves, roads, and water and wastewater infrastructure and community facilities) by requiring a development contribution when a resource consent, building consent or service connection authorisation is granted. The stated statutory purpose of a development contribution is "to enable territorial authorities to recover from those persons undertaking a development a fair, equitable and proportionate portion of the total cost of capital expenditure necessary for service growth over the long term" (section 197AA Local Government Act). The contribution must fund a capital project set out in a council funding plan. It must be consistent with a development contributions policy agreed to by the council. The contribution must relate to a particular development that creates a need to provide new or additional infrastructure or infrastructure capacity. The contributions need to be determined according to, and proportional to, the persons who benefit from, and the persons who create the need for, the infrastructure investment.

In *Neil Construction Ltd v North Shore City Council* (supra) the requirements were summarised (at para 116) as being: there must be a development which either alone or in combination with another development will have the effect of requiring expenditure of infrastructure and the contribution must be provided for and consistent with a valid contributions policy of the council. In that case it was held that the legislation did not permit the council to require contributions whenever consents were granted based on a view of the long term infrastructure needs of the council.

Councils can and do also enter into development agreements. These are similar to development contributions but the developer itself supplies and meets the cost of the infrastructure investment instead of financing the council to do so. As the Commission's 2015 report noted (pages 172-174), this is likely to be most suitable for developments with a single developer that has the financial resources to fund the costs involved.

The Extent to which Existing Funding Sources are used to Fund Council Infrastructure Investment

User Charges

Councils do utilise charges to fund many of their activities. In 2015 17% of local government operating revenue came from the sale of goods and services. This was equal to about one third of the revenue collected from rates (Statistics New Zealand – Local Authority Financial Statistics). User charges are applied especially in the funding of water through water rates as shown in Table A Annex A. Under section 19 of Rating Act, councils can levy targeted rates set in terms of the volume of water supplied. This compares with general rates that may be differentiated based on whether property is connected to a water supply. However, overall, user charges make up only 36% of water supply costs and 51% of council solid waste/refuse costs (Local Government Funding Review, Local Government New Zealand, 2015, page 15 – "the 2015 LGF Review"). There is a considerable variation between councils in the ratio of user charges to general rates. The Far North District Council collects $2 in fees and charges for every $10 in general rates whereas Auckland collects $6 (2015 LGF Review page 42).

Rates

It is estimated that rates have remained approximately constant as a proportion of household income for many years. They have been around 2% of GDP for about 100 years. (2015 LGF Review page 54)

Data on rates taken from the Department of Internal Affairs Rates Analysis is set out in Annex A. This shows that the main form of rates is general rates but targeted rates (the rate form that could be expected to align the costs of infrastructure with its expected benefits) constitutes 23% of rates (excluding water rates) – Table B.

There is a high use of differential rating – 80% of general rates. Differential rating is also able to be used to align infrastructure spending and benefits – Table D.

The predominant rating base in New Zealand used to be land value. The Shand Report 1985 noted that in 1985 approximately 85% of councils were rating on land valuation. Over time there seems to have been a general trend away from a land to a capital base. Wellington, for example, moved from a land to capital rating base in 1988. As a result, the predominant rating tax base is now capital value (land plus improvements). As shown in Table C some 43% of general rates were levied on capital value and, as shown in Table D 76% of targeted rates. Overall over half the rating base was on a capital base (Table F). This data was prior to the 2010 restructuring of Auckland. Restructuring resulted in Auckland moving generally to a capital value rating base furthering the trend towards reliance on capital value for rating purposes. Reasons for this trend seem to be a perception that capital base is fairer. Even if capital value may not better reflect wealth or income (Chapter 4 of the Commission's 2015 Report) it can still be seen as a better indicator of ability to pay on the basis that a person owning bare land (or land with minimal improvements) may have little other resources to pay rates. In addition, under the capital value base, councils benefit from an immediate increase in their rating base from improvements through the resource/building consent process rather than having to wait until the next valuation. Not only does this produce more immediate cash flow for councils but an increase in the rating base arising incrementally from improvements may be less likely than an increase in rating revenue following a general re-valuation to be seen as a general rate increase.

Apart from this incremental movement away from a rating land base to a capital value base, a review of the underlying rating data held by the Department of Internal Affairs does not suggest that there is any clear pattern to how councils level rates. Urban areas with significant growth and infrastructure investment needs do not seem more likely than a rural area with low growth to utilise targeted rating or general rating or differential rating. Nor does there seem to be any such pattern with respect to the choice of rating base – land or capital value. Instead rating decisions do seem to be based largely on local values and views as to what is most appropriate.

Development/Financial Contributions

Development/financial contributions are an important source of council infrastructure funding although they make up only about 2% of local authority operating revenue - $142 million in 2010

(page 17 Development Contributions Review, Department of internal Affairs, 2013) – and about 4% of the estimated $3.5 billion annual council capital expenditure noted above. There is a wide variation in the extent to which councils use development contributions as a percentage of council revenue – 12% for Selwyn District Council and 2% for Auckland City (2015 LGFR page 51).

The Efficacy of User Charges, Rates and Development Contributions to Fund Council Infrastructure Investment

As outlined above, councils have a number of options to fund (or service loans raised to fund) infrastructure investment. As argued above the most efficient option is likely to be the funding mechanism that most closely aligns the cost of the investment with the benefits arising from that investment. In considering options, a key issue is the extent to which the benefits of the enhanced or new infrastructure and funding burden are likely to be capitalised into land prices. To the extent to which both benefits and burdens are capitalised into land prices, then if councils can capture some of the increased land price to meet their revenue needs, there is an alignment of benefits and costs.

This is the idea behind value capture funding. For example it would generally not be feasible or desirable to fund a new urban park by charging for entry so that it is paid for by users. However, the establishment of the new park should increase surrounding land values. By capturing some of this increase in land values to help fund the park's establishment, costs and benefits are better aligned and a fairer and more efficient funding source than general rates is obtained.

User Charges

As noted in Chapter 10 of the Productivity Commission's 2016 draft Report, where practical councils should move more towards a user charge approach for council provided services not only to ensure adequate funding for the investment required by such services but also to achieve more efficient and fairer outcomes. However, as the 2016 Report noted there are limitations on the extent to which a user pays approach can realistically be expected to fund required council infrastructure investment needs.

Apart from goods and services that councils provide that the community might consider should be provided to everyone free of charge on the basis that they are public goods or should for some other reason by provided free of charge, there are a number of possible problems in funding activities by way of a user charge. It may simply be impractical to enforce or collect a charge. The costs of providing the goods or services can be hard to quantify with accuracy particularly if part of the costs are seen as a general council overhead. There is also a general concern that excessive user charges can result in over-recovery of cost in which case the charge effectively operates as a tax on the activity provided. Any such overcharging can be expected to create significant welfare losses because the community will use less than an optimal level of goods or services if the council is the only provider and it provides the goods and services at an excessive cost.

There is also the issue of whether the user charge should be the marginal cost of providing that good or service or the average cost. The short run marginal cost can be much higher than the average

cost if capacity restraints have to be overcome to provide the infrastructure. Pricing on the basis of short run marginal costs puts much of the financial burden on existing residents who may see little advantage in expanding capacity and this in turn can be expected to increase the political constraints on funding growth. Average cost pricing is likely to be inefficient if the marginal cost for use is very low (for example allowing a person to use a park). Charging at the average cost level so as to fully recover council costs is likely to incur significant welfare losses since a marginal user will not be prepared to use the facility (enter the park) when there is a private benefit from that use and very low social cost for allowing it.

The private sector can often manage these costing issues by the use of discriminatory pricing – charging different consumers a different price. To make this sustainable it is usual that the supplier must be able to distinguish the goods or services offered at different prices in a way that justifies the price discrimination (cheap air tickets booked at the very last minute) or by keeping the different prices secret. Generally these options are not likely to be sustainable for a council providing community services and subject to democratic constraints.

User charges are most likely to be an efficient form of funding for council infrastructure where the above problems do not apply, the costs are easily measured and there is a direct link between council costs and the benefits to users arising from council provided infrastructure. A feature of user charges is that where they are appropriate and where they are properly set, they and the infrastructure they fund do not alter the market value of properties serviced or affected by the infrastructure. The property owner receives benefits from the new or enhanced infrastructure. That increases the value of the property. However, to the extent that the benefits are fully charged for, this reduces the value of what the property might otherwise be worth.

Rates and Development/Financial Contributions

The likelihood that rates and development/financial contribution requirements will affect values of affected property distinguishes this form of infrastructure financing from user pays.

In theory, to the extent that infrastructure investment cannot appropriately be funded by user charges, councils should be able to fund most infrastructure spending out of rates and development contributions. That should be the case if they could easily and efficiently use rates and development contributions to capture part of the economic benefits arising from urban development and then use this to fund the infrastructure investment required by that development. The appropriate level of infrastructure spending could be funded to the benefit of the overall community and economy.

Taxing Unimproved Land Values

Much of the economic benefits of urban development are likely to be reflected in an increase in the unimproved value of the land (land value in terms of the Rating Act). Social investments that can be enjoyed by owners or occupiers of land are usually quickly capitalised into the price of land. We see this with school zoning. Houses in a desirable school zone have a higher market value than the equivalent houses in a less desirable school zone. The owners at the time of any rezoning benefit from the social investment in the desirable school by way of an increase in the value of their house.

The same applies when social infrastructure is improved more generally such as better transport links provided to one suburb – property prices in that suburb increase. The Commission, in its 2015 Report cited a 2013 study by Grimes and Young estimating that improvements to the Waitakere Western Line railway stations resulted in an increase in affected property values of $667 million compared to the cost of $620 million of these developments (Commission 2015 Report Box 10.3). Another study has estimated that a Seattle streetcar upgrade cost USD 56.4 million with surrounding properties increasing in value from USD 530 million to USD 2.3 billion. (Value Capture – Options, Challenges and Opportunities for Victoria, Infrastructure Victoria, 2016, page 67).

If, on the other hand, the services from improved infrastructure are paid for (such as improved internet connectivity) then land prices are less likely to increase because the improved services are offset by the fees for those services. The improved services are not a free good associated with the land.

Council infrastructure investment required to turn a bare parcel of land into land with all the facilities to be developed into housing development, if provided as a free good, has similar attributes to school rezoning. It provides a windfall gain to the owner of the land. The council investment must be paid for but the owners of the land being developed may have to meet only a fraction of the cost.

Council rating power is one option for recouping this cost. However, current rating powers, as described above, have some limitations in this respect.

In theory the power to levy rates on the unimproved value of land (land value under the Rating Act) seems to provide councils with an efficient tax base that could be targeted at meeting the costs of funding required for infrastructure investment. The council investment increases land values thus increasing the rating base.

This does not apply to rates levied on capital value, annual value or improvements. All these rating bases are a tax on improvements. While there seems to be a reasonable connection between council infrastructure investment and unimproved land values, there is no obvious correlation between the value of improvements and such council investment. If an owner improves the aesthetic appeal of a house or building, that should increase its capital value and this is unrelated to any infrastructure investment by the council. Evidence for the negative impact on development activity of rates based on capital as opposed to land values was presented in the Commission's 2015 report *Using land for housing* (pages 81 and 82).

Taxing improvements acts as a tax on urban development, rather than recouping the costs needed for such development to take place. For example, taxing improvements results in lower rates than would otherwise apply to bare land that is held as a "land bank" and is left undeveloped.

Whereas in economic terms a tax on unimproved land is an efficient tax that does not reduce national welfare, taxes on improvements is the opposite. An economically efficient tax is one that does not alter the relative incentive to behave (by investing, working or saving) in a way that produces the best personal outcome. In other words, an efficient tax is one that does not induce sub-optimal behavioural choices compared to those that would be expected to be made in a world without tax. The unimproved value of land is outside the control of the land owner. No action by the owner affects the unimproved land value and thus the tax does not distort his/her behaviour. By

contrast a tax on improvements by its nature discourages personal investment in land improvements.

A tax on the unimproved value of land is also an equitable tax once implemented. That is because the tax will be taken into account in determining the market price of the land and thus capitalised into land prices. Land subject to a tax on unimproved value will have additional costs (the rates) and thus can be expected to generate a lower return and consequentially have a lower land value than land without such an impost. When a tax on unimproved value is implemented the taxing authority in substance captures a proportion of the rights over the land leaving the taxing authority with an ongoing revenue stream but future decisions by the land owner remain unaffected. That is provided the imposition of the tax (and the effective capture of some of the increase in land values) is expected to be one-off. The original imposition of a tax on unimproved land value does however create fairness issues since the full burden of the tax is borne by existing land owners.

These issues have been canvassed by the 2009 Australian Henry Tax Review - Australia's Future Tax System – Part 2 Volume 1 at pages 247-249) , the 2010 Victoria University of Wellington Tax Group (at pages 50-51) and the UK 2011 Mirrlees Tax by Design Review (at pages 368-375). All reached the same conclusion. In particular, these reviews noted that not only is a tax on the unimproved value of land efficient from an economic perspective, it can also be viewed as a very fair tax. For example, where a council's infrastructure spending improves the facilities that the land enjoys, the value of the land can be expected to increase through no effort of the land owner. The higher tax payment in effect claws back this windfall gain to the landowner and of course, because the land now has an extra cost associated with it (the land tax), the value of the land can be expected to fall offsetting (at least to some extent) the original windfall increase in value.

Using Differential/Targeted Rates Based on Land Value

Given the economic efficiency of rates on unimproved land values, it is a desirable source of council funding for required infrastructure investment especially if rates could be targeted at increases in unimproved land values directly resulting from such infrastructure investment.

The operational difficulties of utilising rating powers to fund required council infrastructure investment were canvassed in the Commission's 2015 report on *Using land for housing*. While urban development should increase land values and the rating base generally, councils have difficulties in justifying using the resulting increase in the rating base to increase revenue to fund the infrastructure investment that such development requires. Ratepayers naturally hold councils accountable by keeping them to a budget constraint and they tend to view the rate burden in terms of the absolute level of rates collected rather than the rates as a proportion of property value. That can be a very reasonable view when there is property price inflation and property values are increasing in a manner that is unrelated to urban development and the council infrastructure spend that that requires. For these reasons the Commission's 2015 report reached a finding that existing homeowners have an incentive to oppose development that involves council expenditure on infrastructure that will be paid for by higher general rates (page 58).

One way of ameliorating this problem is targeting rates closely to infrastructure spending requirements by way of differential rating so that those areas benefiting from the new infrastructure

bear the burden of the increased rates. The geographic area expected to benefit from the council infrastructure spend is identified and an ongoing rate surcharge by way of a differentially higher rate on the unimproved value of land in the area is levied. To be efficient and fair such a rate surcharge needs to be based only on unimproved land values. If the rate is levied on improved value (or on some other basis), then, as noted above, it will discourage investing in improvements and be less related to council spending. For example, where a person invests in improving the aesthetic appeal of a property or extending the living areas of a house, there is no obvious link between the resulting increase in the property's value and the basic infrastructure required by an urban development and enjoyed by property owners generally.

Using differential rating in this way should enable councils to pay for required infrastructure investment by accessing part of the increase in the value of the land arising from that investment. Such differential rating also seems in accordance with existing rating powers under the Rating Act.

It may nevertheless be considered unfair that ratepayers in the geographic area subject to the rate surcharge face the ongoing burden of higher rates. While they can be seen as benefiting from the council infrastructure spend in terms of services (such as "three waters", transport and community services) ratepayers in the area subject to the surcharge may see themselves as simply benefiting from the same basic council services as is provided elsewhere by the council. Why should they pay higher rates than elsewhere in the local authority area simply because their property is located in a recently developed area?

If, however, the differential rate is set early in the development process, the higher rates for the area should be capitalised into the land prices for that area. A development area will be known to be subject to a higher differential rate level. This will make property in that area more costly to own, and thus less desirable, than property in areas without the higher rate charge. The higher cost of servicing the rates will therefore, in an open property market, lower the price that the developer (or the original owner to the land subject to development) can sell the land for. This process can be observed with homes on leasehold land. A home on leasehold land can be expected to be valued at a price less than the equivalent house on freehold title. The lower price of a leasehold home will reflect the lease payments the homeowner will need to pay in the future. Unanticipated increases in lease payments can be expected to be reflected in a reduction in the market price of the house on leasehold land.

Thus, under differential rating, ratepayers in the developed area face a higher than normal rate burden but pay less for the property on which those rates are levied. The lower price is reflected in a lower actual or implicit interest cost on the capital to buy the property. In effect, the burden of the higher differential rate is borne by the property developer - or perhaps the original land owner from whom the developer bought the land. The purchaser of the developed property might pay higher rates but he or she pays a lower price for that property and thus lower interest rates to fund the purchase. Again it is emphasised that markets operate in this way only with respect to rates levied on unimproved land values.

While a differential rate should be borne by the developer (or the original owner of the developed land) by way of reduced land values, if set accurately to reflect the benefits infrastructure investment provides to the land in question, this fall in land value should be offset by an increase in

the land value flowing from the infrastructure investment. In a perfect world with perfect measurement of costs and benefits the long term value of the land remains the same and the council can meet infrastructure costs out of the rate on the unimproved value of the land. The end result is the same as if the infrastructure were paid by a perfect user charge.

While markets can operate in this way to overcome some of the perceived equity issues with differential rating, this may be difficult to sustain administratively and politically after a period of time. It seems difficult to sustain different levels of rates for different areas receiving the same basic council services many years after the developments on which those differential rates are based have passed. To manage this issue, councils can establish a sinking fund for each development. This is a fund to meet the costs of infrastructure spending related to a particular development. The funds are borrowed by the council. The differential rate is set so as to service the loan and amortise the repayment of principal over a number (say 20) years. At the end of that period the loan is repaid and the differential rate is removed. Obviously the time limit on the differential rate will be reflected in property prices in the developed area – they will reduce by less than in the absence of such a time limit. Sinking funds along these lines were commonly used to fund public projects in the Victorian era – also a time of rapid urban development. They are also commonly used by municipal authorities in the United States of America. For example, the Michigan school system is largely funded by bonds tied to specific rates that are set so as to service the loans and repay the debt.

Development Contributions

Development contributions should be seen as an alternative/supplement to differential rating. With development contributions the developer agrees to meet some of the infrastructure investment costs directly reducing differential rating and increasing the price for which the developer can sell the developed land. While differential rating is levied on land owners and development contributions paid by the developer, the end result should be the same – the burden falls on the developer who is the person benefiting in the first instance from the council investment in infrastructure. Development contributions seem more appropriate for those council costs most directly related to the development – parks and roads and new reticulation. Differential rating seems more appropriate for those council costs that are not so directly related to the development. For example, development contributions seem well suited to funding the costs of connecting a development sight to sewage facilities but less suited to meeting the costs of increasing the sewage treatment capacity of the community in which the development takes place.

On the basis of the above, in theory a marginal development will produce returns to the developer so as to compensate it for its costs and risks of undertaking the development and the council can be compensated for its costs and risks by way of differential rating on unimproved land and development contributions. This is all reflected in changes in unimproved land values.

However, while differential rating on the unimproved value of land and development contributions should be able to meet much of the fiscal costs to councils arising from urban development that is unlikely fully to be the case.

Difficulties with Using Land Value

Theory is unlikely to be fully reflected in practice. There are a number of reasons for this.

First, the benefits of any council infrastructure spend are unlikely to be easily attributable to defined geographic areas that can be subject to differential rating. The benefits are likely to be geographically dispersed, uneven and uncertain. For example, an improved transport link can impact on properties distant from the area of development and can be uneven in their effect. The Commission in its 2016 draft report noted a 2013 study by Grimes and Young where improvements in Waitakere's Western Line railway stations increased property values but in a variable manner. For some stations property values close to stations increased most in value but in other areas increases in property values were more evident at a distance from stations. A new development may also benefit those located in a city core area which then is servicing a greater population but the city core bears no geographic proximity to where the development takes place.

An example of this was *Neil Construction Limited v North Shore City Council* (op. cit.). North Shore City wanted to fund improved roading and bus transportation infrastructure. The costs were considerable. The council was of the view that the need for this investment arose from the need to service new developments that over time were putting increased strains on the existing transport infrastructure. It therefore decided that as part of its development contribution policy much of the cost should be met out of development contributions. The development contribution policy was challenged in court. The expert evidence cited in the judgment disagreed as to when increased demand created a capacity constraint that required the infrastructure investment and thus which particular developments were the cause of the increased cost on the council. In addition, while it seemed evident that both existing ratepayers and new residents would benefit from the new investment, the extent to which benefits could be attributable to either was open to debate.

Secondly, councils have noted that having invested in infrastructure to accommodate urban development, councils face the risk that such developments do not proceed and thus there is no increase in the rating base to fund the infrastructure costs. For large councils, such as Auckland, such risk should be manageable through its diverse portfolio of development projects. For smaller councils that is less the case, although smaller councils are less likely to face urban development pressures. The risk may need to be considered as a cost that the overall community should bear.

Thirdly, a new development can incur significant marginal costs that would not be incurred without the added infrastructure requirements of the development. For example, meeting the requirements of a new development may require a new sewage treatment plant whereas existing facilities may have been adequate for many years without the development. Similarly transport links may be upgradable at low cost in the absence of a development but the development may require extensive new investment in transport infrastructure.

User Charges

If services provided by councils were instead provided by the private sector under perfect market conditions, these issues would be managed by pricing based on long run marginal cost or by price discrimination (charging different consumers a different price for essentially the same good or service). In addition, the private sector may not provide services to some uneconomic locations or

would provide them only at an increased fee. For example, banks closing branches in provincial areas.

Council provided services do not have such flexibility. It would not be sustainable for a council to significantly differentiate what basic services (or the price charged for them) based on geographic location within the city. Existing ratepayers are naturally resistant to rate increases required simply because a new sewage system or major transport upgrade is required because existing infrastructure capacity has reached its limit and a new development requires an expensive expansion in capacity.

Economically a new development may nevertheless deliver a net social benefit after taking into account any costs involved in bringing forward the need for expanding infrastructure capacity. The benefits are however city-wide and the burden of meeting those costs should be borne by all those who benefit.

The benefits should be able to be captured by rates on the city-wide increase in property values that the development gives rise to. However, as previously noted, these are not easily identifiable and a general increase in the amount of rates collected can be interpreted as lack of fiscal management by the council.

To the extent possible councils should use user charges, differential rates on unimproved land values and development contributions to fund required infrastructure investment. However, to the extent that these revenue sources cannot meet their requirements there may be a need also for councils to be able to fund some infrastructure spending from general rates on unimproved land that is reflective of the overall community benefit arising from urban development.

Betterment Taxes – Rates on the *Increase* in Land Value

The overall community benefit arising from urban development should still be reflected in overall increases in the value of unimproved land. However, as previously noted, this may not easily be attributable to specific urban development requiring spending on infrastructure. To establish such a linkage it is suggested that a betterment tax be explored. A betterment tax is not a tax on property values (such as most current rates) but a tax on the increase in such values arising from urban growth. As the Commission's 2015 report (*Using land for housing*) noted (at page 27) New Zealand's Town Planning Act 1926 provided for a tax on the increase in property values arising from council actions under that Act. This never came into effect. This was it seems because of administrative and calculation problems. It is it seems too difficult to attribute any property value increase to particular council infrastructure investments or decisions.

The idea, however, seems to have merit. To overcome the attribution problem, it is suggested that councils be empowered to levy a rate on the increase in the unimproved value over a period. To avoid the noted concern that this would include general property inflation the increase would be limited to an increase over and above say 120% of the general increase in unimproved property values in the local authority area. This should mean that only those properties that have risen by more than average would be subject to this charge. The reasonable assumption would be made that such abnormal increases in property values is attributable to urban development. It thus should

have the attributes of a windfall gain to the property holders that can be reasonably attributable to council infrastructure investment.

Such a rate would work in the following way. Assume the original unimproved value of the property is $100,000. Over a measured period (say 5 years) unimproved property values across the city double (i.e. increase by 100%). This property has increased by 150%, so its unimproved value is $250,000. The threshold before which the rate charge can be levied is 120% of general property increases which in this example means that the threshold below which no rate is levied is the increase from $100,000 to $220,000 in value. The property has increased in value to $250,000 meaning that the rateable value is $30,000. The council would levy a rate as a percentage of that $30,000.

Property values may vary considerably year by year and the costs of annual valuations etc. would be high. In general, currently properties are re-valued every three years. The impact of urban development on land values (such as an increase in inner city commercial land values because of increased population housed by new urban development) would be likely to become apparent over an uncertain period as information on new developments is capitalised into land prices. Moreover, annual valuations would create uncertainty in council cash flows. It would thus seem appropriate to set the rateable value once every, say, five years but have the rate paid in instalments along with other rates over the subsequent five years. This would help highlight the fact that this should not be seen as a tax on capital gains but instead an additional rating charge albeit one calculated on windfall increases in unimproved property values.

In the example, the rateable gain is $30,000. Rates are levied on this value at a rate of, for illustrative purposes, say 10% - $3,000. If the rateable period is 5 years this would be $600 per annum payable over the next five years (in say 4 instalments a year).

Where property is sold between valuations there may be a perception that levying the rate by instalments for the five years following the measurement of the windfall property gain creates an unfair result. It may be recognised that the original land owner made a significant windfall gain and that this gain can be attributable to urban development funded in part by council infrastructure investment. However, the later purchaser of the property, the new owner and ratepayer, would pay rates based on that windfall gain until the next valuation which may be up to five years.

This may be perceived as unfair treatment of the new owner. Such a perception overlooks the fact that the additional rate charge on this land would be transparent and would be known as an extra cost that a purchaser would be required to meet. The land would thus be less valuable and this should be reflected in the price the purchaser is prepared to pay and the vendor received. As with other examples above, the tax should be capitalised into the price of land so that the real burden of the tax should fall on the original land owner (the recipient of the windfall gain) by way of a lower market value for the land (compared with the position had the additional rate not been levied).

It is envisaged that any such rate set on the basis of windfall land price gains would fund a designated council urban development fund and only be used to fund development infrastructure. It is nevertheless recognised that council moneys are fungible – a council could decrease the amount that would have been spent on infrastructure investment from general rates, use the urban

development fund to make up the shortfall and then use the surplus of general rating money to fund other council activities.

The Rating Act does not currently allow councils to rate on the basis of an increase in the unimproved value of land as opposed to the value of land. Implementing such a rating base would therefore seem to require an amendment to that Act.

A rate based on an increase in the unimproved value of land as outlined above is merely another form of targeted rate. Consideration has been given to whether other (already allowable) targeted rates could be used efficiently to help fund council infrastructure spending requirements. Arguably rates levied on building floor space, reticulation connections, paved services, water closets etc. aim to reflect the costs associated with urban development such as more intensive land use, tourist demand or (in the case of paved services) storm water services. In some cases such proxies may be the best available but on the whole they seem to be only loosely related to benefits landowners accrue as a result of urban development which is better measured by changes to unimproved value. If, for example, more intensive development is allowed in an area that has an associated infrastructure cost, this should be reflected in an increase in the unimproved value of the land that is now able to be more intensively developed. Rates on floor space and other improvements suffer from the general defect of rates based on improvements – they discourage the investment in such improvements and thus, for example, incentivise land banking.

Other Tax Options for New Zealand Local Authorities

Consideration has been given to other forms of tax revenue that councils could conceivably use to fund infrastructure investment.

As outlined in Local Government New Zealand's 2015 discussion paper, Local Government Funding Review, (at page 66), there are a limited number of other tax bases available apart from taxing land (the basis of rates).These are:

- Income
- Expenditure
- Poll
- Transactions

Any analysis of local authority taxing options should categorise potential tax bases and then consider their suitability as local authority revenue sources in the New Zealand context.

The normal criteria governments use for assessing tax options are fairness, efficiency and simplicity.

Fairness

A local authority revenue mechanism needs to be intuitively sensible, fair, reasonable and sustainable in comparison with other local authority revenue mechanisms and central government tax. It would not be acceptable for a local authority revenue mechanism to ignore fairness issues

with respect to those living outside the local authority to the extent that a national government can ignore the fairness concerns of non-residents.

Efficiency

Adverse incentives are likely to incur higher costs at the local authority level. Moreover, because of national welfare concerns, consideration needs to be given to the incentive effects at an even broader level than is normal when considering national tax systems. For example, there needs to be a focus on the incentive effects on the revenue-raising local authorities themselves. Does the revenue mechanism align the local authority incentives with the national welfare interest and with their accountability to the local community? It would thus seem critical to identify the incentives that would obtain this alignment of interests.

Simplicity

When considering administration and compliance costs, consideration also need to be given to integration with the tax system. There are significant economies of scale in tax collection. It is unlikely that it would be justifiable to have local income taxes and GST with different rules and rates throughout New Zealand. The compliance and administrative costs of doing so would be very high.

Income Tax Base

In other countries income taxes are often used as a revenue source for regional and local governments – in USA at all levels and in Canada at provincial level.

While that is the case, it is unlikely that a New Zealand government would agree to local authorities being able to levy their own income taxes. The administrative economies of scale are large – it is inconceivable that local authorities could justify replicating IRD resources. A local authority income tax could be a surcharge on the existing income tax but this would require complex rules to allocate the tax revenue to each local authority – an internal web of the equivalent of our international tax treaties. Where, for instance would you allocate the tax on a company with a Christchurch head office, owned by shareholders in Dunedin, manufacturing in Wellington and selling in Auckland?

That said, the central government income tax provisions applying to land sales might be viewed as closely approximating a tax on an increase in land values arising from urban development.

Sections CB 6 to CB 23B of the Income Tax Act 2007 provide a series of statutory rules that bring into taxable income various gains made from the purchase and sale of land (including improvements). These sections operate as a form of limited capital gains tax in New Zealand taxing the difference between the price a parcel of land is purchased for and what it is sold for. There are particular provisions taxing as income profits from land development and subdivisions (section CB 12 and CB 13), and land rezoning (section CB 14). Since, as argued above, the benefits from urban development should be reflected in increased land prices it is worth considering whether the revenue from these existing income tax provisions could be transferred to local authorities to fund the infrastructure spending they have to undertake as a consequence of the activity being taxed under the income tax.

The relevant income tax provisions are summarised in the Annex B of this paper. The policy objective underlying the income tax provisions is to tax land sale gains that are closely substitutable for ordinary income. For example a builder, dealer or developer earns normal business income from the activity of building on land or from dealing or developing land. The income tax provisions aim to ensure that the income from such activity remains taxable even if the taxpayer might be able to argue that the building, dealing or developing activity took place outside and not as part of the normal business. In other words the provisions in the main merely aim to buttress the ability of Inland Revenue to tax ordinary business income.

The provisions taxing gains from land development and subdivisions and rezoning seem more closely aligned with the benefits from urban development that is directly related to council infrastructure spending. However, they have a number of deficiencies, compared with rates on the unimproved value of land or on the increase in such values, as a measure of the benefits of development that should be used to pay for the costs associated with such development.

First, the provisions include numerous exclusions from taxability that may be appropriate in an income tax context but seem contrary to any objective of capturing the overall benefits derived from council spending on urban development. The development, subdivision and rezoning provisions apply only when land is sold within ten years. The development/subdivision provisions do not apply to land used as a residence or for a business or acquired and disposed of for farming. The rezoning provision does not apply to land acquired and sold for residential purposes or used for farming. The rezoning provision is also problematic as a revenue source to fund infrastructure because it does not apply to tax land transactions if that transaction is also taxed under one of the other land tax provisions. Tax collected under the rezoning provision is for this reason likely to be relatively small and somewhat ad hoc in when it applies.

A second issue with the land tax provisions as a source of infrastructure funding is that the provisions tax the activity of improving land. They do not, unlike rates on land improvements, tax the improvements themselves, but they tax income generated by the improvement activity. As part of a tax on income this is what they are supposed to do. However, this is not as directly related to the benefits that flow from urban development as are rates on unimproved land values. The rezoning provisions may be seen as having a closer correlation with the benefits of urban development but as noted these provisions are likely seldom to apply in practice and their application is somewhat ad hoc.

The fundamental issue is that the land tax provisions are designed to buttress the income tax base and not to reflect the benefits of urban development. Rates, including any property tax on increases in the unimproved value of land outlined earlier, would be a deductible cost against income. Rates are a tax on the improved or unimproved value of the land. That is the case even if rates were levied on the basis of an increase in the land value (as suggested above). The income tax provisions on the other hand aim to measure income generated from activities (such as dealing, developing and building) undertaken on land. These are measuring different things and, provided rates are (as already the case) treated as a deductible income tax expense where land gains are taxed, then rates and the land income tax provisions can operate in tandem as they do now.

Arguably, current income tax provisions encourage land banking. Land banking, in this context, is where areas of bare land on the fringe of urban development are held undeveloped in the expectation that the property value will increase over time so as to produce a higher gain than would result from immediate development. If large tracts of land are held in this way this restricts the supply of land for current development. Land banking is economic if the costs of holding land and the opportunity cost of deferring development of the land are outweighed by the expected increase in value of the undeveloped land. Tax can encourage land banking if the tax system operates so as to reduce the costs of holding undeveloped land or if there is a higher post-tax return from deferring development of the land as opposed to immediate development.

The focus of this paper is on revenue raising options for councils to fund infrastructure spending required by urban growth. It is nevertheless noted that current taxes may encourage land banking in two main ways.

First, the income tax provisions may allow land that is banked to produce a tax-free capital gain. This may not be a particularly important incentive for land banking where the gain is tax-free irrespective of whether land is sold and developed now or in the future – the gain is always tax-free. However, sections CB 9, CB 10, CB 11 and CB 12 have ten year thresholds. If the land is held for over ten years, gains are not taxable under these provisions (it could still be taxed under CB 6). The reason for the ten year threshold seems to be to identify land that is not in reality generating normal income that should be subject to tax. Thus land held outside the business by a dealer, developer or builder is in effect taxed as if it were held in the business unless the ten year threshold is met. The issue is that such a ten year threshold provides clear tax incentive to hold the land for at least ten years. In some cases, that is likely to encourage land to be left undeveloped and not put to its best use – that is there can be an incentive for land banking in the income tax rules. We note that the subsequent gain may in part be taxed under section CB 13 (land disposed of as part of a major development), but the gain up until the commencement of the development is not taxed.

The choice of rating base may incentivise land banking by reducing the holding costs. Where rates are levied on capital value rather than land value they could also incentivise land banking. That is because banked land by definition has a low level of improvements that are subject to rates under a capital value base. Land owners with a low level of improvements (including land bankers) can be seen as being subsidised by those owning land with significant improvements. Moving more to the use of land values as a rating base for financing council infrastructure investment required by urban growth (as suggested in this paper) should reduce the concern that the rating base encourages land banking. Further moves back to a land value rating base should further reduce the possibility that the rating base used by councils is encouraging land banking.

Expenditure Tax Base

Another form of common local authority tax base is expenditure tax – sales taxes, taxes on specific types of expenditure (hotel room taxes), payroll tax.

Given that New Zealand policy is to have a broad based consumption tax (GST), it is unlikely that the government would agree to local authorities being able to undermine this policy by imposing selective expenditure taxes, including a payroll tax.

Given New Zealand's internationally acclaimed and comprehensive GST it would seem sensible that any local authority expenditure tax revenue be a supplement to the GST rate. However, the revenue would have to be geographically allocated. Calculating the amount of net GST tax (output tax less input tax credits) attributable to a particular geographic area seems very problematic. Even if this were possible it would result in tax revenue being allocated to areas that consumed a lot to the detriment of those that produced – especially rural areas where a lot of economic activity is zero rated exports.

There may be value in exploring expenditure taxes that are selective because for policy purposes it is considered desirable to discourage activities that have negative spill-over effects such as activities with adverse environmental effects. It is noted that New Zealand already has excise taxes justified on this basis. Taxes on consumption or activities seen as environmentally damaging could be explored. Many of these seem to directly relate to local government responsibilities – refuse disposal, clean water etc. However, the level of revenue may not be large and care would be needed that this did not result in environmentally damaging activities relocating to areas where such taxes were kept low when the problem is a national one. Well-designed road user charges could be used to reduce congestion (and thus demand for infrastructure spending) as well as raise revenue. To be well designed such charges need to focus on congestion and peak demand so that road usage when there is adequate capacity (outside peak times) is not also discouraged.

Consideration has been given to introducing a cash flow tax to help fund infrastructure spending by councils. A cash flow tax has economic features similar to GST in that it does not impose a tax burden on capital or business income. An economic cash flow tax does tax capital or capital income but only to the extent to which an investment or business activity earns more than the rate of return that an investor requires in order to meet the costs and risks of undertaking an investment. In its pure form a cash flow tax gives a deduction for amounts invested. In this way the government takes a stake in an investment. When the investment is cashed out, the government gets its investment back plus a proportion of the return to compensate for the time value of that investment. In addition it takes a proportion (determined by the tax rate) of the above normal return.

The attraction for this type of tax in the context of revenue sources for infrastructure is that the above normal returns that is the focus of a cash flow tax is the economic rents or windfall gains that owners of land benefiting from urban development accrue which as argued above should be used to meet the council infrastructure costs. If a cash flow tax could be applied to urban property it could thus be seen as a means of taxing urban development benefits leaving the normal rate of return for urban developers untaxed.

While a cash flow tax does have attractions from this perspective it would seem extremely difficult to put into practice. In order to make such a tax work all the cash flows associated with urban development would need to be measured and taxed so that tax is levied only on the extent to which positive cashfows are greater than negative cashflows. This would seem problematic enough to apply to a defined geographic area but also cashflows would need to include other consumption type benefits derived from urban development. The main one of these would be the imputed rental income of home owners. A tax on home ownership imputed rental income was raised by the 2001 McLeod tax review but not advanced in its Final Report on the basis that such a tax had little public support and would thus be politically unsustainable.

The issue can be illustrated with GST. A pure GST would also tax imputed rental income of homeowners because it measures the consumption of a service. GST does not do so. Instead GST is levied on new houses when they are sold (on the basis that the builder is a registered person). This avoids the need to value cashflows and benefits post sale. However, that means that GST does not tax above-normal returns from housing.

Measuring investment returns (including imputed returns on consumption items such as housing) is necessary to make any pure cash flow type. This is not feasible with housing. Since housing makes up a high proportion of the tax base of any tax on the benefits derived from urban development, this seems to effectively rule out a cash flow tax as a viable option to fund council infrastructure spending.

Land Tax Base

This is the rating tax base discussed above.

Poll Tax Base

A poll tax is levied as a lump sum on each person in the population. The poll tax base has many theoretical (efficiency) merits for consideration. However, the fairness concerns that have made a poll tax unattractive at central government level also seem to apply at the local authority level. Consideration could be given to relieving some of these concerns by way of central government low income rebates.

Transaction Tax Base

Again, overseas there are many precedents for transaction taxes at the sub-central government level. Australia's stamp duties are an example. Many of the potential revenue options for local authorities are likely, when analysed, to amount to transaction taxes. However, the New Zealand government has as a matter of policy removed such taxes and it would not seem likely that it would want to undermine this policy position via local authorities.

Conclusion

It has been suggested that limitations in funding options is acting as an impediment to efficient urban development in New Zealand. In particular, it is argued that councils need to fund the infrastructure investment required for urban growth out of the rating base. This is seen as meaning that existing ratepayers have to pay for the facilities provided for development. Existing ratepayers argue that they do not derive benefits from growth (that accrues to developers and new residents). Existing ratepayers are often resistant to this perceived subsidisation of urban development. As a result councils are reluctant to invest in infrastructure to the extent urban growth requires. That leads in turn to a shortage of land available to development with land that is available for development rationed by way of excessively high prices.

There appears to be no perfect solution to this issue. There are however a number of funding options available to councils that if properly employed should at least mitigate the problem. The conclusion of this paper is that councils should employ a suite of options to try to align the benefits

of urban growth with the costs involved. To the extent that benefits of growth are aligned with costs, beneficiaries of growth will meet the costs of that growth removing any need for growth to be subsidised by those existing ratepayers who see little personal benefit in the required council expenditure.

The limitation of this approach is the very practical one of accurately measuring costs attributable to urban growth (for example, whether breaching capacity limitations on existing infrastructure is attributable to a specific new development) and who benefits from enhanced or new infrastructure. The danger here is not just that beneficiaries of infrastructure spending will be undercharged requiring unpopular subsidisation by other ratepayers. There is also the danger that developers and those wanting to move to the growing urban area may be over-charged. The first results in lack of infrastructure investment and a shortage of developed land. The second results in an excessive cost burden on developments. Both end up with a shortage of developed land and/or lower than optimal urban development. It is not easy to avoid these essentially cost and benefit measurement problems. That is why no approach is likely to be perfect and why councils are likely to need to employ a suite of options tailored to the particular needs and circumstances of the locality.

The following is a suggested decision framework.

Where the users of goods or services supplied by councils can reasonably accurately be identified and efficiently charged for the use of those goods and services, user charges should be employed. Goods and services should then be provided on the same basis as happens in private sector markets. The provision of water generally seems to fit within this category to a large extent and many councils do substantially fund water supplies through user charges.

Where council infrastructure investment can be directly related to a particular development it seems reasonable and efficient that the developer (or the original owner of the land subject to development) meet these costs. This can be achieved through the use of development agreements and/or development/financial contributions. In such cases the council infrastructure costs are simply part of the costs of the development.

Where there is no direct connection between the costs and the user of the goods or services or a specific development, councils should attempt to fund their required investment by way of capturing some of the value created by the development. Where it is difficult to identify a specific beneficiary in terms of a specific user or developer, the value created by development should be reflected to a large extent in an increase in the unimproved land value of affected land. As a result of the council infrastructure spend bare land will have better attributes associated with it and this should be reflected in the land's market price. Councils should be able to capture some of this value by way of targeted/differential rating. Provided such rates are transparent early in the development process, the higher rates will be a burden associated with the land, lowering its price and offsetting the rise in price flowing from the infrastructure spending.

It is recognised that in some, or perhaps many, instances the benefits of council infrastructure investment may flow diffusely across a local authority area. In such cases it will not be realistic to fund the expenditure by way of rates levied on a defined geographic area of the local authority. If the infrastructure investment is providing benefits to the community, then it should still be reflected in an increase in the unimproved value of the land. It is just that this impact is likely to be uneven

and widely spread. In such cases it is suggested that a general betterment tax be explored by way of a rate based on the increase in the land value across all the local authority area.

It is emphasised that rates to pay for infrastructure that aim to capture part of the value arising from that infrastructure need to be on land value not capital value. That is because capital value rating taxes improvements. Almost all the value created by council infrastructure investment is likely to be reflected in increases in the unimproved value of the land. There is likely to be a weak correlation between the value of improvements and the value created by infrastructure spending even though in some cases the infrastructure spending may be necessary to enable the improvements to take place.

To the extent council infrastructure spending cannot be funded from the above other taxes can be considered where there is a link between the infrastructure and the tax base. Examples are petrol taxes and toilet taxes and hotel room taxes. Care needs to be taken however. While there may be a link between the tax base and the infrastructure spending requirements (roads and petrol, toilets/hotel rooms and tourism infrastructure requirements), weakly linked tax bases can give rise to perverse and inefficient incentives. Examples are: petrol stations located just outside the area subject to a local petrol tax, and 1 but not 2 bathrooms in family tourist accommodation.

ANNEX A - LOCAL AUTHORITY RATING BASE 2009/10

Source: Department of Internal Affairs Rates Analysis

TABLE A - ALL RATES

	$ million	%
General	2,110	46.9
UAGC	510	11.3
Targeted	815	18.1
Land area	28	0.6
Other – water charges	1,040	23.1
TOTAL	4,503	100

TABLE B -EXCLUDING "OTHER - WATER RATES"

	$ million	%
General	2,110	60.9
UAGC	510	14.8
Targeted	815	23.6
Land area	28	0.7
TOTAL	3463	100

TABLE C -GENERAL RATES BY BASE

	$ million	%
Annual value	544	25.8
Capital value	898	42.6
Land value	668	31.6
TOTAL	2,110	100

TABLE D - GENERAL RATES – USE OF DIFFERENTIAL RATES

	$ million	%
Differential rating	1,705	80.8
Non-differential rating	405	19.1
TOTAL	2,110	100

TABLE E - TARGETED RATES BY BASE

	$ million	%
Annual value	34	4.3
Capital value	622	76.3
Land value	157	19.3

Improvements	2	0.1
TOTAL	815	100

TABLE F - GENERAL AND TARGETED RATES BY BASE

	$ million	%
Annual value	578	19.8
Capital value	1,520	52.0
Land value	825	28.2
Improvements	2	0.0
TOTAL	2,925	100

The above is prior to the restructuring of Auckland City. That restructuring will have resulted in less use of land value and annual values as a rating base and lesser use of Uniform Annual General Charge. Waitakere and Papakura placed considerable reliance on UAGC and land values. Auckland and Manukau placed high reliance on annual values. Auckland City now predominantly uses capital value.

Annex B – Land Income Tax Provisions - Summary

Annex – Land Income Tax Provisions - Summary

The Income Tax Act provides that a taxpayer could be taxed on land transactions if that income forms part of their ordinary income. There are various additional provisions that tax profits from land transactions. A summary of the additional specific provisions is as follows:

CB 6A Disposal within 2 years: bright-line test for residential land

This provision taxes gains from the sale of residential property (it does not apply to commercial or farm land) if it is sold within two years of its acquisition. This is simply an objective test of selling the property within 2 years of acquisition. There is no need for there to be any connection to a business undertaking or undertaken with a view to making a profit. For example, it would likely apply to the sale of a private holiday home if that property was sold within two years of its acquisition. There are various exemptions including if it is the owners main dwelling.

CB 6 Disposal: land acquired for purpose or with intention of disposal

This provision taxes gains where a person derives income from disposing of land if they acquired the land for a purpose or an intention of disposing of it. This is a subjective issue as it requires knowledge of the purpose or intention at the time of acquisition.

There are exemptions from this provision for land occupied as the taxpayer's personal residence or from where they operated their business.

CB 7 Disposal: land acquired for purposes of business relating to land

The provision taxes gains made by land dealers, land developers and builders (where they erect a building on the land) where the land is acquired for the purposes of that business. It also includes associated taxpayers of dealers, developers, builders where the land is acquired for the purposes of that business.

There are exemptions from this provision for land occupied as the taxpayer's personal residence or from where they operated their business

CB 8 Disposal: land used for landfill, if notice of election

This provision applies where a taxpayer uses the land as a landfill.

CB 9, 10 and 11 - Disposal within 10 years: land dealing, development or building business

These provisions buttress section CB 7 noted above. The sections apply to land acquired by dealers, developers and builders and anyone associated with them where the land was not acquired as part of their business but was sold within 10 years of that land being acquired.

There are exemptions from this provision for land occupied as the taxpayer's personal residence or from where they operated their business

CB 12 Disposal: schemes for development or division begun within 10 years

This provisions taxes gains when a taxpayer undertakes the development or sub division of the land where the development or division work is not minor; and the undertaking begun within 10 years of the acquiring the land. This can apply to any land held by a taxpayer and need not be part of a business.

There are exemptions from this provision for land occupied as the taxpayer's personal residence, from where they operated their business, for farm land, or where the development of subdivision was for the purposes of deriving rental income.

Obviously the exemption from tax after the ten year holding requirement is met encourages retention of property for that period of time and as such this encourages land banking.

CB 13 Disposal: amount from major development or division and not already in income

This provision taxes gains where a major subdivision of land is undertaken if it is not already caught by any the other provisions that tax gains from the sale of land. There is no time limit to the exemption, that is it could apply to land held for greater than 10 years. It does require significant expenditure on channelling, contouring, drainage, earthworks, kerbing, levelling, roading, or any other amenity, service, or work customarily undertaken or provided in major projects involving the development of land for commercial, industrial, or residential purposes.

If this provision applies, the taxpayer obtains a deduction for the market value of the land immediately prior to commencing the undertaking (i.e. the original cost of the land is not deducted to determine the profits, rather the, presumably higher, market value of the land prior to commencing the undertaking).

There are exemptions from this provision for land occupied as the taxpayer's personal residence, from where they operated their business, for farm land, or where the development of subdivision was for the purposes of deriving rental income.

CB 14 Disposal: amount from land affected by change and not already in income

This provisions tax gains from disposing of land if

- the amount is not income under any of other land provisions; and
- the person disposed of the land within 10 years of acquiring it; and
- the total amount that they derive from its disposal is more than the cost of the land; and
- at least 20% of the gain is due to a factor such as
    - the rules of an operative district plan under the Resource Management Act 1991:
    - the likelihood of the imposition of rules:

- a change to the rules:
- the likelihood of a change to the rules:
- a consent granted under the Resource Management Act 1991:
- the likelihood of a consent being granted:
- a decision of the Environment Court made under the Resource Management Act 1991:
- the likelihood of a decision being made:
- the removal of a condition, covenant, designation, heritage order, obligation, prohibition, or restriction under the Resource Management Act 1991:
- the likelihood of the removal of a condition, covenant, designation, heritage order, obligation, prohibition, or restriction:
- an occurrence of a similar nature to any of the occurrences described in any of paragraphs (a) to (j):
- the likelihood of an occurrence of a similar nature to any of the occurrences described in any of paragraphs (a) to (j).

There are exemptions from this provision for land occupied as the taxpayer's personal residence or for farm land.

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