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Report on Land Based Local Tax Systems – a comparison of a rating base that applies over successive years as compared with the current New Zealand rating system

Executive Summary

This paper has been prepared for the New Zealand Productivity Commission to assist it with its inquiry into local government funding and financing.

The issue is whether legislation governing local authority rates should be amended to allow councils more easily to capture the benefits of growth through a rating system whereby taxes on property would increase in line with increasing property values – referred to in this paper as a local property tax.

The paper outlines relevant aspects of the current rating framework applying to New Zealand councils. This requires councils to set out forward expenditure estimates in a long-term plan and then set rates (a tax on property) to fund this level of expenditure. It has been argued that, because rate revenue is merely seen as the outcome of expenditure decisions, this means that it is council expenditure that drives rates. It is argued that consequently there is not a transparent link between the investment required of councils to provide for local growth and the additional revenue that such growth should generate. This in turn, it is argued, results in councils having an insufficient incentive to invest in growth despite growth being seen as good for the community and the council governing it. Thus, there is a misalignment of the incentives facing council and local welfare. Incentives would be better aligned, it is argued, if rate revenue increased more directly or transparently in line with property values as would be the case under a property tax as discussed in this report.

In effect the argument is that a change in the mechanics of council funding can materially change incentives. It is the validity of this argument that this paper explores.

The paper reviews economic literature relevant to council incentives and decision making. There is a basis in that literature for concluding that it can be most efficient for local government to fund its activities in ways that has a direct as possible connection between the tax levied and property values. This can be achieved by local governments providing amenities that directly impact on property values and councils having the ability to raise the revenue required to fund such amenities from increases in property values. That seems to offer some support for the argument for changing the mechanism under which rates are set to allow for a property tax along the lines advanced.

However, the literature in this area stresses the importance of the context in which local government operates. Much of the literature is based on the experience of the United States of America where the amenities provided by local government include a greater range of goods and services that seem directly related to localised property values (schooling and policing) more than the services provided by local government in New Zealand (basic infrastructure). Amenities such as

schooling and policing are seen as mainly matters of urban improvement where there is, under a property tax, a direct link for current residents between taxes paid, the amenities provided and property values on which tax is levied. This is the focus of the American studies. In New Zealand the main concern is with funding the infrastructure requirements of urban growth. Here the link between the expenditure, the tax to pay for that expenditure and benefits are not so clear for existing residents.

A relatively direct link between property values and the amenities that property tax funds is critical to the conclusions of those studies. The United States' experience has been that where property values rise significantly because of factors independent of the provision of amenities (a fall in interest rates, immigration, zoning restrictions limiting new housing), property taxes lose a linkage with the goods and services they fund and very significant voter resistance to property taxes can result.

Moreover, New Zealand councils would seem to be able to achieve broadly the same outcome as a property tax by setting expenditure estimates in line with the expected growth from the rise in the rating base (property values) that council investment generates. Indeed, under the existing rating framework, rates do seem in fact to increase in line with economic growth so that in this sense growth does pay for itself even if this may not be always recognised as such. However, even if councils recognise this and thus are incentivised to fund growth, councils may face voter resistance which acts as a constraint given a natural council incentive to be re-elected. Voters may see the costs of growth (the immediate expenditure requirements, increased congestion and demand on existing facilities etc.) while the benefits (additional revenue in the future) are more speculative and dispersed.

This highlights the desirability of as transparent as possible linkages between the funding for growth and its benefits. The factors that might give rise to voter resistance to funding growth seem also to apply to property taxes and under the existing rating framework there are already several options open to councils to make these linkages. As previous Productivity Commission reports have set out New Zealand councils already have a range of tools to align the costs of growth with those who benefit from growth (albeit as also previously outlined in Commission reports there is some room to improve those).

It does not seem plausible that the incentives on councils to fund growth can be aligned with national welfare and that voter resistance to funding growth can be fixed by simply changing the rating mechanism so that the level of rates is set in the expectation that increased property values will fund growth versus the current framework under which expenditure requirements are estimated and the level of rates is set so as to fund that level of expenditure. The literature and experience of the United States of America does not necessarily support such a view.

Of most concern in analysing this issue is that the same general economic literature that can be advance in support of a change in the rating framework also supports robust fiscal constraints on councils. The current rating framework provides such constraints and there seems to be no obvious better option. On that basis the grounds for changing the current rating framework do not seem persuasive.

If it is still concluded that enhancing development can often not be funded by councils because of the risk involved in funding development or that in net present value terms the enhanced revenue from development does not justify the costs, but the development is national welfare enhancing, then that may be because some to the additional revenue from growth is being captured by central government through enhanced income tax/GST revenue. That would be a case for some form of revenue sharing by central government by which councils are partially funded to undertake such development.

Introduction

This report considers whether legislation governing local authority rates should be amended to allow councils more easily to capture the benefits of growth through a rating system whereby taxes on property would increase in line with increasing property values – referred to in this paper as a local property tax.

The issue is raised in the Productivity Commission's November 2018 Issues Paper – Local government funding and financing. The issue is raised in three questions:

> Q38 Do local authorities have sufficient financial incentives to accommodate economic and population growth? If not, how could the current funding and financing framework be changed to improve incentives?
>
> Q42 What are the advantages and disadvantages of a local property tax as an alternative to rates?
>
> Q48 If New Zealand replaces rates on property with a local proper ty tax, should it also adopt tax increment financing to finance growth-related infrastructure investments? What are the advantages and disadvantages of tax increment financing?

Q38 and Q42 involve the incentives on local authorities – are the current incentives councils have aligned with paying the costs that growth generates? If incentives are not aligned councils will not support local growth to the extent they should if such growth is national welfare enhancing. Q 48 is a separate issue and is in response to submissions that tax increment financing is only viable under a different funding framework. It is not concerned with the alignment of incentives to support growth but highlights an instrument (tax increment financing) that could be used to fund growth if the funding framework were changed. This report focuses on how the existing and a potential revised funding framework impacts on the alignment of incentives. However, it is useful to consider whether a local property tax would facilitate tax increment financing.

The Issue – Current Rating Rules and Incentives to Support Growth

The Productivity Commission inquiry into local government funding and financing is an inquiry into the costs of services provided by local government and how they are paid for – the adequacy and

efficiency of the current local government funding and financing framework. This paper considers funding – the sources of money available to provide for infrastructure and services over time. This is important because as the November 2018 Productivity Commission Issues Paper (the Issues Paper) notes, the funding framework enables local government to deliver quality services where and when they are needed (page 3).

Rates are the main source of local government funding – rates are 48% of local government revenue in 2017 (Issues Paper page 15). On average the contribution of rating to local government funding has remained constant over recent decades (Issues Paper page 25).

The local government rating framework is set by the Local Government Act 2002 (the LG Act) and the Local Government (Rating) Act 2002 (The Rating Act).

The Rating Act sets out the method by which councils raise revenue through rates. Councils are required first to establish expenditure requirements, and then set rates to cover such requirements. Expenditure needs that arise are established under the various documents required under the LG Act: the at least 10 year plan (including a financial strategy and forecasts of revenue and expenditure), that councils are required to develop and adopt every three years, an infrastructure strategy, asset management plan, annual plan and annual report. The government also sets financial prudence benchmarks for local authorities. The expenditure proposals need to be funded in a manner that promotes the current and future interests of the community.

As the Issues Paper notes (page 15), "it is council expenditure that drives rates" – it is not rate revenue that determines expenditure. A general increase in the rating base (the value of property – improved or unimproved) does not increase rate revenue because, under the current rating framework, an increase in the rating base flows through to a reduced rate of local government tax on that base. Changes in the relative value of property within a council area alters the amount of rates paid by individual households or businesses but not the overall level of rate revenue available to fund council activities.

Thus, if there is an overall increase in the value of property in the council area but one area rises more than another, the level of rating revenue is the same (being set by the planning and financial documentation described above) but the area with higher increases in property values will bear a greater proportion of the rate burden and the area with lower increases in property values will bear a lesser proportion of the rate burden.

The above funding framework is clearly designed to provide financial discipline and constraints on councils. That is its benefit. However, observers have noted that this increased financial discipline and constraint has a cost. It is argued that the funding framework impacts on the funding of the new and upgraded infrastructure that growth in the local authority area generates. In particular, the Issues Paper notes the concerns raised that the funding framework may be "creating an environment where councils are reluctant to embrace growth which in turn contributes to a sluggish supply of land for housing and worsening housing affordability" (page 3). The Issues Paper goes on to note (page 54):

> "The Commission's previous inquiries have found that fast-growing Councils often struggle to finance and fund the infrastructure needed to accommodate growth. . . Accommodating

population growth is not seen as beneficial to local government, but as a drain on resources".

The argument is that the incentives on councils are not aligned with growth because growth generates demand for expenditure to be funded out of the level of spending set by the current funding framework described above. Growth however does not expand the overall revenue to fund those costs (the increased expenditure that the council can incur because of growth).

As discussed further below, growth itself should still expand the council revenue base by increasing the value of land subject to rates, but it is argued that councils undergoing growth may still see themselves facing a set revenue base and higher costs and need to face difficult issues of trading off existing expenditure commitments to accommodate the new expenditure pressures generated by growth. The natural reaction, it is argued, is for councils to discourage growth (reduce the expenditure pressure) and/or underfund growth expenditure leading to poor infrastructure and a scarce supply of housing.

Residents, ratepayers and voters in council areas undergoing growth face the prospect of growth leading councils to reduce expenditure on existing services provided by councils to accommodate the extra costs growth generates within a set revenue level. On the basis that these households and businesses value those existing services, they see themselves as net losers from growth. They also therefore have an incentive to discourage and/or underfund growth. They can react to this by voting for councils that will discourage and/or underfund growth. This reinforces the incentives, noted previously, on councils to discourage and/or underfund growth.

Concerns in this area have been echoed by the Minister of Housing and Urban Development, Hon Phil Twyford. In a speech to the New Zealand Initiative on 22 March 2019 he stated:

> "to a large extent local government politicians have been unable to convince their ratepayers to invest in growth, leaving a burgeoning infrastructure deficit for the next generation.
>
> The unwillingness or inability to invest in the infrastructure to support development stops cities growing. When a city cannot grow in response to demand, a pressure cooker effect is created, which is what has given Auckland some of the most expensive urban land and housing in the world relative to local incomes."

It is this concern that has led to the suggestion that the current rating framework should be amended so that instead of the current rating system (where the rate is set each year as a consequence of a local authority decision regarding its medium term costs and thus revenue requirements), the rating framework provide the option of setting a rate percentage for successive years so that rate revenue changes with the rate base (the value of rateable property).

At the heart of this issue is the incentives faced by councils and the households/businesses within the council area. This note considers an economic assessment of such incentives. It then assesses the case for a change in the current rating framework considering the following questions:

- Is growth in a council area national welfare enhancing?
- Does growth in fact generate high costs on councils undergoing growth?

- Are incentives misaligned under the current rating framework as suggested above?
- Is it likely that such misaligned incentives create barriers to the adequate funding of growth by councils?
- What sort of changes to the rating framework would be required to better align incentives?

Previous Consideration of Growth Funding Issues

The general issue of the impediments councils may face in funding growth and reforms that could better make growth pay for itself from a council perspective have been considered by a number of past Productivity Commission reports – Housing Affordability (2012), Using Land for Housing (2015), Better Urban Planning (2017).

The last of these – Better Urban Planning - concluded in Chapter 11 that the argument that "growth does not pay for growth" is inconclusive on available evidence. However, it recognised that many councils hold such views. That of itself could be expected to discourage such councils from investing in growth such as spending on infrastructure. The Report also noted that to the extent infrastructure projects pay for themselves they do so only over long periods of time.

The Report's response was that there should be transparent linkages between growth expenditure and the benefits flowing from growth. In particular, those who benefit from growth should more clearly bear the cost of such growth. The Report (at page 324) set out a hierarchy of funding tools for councils to fund local infrastructure.

> "Pricing and user charges (e.g. water and congestion pricing) should be charged where practical and efficient. Where benefits are localised, councils should use development contributions and targeted rates. Otherwise they can use general rates, value capture and, sometimes, central government funding to ensure costs are fully recovered. "

The way growth benefits are dispersed varies and this should be reflected by councils using a range of funding options to align the benefits of growth with how the costs of growth are distributed. The existing legal framework already allows councils considerable flexibility in choosing funding options. This was canvassed in the Revenue Funding Options paper by Olivershaw Limited released with the February 2017 Report.

Innovative approaches may be required. An example of this is the Milldale development in Wainui north of Auckland. This is expected to support 4,000 dwellings in the Milldale area and an additional 5,000 dwellings in the surrounding area. The project and its associated infrastructure requirements are being undertaken and funded by a joint venture of Crown Infrastructure Partners (CIP), Fulton Hogan Land Development, Auckland Council, Auckland Transport, Watercare and ACC. CIP has established a Special Purpose Vehicle that is equity funded by CIP. It has raised 35-year long-term debt from ACC. CIP equity and the ACC debt are secured over the individual land titles in the development and will be repaid by annual "infrastructure payments" over a period of the loan to be made initially by the developer and, in time, by the final section owners. In this way the new dwelling owners will make payments that will be used by the Special Purpose Vehicle to repay the money borrowed to fund the bulk housing infrastructure plus interest over time. Auckland Council will find its contribution by way of development levies on future development on surrounding land.

Using approaches such as this, the beneficiaries of growth can bear the cost of growth. In the Milldale case, the beneficiaries are the developer and the eventual dwelling owners. Dwelling owners fund the infrastructure through the future "infrastructure payments". The developers also bear this cost through, presumably, a reduced price of the developed land as a result of that land being encumbered in the future with "infrastructure payments," as well as development levies paid to Auckland Council.

This demonstrates the existing tools available to "make growth pay". As noted in the February 2017 Report by Olivershaw, there are some legal constraints on the ability of councils to avail themselves of all the tools that might be useful in funding growth. A key issue seems to be the limited ability to capture revenue from value creation. Consideration should be given to relaxing those constraints.

Economic Framework for Considering Property Taxation

Although tools may be available to councils "to make growth pay," the argument advanced is that the legal framework required of councils in the levying of rates does not provide councils with an incentive to use those tools because, as outlined earlier, although growth may increase the base on which rates are levied (property) "council expenditure drives rates" – it is not rates that drive expenditure. The link between growth and increased rating revenue, it is argued, is not clear and transparent.

This argument was referred to in the Productivity Commission's 2015 Report Using Land for Housing (page 70) and explicitly in the 2018 Issues Paper. Infrastructure New Zealand in its June 2008 Report Enabling City Growth: Lessons from the USA, argues that Denver and Portland in the USA are cities with many of the characteristics of New Zealand cities with limited land supply and costly housing whereas the opposite is true of Houston and Dallas. The Report partly attributes this to the manner tax is raise by the local authorities. Houston and Dallas rely heavily on property taxes that are described as "ad valorem" taxes – they are set at a percentage of the value of property so that local authority revenue increases as properties increase in value so as to provide a revenue stream to invest in the new services required by growth.

Clearly if expenditure on growth enables cities to grow and such growth increases property values, this increases the rating base. This provides the basis for increased council revenue irrespective of whether council is first required to set its level of expenditure and rates levied to match that (as in New Zealand); or, as is reported to be the case in Houston and Dallas, the level of revenue determines the amount that a council can spend. The former merely requires councils to include growth in their expenditure forecasting models.

Under the New Zealand model, expenditure on growth and development leads to higher council revenue in two ways. First, such development may result in more developed land, and thus more houses or commercial and industrial properties. There are then more properties (rateable units) to levy. This means, the level of rates per ratepayer can be held constant but the increased number of ratepayers means higher overall council revenue. Secondly, development expenditure may lead to enhanced amenities for residents, such as a road providing access to land previously unable to be fully utilised. That increases the value of that land. If the dollar amount per rate value is held

constant, that increases the amount of rates levied on that property but this should be offset by the increased level of amenities being provided.

Under the property tax model, the same outcome is reached with respect to rates per person and rates on particular properties. It is just that instead of forecast expenditure being set out in the council planning process, the level of tax per value of property is forecast in such planning to remain constant and the overall level of revenue increases in line with property values. The overall level of revenue available to councils in both cases should be the same, the differences is in how this is set out in the mandated council planning process.

It does seem that in New Zealand council rate revenue does increase in line with growth. As set out in the Productivity Commission's November 2018 Issues Paper (at pages 26 to 27) overall New Zealand rate revenue has since 1996 largely increased in line with or above GDP and in excess of CPI (albeit rate revenue exceeding the growth of GDP during the Global Financial Crisis of 2008-12). This does suggest that growth (as measured by GDP) leads to higher rate revenue. The Issues Paper did note that there seemed little correlation between high population growth and increased in rates per person although there seem to be several possible explanations for this (high established infrastructure overheads for low growth councils and use of user charges and development levies by higher growth councils). It follows from this that high population growth and high council expenditure requirements to fund that growth do not necessarily lead to an increase in rates levied per ratepayer over and above that applying in lower growth areas.

This supports the view that the institutional structure by which rates are set should not be important in incentivising councils to fund growth. Nevertheless, the view seems widely held that institutional factors are important in discouraging councils from investing for growth and the view that growth does not pay seems to be widely shared. Behavioural and modern public economics lends some support to this in that they have increasingly stressed the importance of the institutional context in considering the choices made by the government and its agents.

The basis of economics is that people are rational and are motivated by the incentives they face. Thus, in order to maximise national welfare, the incentives on people, households and firms should be aligned with increasing national welfare. Thus, a free market economy is successful if it incentivises firms to make goods efficiently for consumers who then benefit from choice and low prices. Taxes on costs not borne by a consumer but by society and subsidies for things people do that generate benefits for others but not themselves improve national welfare by aligning the incentives on people and firms to do things that are good for society. Put another way people react to private costs and benefits but to ensure overall welfare social costs and benefits should be aligned.

The concerns expressed above about the current rating framework suggest that the rules as to how rates are set can result in a misalignment of the incentives of councils and voters to support funding for growth.

Traditional public economics does not allow for this. It is focused on the incentives faced by voters with the political institutions being pure agents operating in a political exchange maximising benefits of voters in terms of linking expenditure and tax decisions (Knut Wicksell - 1896). Under this model, voters support/oppose growth funding and councils follow the will of voters.

There is little room here for institutional structures altering tax and expenditure decisions. Voters may oppose growth funding because the benefits are seen as flowing to future generations of households/businesses, but the costs are incurred by current voters. However, these concerns should be able to be dealt with by way of financing choices – debt financing rather than financing infrastructure out of current rates.

Thus, provided a majority of voters favour growth and councils have reasonable access to financing options, under this model councils will also adopt growth orientated policies including spending on infrastructure.

An economic view of the operation of the political system has developed, however, to take into account information asymmetries and differences in the distribution of costs (who bears the tax) and benefits (who benefits from expenditure) – Buchanan and Tullock The Calculus of Consent: Logical Foundations of Constitutional Democracy (1962), Bryan Caplan The Myth of the Rational Voter (2007), Gary Becker A Better Kind of Violence: The Chicago School of Political Economy, Public Choice, and the Quest of an Ultimate Theory of Power (2016). These theories attempt to explain why lobbying can successfully result in outcomes that are not consistent with national welfare and thus presumably majority voter preferences.

These theories might explain why voters prefer policies unsupportive of growth – such as restrictive town planning rules. The relevance to the issue over New Zealand's rating framework may be that a small number of voters that do not benefit from growth can be advocates for policies unconducive to growth. Even if we assume it is in the interest of a majority of voters to support growth, and that councils act as pure agents of voters, councils may not support growth policies if actual voting reflects the views of a non-growth minority. This may occur if the benefits of growth to the majority are widely dispersed, the costs of growth are concentrated on the minority, and the link between expenditure, growth and the increased revenue that growth generates (the expected increase in property values that augments the rating base and thus allow for higher rate revenue) is not transparent.

While this may plausibly lead to restrictive town planning laws, it is less plausible to see infrastructure spending accommodating growth giving rise to concentrated costs and dispersed benefits provided councils have and use appropriate financing options (to avoid a concentration of the costs on current residents), and provided the link between expenditure accommodating growth can be seen as leading to an increase in the future rating base so that growth is seen as funding the costs of growth. As previously noted, New Zealand councils do have a number of tools available to them to fund the investment required for growth and in a manner that the beneficiaries of growth bear most of the cost (although there seems room to provide some more flexibility in areas as taxing value creation). The main issue seems to be whether councils have appropriate incentives to utilise the funding tools that are available to them.

The links between the benefits of growth and the costs of funding growth can be complex and there may not be a transparent link between expenditure on growth and increased rating revenue to fund growth generated expenditure. The information costs for voters in understanding those linkages may be higher than perceived benefits from this investment of time and intellect required to understand the linkages. This may result in voters making less than optimal decisions and/or those

with non-growth interests using the complexity and non-transparent aspects of the rating framework to advance their non-growth agenda.

This may point to the desirability of more directly and transparently linking the costs of growth with additional rating revenue to fund that growth.

Strengthening this point are more recent economic models that do not have the above assumption that councils are pure agents of voters. Commentators have noted that such an assumption of pure agency is difficult to reconcile with other aspects of economic agency and firm theory which sees firms as having separate goals and incentives to shareholders, consumers and other stakeholders. This stresses the importance of aligning the interests of firms (management) with the interests of those stakeholders through appropriate incentives. More recent public choice economics has relaxed the assumption of pure agency.

Instead of ascribing to public authorities (such as councils) the same motivations as ascribed to taxpayers as per standard public choice theory (or ascribing to such bodies a benevolent motive to advance public welfare as per orthodox public finance models) public bodies are seen as having their own motivations which if not aligned with the public interest will result in sub-optimal welfare outcomes. Geoffrey Brennan and James Buchanan in The Power to Tax: Analytical Foundations of a Fiscal Constitution (1980) adapted the standard economic model of the monopoly and advanced the concept of the revenue-maximising Leviathan state. The motive of councils and the like is to maximise revenue (within constraints imposed by voter choice) giving rise to a need for fiscal constraints. As noted above, New Zealand councils have fiscal constraints imposed on them by their governing legislation. This is presumably to enhance good local government by way of transparency in decision making and appropriate consultative processes and community engagement. Such fiscal constraints are also supported by this economic literature which highlights the bias councils can have to increase expenditure (subject to voter/ratepayer constraint which may not necessarily be fully informed or engaged).

The idea that government has a revenue maximising objective may seem overly pessimistic and not adequately take into account the higher public welfare motives that many government officials (elected and permanent) undoubtedly have. The issue is, however, what assumptions better allow for models that are useful in identifying incentives and predicting behaviour. Overall, it is reasonably arguable that a revenue maximising objective is more realistic in this sense than assuming either that officials are always benevolent actors for the public benefit or simply agents of voters (the other models) which allow no role for the incentives on councils or officials to affect outcomes. As Wallace Oates has written – Oates (2008) at page 315 - in rejecting the alternative benevolent behaviour hypothesis:

> "This literature looks more realistically at a setting that views public officials as conventional utility-maximizing entities with their own objective functions, who operate within a constellation of incentives and constraints that depends on existing political and fiscal institutions".

This line of analysis has been specifically applied to local property taxes by Glaeser – Edward Glaeser (1995 and 2008 especially at pages 236-238). Moving from the observation that the most effective tool for convincing local government officials to support neighbourhood beautification was that this

would increase property values of the neighbourhood Glaeser drew on Brennan and Buchanan and related work to explain why property taxes have been the major source of local government taxation in the United States of America and why such taxes are efficient from an economic standpoint over and above the traditional efficiency arguments in favour of a tax on the unimproved value of land.

Following Brenan and Buchanan, the assumption is that local governments' motives are to maximise revenues. The argument is first that local authority taxes based on property values provide strong incentives for councils to fund growth because local amenity provision determines property values which then determine local tax revenues. Secondly, as current property values reflect expectations about future amenity levels, property taxes create incentives for the most myopic government to invest for the future/growth. As his 2008 NBR Working Paper (at page 4) sates: “Since property values will reflect, immediately, expectations about improvements in future amenity levels, taxes based on property values will induce politicians to worry about the future.”

The issue in New Zealand seems to be that the rating framework imposes fiscal constraints on councils, consistent with public choice economic theory, but it may do so in a way that, by reducing transparent linkages between growth expenditure and the increased revenue to fund such expenditure, misalign council incentives to fund growth with incentives not to do so. Arguably that is the case even if, as discussed above, linkages between growth and revenue remain but less transparently.

The economic theory outlined supports the view that the more transparent are the linkages between revenue and the provision of amenities the more likely council incentives will be aligned with long-term community welfare. Property taxes are seen as well-suited to offering such transparent linkages. However, it is important to note the caveats or assumptions underlying, for example, the findings of Glaeser.

First, it is to be noted that Glaeser’s models, in reaching these conclusions, are not it seems dependent on how, or the way, local taxes are set. Glaeser’s models are highly rational. Provided property taxes are used to improve amenities that are then reflected in property prices, property taxes are efficient. It seems dubious to apply an economic model so based on rational behaviour to support a change in revenue mechanism (a change from the current rating framework to a property tax) when, as noted above, the actual outcome in terms of revenue tracking growth should be the same.

Secondly, it is specifically assumed that the amenities provided by local government have a direct and an immediate impact on property prices. This is assumed by Glaeser seemingly as obvious. In the United States much local government expenditure is on schooling, policing and similarly amenities that may reasonably be seen as directly impacting on local property values. The assumption is critical and is the basis for his argument that property taxes are much more prevalent in funding local government compared to higher levels of government. He argues that at the national level, because of the lack of any direct connection between property prices and the goods and services provided by a national level government (such as defence expenditure), property taxes are likely to be less efficient than other forms of taxation.

The amenities that Glaeser sees as being efficiently funded from property taxes are those related to urban improvement (better schools, safer streets and local beautification). There is no focus in this

work on urban growth leading to increased population and the funding of that growth. For this reason, Glaeser argues that , because migration costs are higher at a national level than at a local level, increased amenities funded by taxes are less likely to lead to inward migration and higher property prices reflecting increased demand. Along the same lines, Glaeser notes that, under his model, if the additional amenities provided by local government leads to additional dwellings so that the additional amenities simply support a greater population with no increase in property values, a property tax may not be effective in aligning council incentives with growth.

Finally, following from the argument that property taxes are efficient if used to fund amenities that increase property values, it is obviously critical to this conclusion that property prices are substantially driven by the level of local amenities. Glaeser notes that if property prices are in fact driven by factors extraneous to the level of amenities provided by property tax revenue a property tax can become inefficient or at least unstable.

Glaeser uses the example of Proposition 13 in California in 1976 to illustrate this. Proposition 13 was a referendum that led, in 1978, to an amendment to the California State Constitution limiting property taxes in California. By its Constitution property taxes are now limited to using 1976 property values with any increase restricted to inflation not exceeding 2% per annum. Re-assessments of property values are allowed outside of this only when property ownership changes or construction takes place. Under the constitutional amendment, the State now collects property tax revenue (not more localised bodies) and the State then distributes the revenue to lower level authorities. A two thirds majority of both houses of the legislature is required to alter this, and any special localised property tax also requires a two thirds majority.

The measure received about 63% support in the referendum and polls indicate it still has this level of support (although there are moves to amend some aspects such as reducing the ability of large corporations to benefit from the cap on property tax).

The result of Proposition 13 was that whereas previously property taxes raised about 90% of local government revenue, this is now down to about 60%.

The reasons for the popularity of Proposition 13 have been analysed – Rabushka and Ryan The Tax Revolt (1982). The most common explanation seems to be the fear that people, especially the elderly, would be forced out of their homes by increasing property taxes when property prices rise significantly. The period when Proposition 13 was brought in (the 1970s) was a period of high inflation in the USA and rising real property prices in California as a result of a growing population so that over the decade average property prices tripled.

Glaeser (1995) argues that the success of Propositon 13 can also be traced to the rise in California property values that broke any discernible link between the raising of taxes and the provision of local amenities. Glaeser (1995 at page 22) notes that with the market and inflation induced rise in California property prices in the early 1970s,

> "the share of the government's contribution to property value changes to the share of all the other forces changing property values seems to have fallen . . .property taxes had become an increasing expensive and inaccurate way to achieve government incentives. The

voters may have reacted to these shocks to property values by turning away from property taxes."

Application to New Zealand

The above economic literature supports the view that clear links between the benefits provided by local authorities (amenities in Glaeser's terminology) and the taxes raised to fund such benefits are fairer and more efficient and better align the incentives facing councils and voters than taxes that do not provide such clear linkages. However, these studies tend to be focused on the USA and its institutional framework with respect to sub-federal level government. Care needs to be taken in too readily applying these results in the context of New Zealand.

First, the role and function and institutional setting of New Zealand seems to differ materially from that applying in the USA. The American studies suggesting that property taxes provide strong incentives for councils to fund growth do so on the basis that much of the local authority expenditure is of a kind that is location specific and can be seen as directly increasing local property values. In particular, US local government funds schools and public safety (police) – services that can be seen as the provision of amenities directly impacting on property values. With some caveats, such expenditure can be seen as increasing local property values quite directly and, under a property tax based on property values, this increases the revenue of the local authority the maximisation of which is the objective function of government agencies under these theoretical models. The focus of the studies is on expenditure on urban improvement (better schools, safer streets and urban regeneration) that increase property prices in the locality directly leading to higher tax revenue under a property tax.

In New Zealand much of local government spending is on basic infrastructure (roading, public transport, water, waste disposal etc). About 40% of council expenditure is on roading, public transport, wastewater and council support services (November 2018 Issues Paper page 12). Such expenditure is significant, and a necessary investment for growth, but it seems usually to have a less direct connection with the overall property values of the district (as opposed to the property values of the land being developed) than the urban improvement police and school expenditure which is largely what the US models seem based upon. Glaeser's own model assumes that if local authority expenditure simply provides for increased population (growth), this expenditure does not give rise to improved amenities for the existing voters. The link between the incentives of existing voters to support expenditure funded by increased property values arising from improved amenities is broken.

Secondly, the economic literature argues that where property value increases are caused by factors other than improved amenities property taxes may not align incentives and prove to be inefficient and unfair. The US tax revolt of the 1970s and Proposition 13 in California is cited as an example of this.

New Zealand has seen historically high property price increases over recent years. The call for more incentives for councils to invest in growth is in part a reaction to that – support developments

increasing the supply of housing to make housing more affordable. In these circumstances, as in California in the 1970s, it seems likely that urban New Zealand residents would see a more transparent link between increasing property prices and increasing tax revenue not as the result of increased amenities paid for by the taxes (which they have reason to support) but as a threat that property taxes will force them to sell their homes. As in California, the result could easily be voter led restrictions on the council tax base or increased voter resistance to rates and less funding available for meeting development expenditure.

One would therefore have to question whether changing New Zealand's rating framework so that councils could set rates as a proportion of property value (increasing rating revenue as property values rise and with expenditure increasing with the increased revenue) would result in material increases in the incentives councils have to invest in growth.

As noted above and previously, rating revenue already tends to track economic growth and councils in New Zealand already have a range of tools they can use to fund infrastructure investment relating to the direct beneficiaries of that investment – owners of the land to be developed, developers and eventual dwelling owners.

Changing the New Zealand rating framework would seem to make the link between growth and the taxes to fund is more clearly understandable and that would be an advantage. If this were seen to be free of cost, the more transparent linkages that could be seen to arise from setting rates on the value of property so that council revenue increases with overall property values might be justified.

However, if instead more clearly linking growth in taxes to growth in the value of properties were seen as linking tax, not to growth but to property values that are increasing because of other factors, that could give rise to the type of tax revolt seen in California in the 1970s undermining, not enhancing, the ability of councils to fund growth. As Blochliger (2015) notes in an OECD survey on the reform of land-based taxes (at page 22):

> "The property tax is highly visible or salient. . . . Salience improves efficiency and accountability of the sub-central tax system since it makes taxpayers aware of the costs of providing public services. But if some taxes are more salient than others, and if voters dislike salient taxes, it is difficult to sell a reform that raises the burden of the most salient tax."

The current rating framework also has a purpose – a government imposed fiscal constraint on councils. The same economic theory that can be employed to justify a change in the rating system to more clearly align growth investment with the incentives of those who decide whether to make such investment, also provides strong arguments for retaining such a fiscal constraint.

There is quite persuasive economic literature on the desirability of fiscal de-centralisation or subsidiarity. This is that government expenditure should as far as practical be undertaken by the lowest possible level of government and that level of government should fund that expenditure from its own taxes. See Oates (1999 and 2008.)

The major caveats to this are:

- Sub-national authorities should not undertake expenditure that is designed to provide national benefits. The most obvious example is defence. Arguably welfare transfers are another example where expenditure is better undertaken at a national level. The argument being that with the free movement of people within national boundaries generous welfare benefits in one locality will attract beneficiaries to locate in that locality incentivising sub national entities to provide low levels of benefits and free ride off more generous parts of the country. In other words, if fiscal de-centralisation creates an unstable structure because of competition at subsidiary levels, expenditure should be undertaken at the national level.
- Where goods or services are provided at a subsidiary level but have spill-over benefits outside that area, this should be compensated by grants from the central government. An example would be one area spending to improve the environment where that benefits surrounding localities. Another is local roading providing benefits to a wider road network.

Oates (1999 at page 1134) summarises this as follows:

> "Central government plays the major role in macroeconomic stabilization policies, takes the lead in redistributive measures for support of the poor, and provides a set of national public goods. Decentralized levels of government focus their efforts of providing public goods whose consumption is limited primarily to their own constituencies. In this way they can adapt outputs of such services to the particular tastes, costs, and other circumstances that characterize their own jurisdictions."

Central government has the advantage of economies of scale and national co-ordination of policies but as Oates (2008 at page 322) points out:

> "The choice between the centralization or decentralization of a particular local public good involves a basic tradeoff between the gains from improved coordination under centralization and the greater sensitivity of local outputs to local tastes (and costs) and perhaps increased accountability under decentralization."

Local government fiscal autonomy with respect to spending and revenue-raising assumes similar market based fiscal disciplines as apply to national governments. Mainly this is the threat of losing the ability to raise finance through borrowing. These fiscal disciplines tend to apply in the United States of America where Congress has since the 1840s consistently refused to bail out states. As a result, sub-national authorities that are seen to be fiscally irresponsible soon face rising interest costs on their borrowing. The threat of bankruptcy is real. These are seen as real incentives for such authorities to act reasonably fiscally prudently.

In New Zealand it is less plausible to see the central government failing to bail out a defaulting council even if that would involve elected officials being replaced by Ministerial appointees. The financial market constraints (although present) seem softer than in the USA. Most councils borrow through the Local Government Funding Agency (see page 18 of the November 2018 Issues Paper). Even though some councils have individual bond ratings (that can feed into the cost of borrowing through the Local Government Funding Agency), the market constraints seem less direct and immediate than in the USA

Wallace Oates refers to this as the problem of “soft budget constraints” (Oates 2008). If a council operates with the expectation that there is a supporting body that will underwrite its financial losses this undercuts the incentives for responsible fiscal behaviour and incentivises inefficient expenditure to the detriment of national welfare. At the local level the United States seems to have hard budget constraints. The theory of fiscal decentralisation leading to the most efficient provision of government services has force. New Zealand seems to have soft budget constraints (in terms of costs of financing and threat of bankruptcy) at the local level. The rating framework, that for reasons of good government and transparency, require councils to set out expenditure in a long-term plan and government set financial prudence benchmarks also harden council budget constraints and thus mitigate the risks that a softer budget constraint than exists in the USA entails.

The issue then is that these measures, necessary to mitigate against the risks of fiscal irresponsibility, are incompatible with a change to the rating framework under which councils set rates by way of property taxes that increased council revenue in line with any overall increase in property values in the council district. Inherent in a move from the existing rating framework to a property tax is a removal of the requirement on councils to set long term expenditure plans that then determine revenue requirements.

The choices therefore seem to be:

- Allow councils to move to an ad valorem property taxes and remove the fiscal constraints incompatible with that. Given the risks this would involve, and the limited benefit expected from changing the rating frame (given already existing tools for aligning investment in growth with its benefits) this would seem unwise.
- Impose on New Zealand councils the type of market driven hard budget constraint that seems to prevail in America. Given New Zealand’s size, history and culture this does not seem viable.
- Impose alternative hard budget constraint on councils. This might involve the central government overseeing council revenue and expenditure estimates in their long-term plans. For example, questioning whether the proposed expenditure on amenities will lead to the expected growth in property values leading to the estimated growth in revenue. That would seem to undermine council autonomy and it is difficult to see central government officials having the expertise or local knowledge to monitor council fiscal projections efficiently in this way.
- Retain the existing rating framework and encourage councils to utilise the tools they have to align the costs of growth with the benefits from growth. This might include some relaxation in revenue raising rules (such as allowing for value capture along the lines of previous Productivity Commission Reports).

While acknowledging there is some basis for the argument that changing New Zealand’s rating structure could better align the need for councils to invest in growth and their incentive to do so, this seems to be based entirely on transparency of linkages between the expenditure from growth and revenue from growth. It seems to be necessary to put the onus of proof on those proposing such a change. This onus seems hard to meet especially given the flexible revenue tools available to councils, the costs that would be involved in terms of replacing or reducing the existing budget constraint framework and the risks of a California type tax revolt.

The context in which local government operates in New Zealand is different from many overseas countries and seems especially different from that of the United States of America as outlined above. While Infrastructure New Zealand has argued that the greater housing affordability in Dallas and Houston compared with Denver and Portland may be attributed to the differing tax systems in those cities, these differences seems more one of higher reliance on property taxes generally in Texas than in Colorado and Oregon rather than the mechanism by which such taxes are set.

Moreover, usually these differences in housing affordability are attributed to stricter town planning regulations in the less affordable states. This is set out in Edward Glaeser's book Triumph of the City (2011) at pages 188 to 193. Glaeser notes that there is a land shortage "throughout much of coastal America, but that shortage is the result of regulation, not nature." (page 191). He notes that in Massachusetts town planning has been used to increase housing lot size but a "ten-thousand-square-foot increase in lot size comes with a 4 per cent increase in prices (page 192) and compares such restrictive regulation with the lack of regulation in Texas. He concludes" (page 192):

> "Houston's freewheeling growth machine has actually done a better job of providing affordable housing than all the progressive reformers on America's East and West Coasts

It has been argued (Infrastructure New Zealand 2018) that tax increment financing would be a useful tool for councils to use to align councils with the need for growth investment. Tax increment financing allows councils to issue bonds to fund development projects where the bonds are repaid out of rates on developed land tied to property price increases. Tax increment financing was considered in the Productivity Commission's Using Land for Housing 2015 Report. That Report concluded (page 203) that tax increment financing "does not appear well suited to financing many types of growth-related infrastructure and does not fit easily with New Zealand's existing rating system." An ad valorem property tax may lessen the second of these concerns. However, as the Milldale project illustrates the existing framework does provide opportunities for innovative thinking within the existing rating framework and this point does not overcome the other problems outlined in this paper.

Overall Assessment

- Is growth in a council area national welfare enhancing?
  The previous Productivity Commission reports cited in this paper are persuasive that, if properly managed, growth in council areas can be welfare enhancing. It is clear government policy to facilitate investment to allow for such growth.
- Does growth in fact generate high costs on councils undergoing growth?
  Again, the previous Productivity Commission reports cited in this paper demonstrate that growth requires significant council investment.
- Are incentives misaligned under the current rating framework as suggested above?
  Economic theory supports the view that clear, transparent links between revenue growth and the costs of growth better provide incentives for councils to invest in growth. While the current rating framework allows for this (indeed council revenue overall has tracked growth as measured by growth in GDP) arguably a property tax along the lines considered in this paper would create more transparent linkages.

- Is it likely that such misaligned incentives create barriers to the adequate funding of growth by councils?
  Given that councils already have tools to link costs of growth with the benefits of growth under the current rating framework (subject to some improvements as outlined in prior Productivity Commission reports) this is not clear.
- What sort of changes to the rating framework would be required to better align incentives? A move to a property tax along the lines considered in this paper would require a relaxation of the existing fiscal constraints on councils, closer government micro-management of council expenditure and revenue forecasts or imposition of market driven fiscal constraints as per USA. Such options do not seem viable or justified in the New Zealand context.
- Overall the preferred approach seems to be to retain the existing rating framework and encourage councils to utilise the tools they have in order to align the costs of growth with the benefits form growth. This might include some relaxation in revenue raising rules (such as allowing for value capture along the lines of previous Productivity Commission Reports.) This seems to be the preferred option. If there is still seen to be inadequate incentives for councils to use the tools available to them to fund growth, the government might have to intervene, possibly by way of revenue-sharing.

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