IMPROVING LOCAL GOVERNMENT REVENUE IN NSW: WHAT ARE THE OPTIONS?

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WITH FOREWORD BY LOCAL GOVERNMENT NSW

International keynote and discussion paper for the Local Government NSW Finance Summit 2016
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Foreword by Local Government NSW

Do Australian governments have a revenue problem?

It’s a question occupying the hearts and minds of economists, taxation specialists, politicians and commentators.

Not before time. As all spheres of government continue the never-ending quest for greater expenditure efficiencies, better governance and structural change, there is a very good chance that they are having less success on a fourth critical front.

How do governments achieve and maintain financial sustainability while improving services and responding to the challenges ahead, including population growth, the ageing of Australia and climate change?

Local Government NSW (LGNSW) believes it is well past time to have this debate as regards the third sphere of government. As the dust begins to settle on a post-amalgamation landscape, and as the Independent Pricing and Regulatory Tribunal (IPART) reviews the local government rating system in this state, it is time to commence an open and meaningful discussion on optimal fiscal arrangements for councils.

The following paper is designed to do just that. It is not a policy manifesto or a call to arms. The options should not be considered to have the support of LGNSW. Instead, LGNSW seeks to promote and inform a discussion about the array of revenue options and tools potentially available to local government.

We all have a stake in ensuring our councils are not hamstrung in their efforts to deliver the services their communities need and want. We must move beyond the headlines and the vested interests to truly examine the best way forward. To this end, LGNSW has commissioned international municipal finance expert Dr Enid Slack to review and report on both the Australian and international experience. We are making the result available to stakeholders and inviting their response in order to open the conversation.

The State of Play

There is a wealth of evidence that local government’s capacity to fund existing levels of services and infrastructure is under increasing stress.

The Independent Inquiry into the Financial Sustainability of NSW Local Government – commissioned by LGNSW’s predecessor organisations – concluded in 2006 that local government needed to find an extra $900 million a year to overcome its infrastructure issues. This did not take account of the additional infrastructure needed in future to accommodate a larger population and the higher standards of service, and therefore public assets, that people increasingly demand of their councils.¹ The news in the years since is no better.

The NSW Treasury Corporation’s assessment of the financial sustainability of NSW councils undertaken in 2013 indicates that existing revenue restrictions severely hamper councils’ ability to fund current, let alone future, levels of service.²

The NSW Independent Local Government Review Panel in its 2013 Final Report found there was mounting evidence that around a third of all NSW councils suffer from weak revenues, infrastructure backlogs and declining populations.³

There is no question that the demands for additional infrastructure and human services from a growing and ageing population will require substantial resources.

Councils are the sphere of government most responsible for creating and maintaining the infrastructure and services that support and build resilient local economies as well as functional, healthy and inclusive communities.

Yet local government has access to just one form of taxation (i.e. rates on land) to fund public services and infrastructure. This poses particular sustainability challenges in regional and rural areas, where the rating base is small and service costs are higher. Councils in these areas often do not have the fiscal capacity to raise sufficient funds on their own and are dependent on intergovernmental transfers. This necessitates a system of horizontal equalisation funding from federal and state government to local government. However, Financial Assistance Grants from the Australian Government and other grants have grown at a significantly slower rate than taxation revenue (i.e. the economy) and Financial Assistance Grants fall well short of full equalisation (i.e. they are insufficient to ensure that all councils are able to provide at least the average levels of services to their communities).⁴


*Total Commonwealth taxation revenue (including GST revenue) is used as a proxy for economic growth.

Unlike the Australian Government and state governments, local government does not currently have the flexibility to spread its taxation effort over a suite of taxation tools.

Restrictions placed on councils’ rating capacity have further exacerbated funding difficulties associated with this limited revenue base, including:

- **Rate pegging.** Rate pegging has restricted the ability of NSW councils to increase rates in line with financial needs for 40 years. It has resulted in direct and indirect suppression of the rating effort. Indirect suppression occurs as the existence of the rate peg tends in practice to discourage councils from seeking to introduce higher rate increases (i.e. via special rate variations), even if it is evident that there is a need. It is safe to stay within the externally imposed peg. This leads to the perverse outcome of neglecting funding needs.

⁴ Independent Pricing and Regulatory Tribunal of NSW, Comparative analysis of local government revenue and expenditure in Australia, (2009), page 30.
such as infrastructure renewal backlogs, weakening the financial sustainability of the council in the long run.

According to the 2013 Final Report of the NSW Independent Local Government Review Panel, over the period 2001/02 to 2010/11, growth in total revenue of NSW councils was 5.7% per annum, compared to an average of 8.0% for the other mainland states. Taxation revenue (rates) increased by 4.4% per annum in NSW compared to an average of 8.0% pointing to “revenue foregone” in rates of well over $1 billion over that period.\(^5\)

NSW local government taxation revenue (rates) over the 10 year period from 2004/05 to 2014/15 increased by 5.7% per annum in compared to an average of 10.9% for the other states and the Northern Territory.\(^6\)

- **Rate exemptions.** Exemptions mandated by the state government for many organisations, institutions and agencies further reduce local government’s rate base (and do so differentially across local government areas). Many of these exemptions are no longer appropriate where exempt institutions act commercially, benefit from council services, and have capacity to pay (e.g. private income generating leaseholds in National Parks, state-owned corporations such as the Forestry Corporation of NSW).

- **Social welfare responsibilities.** Councils are given social welfare funding responsibilities such as partly funding mandatory pensioner concessions on rates (and charges for domestic waste and water supply and sewerage services).

Such constraints have forced councils to resort to user fees and charges such as parking fees or commercial property investment and management. These are unsuited for addressing the structural deficit in funding public goods (or providing subsidies for private goods services with some public goods character e.g. child care). The capacity to get revenue from fees and charges varies significantly, with major CBD councils having far greater opportunities than councils in less dense urban and regional areas.


Councils’ ability to fully recover cost through fees and charges is restricted by NSW Government regulation as regards a considerable number of services, particularly in the significant area of development assessment and with respect to various regulatory activities. In these cases, councils often cannot fully recover the costs of providing the service.\(^7\)

Revenue options to fund infrastructure associated with population growth and significant urban development are also limited. Permitted development contributions are often restricted to essential basic infrastructure, capped at a certain amount per lot, and do not adequately consider land acquisition costs associated with the provision of public and environmental spaces (parks, cultural and sporting facilities, riparian corridors). The latter is a major problem, particularly in cities like Sydney with high land prices.

The effect of these revenue constraints plays out most starkly in councils’ inability or failure to look after their existing basic infrastructure. Faced with expanding demands for human, cultural, educational, health and environmental services, councils find it difficult to renew their slowly declining roads or fix old pipes crumbling away, unseen, underground.

Local infrastructure renewal backlogs in NSW are estimated to be in the billions of dollars. In 2006, the Independent Inquiry into the Financial Sustainability of NSW Local Government found an infrastructure renewal backlog in NSW of $6.3 billion.\(^8\)

The NSW Treasury Corporation’s assessment of the financial sustainability of NSW councils undertaken in 2013 found that the total infrastructure backlog for NSW councils had increased from $5.8 billion in 2009 to $7.2 billion in 2012, with the main component of the infrastructure backlog in public roads at $4.4 billion as at 2012.\(^9\) The Local Government Infrastructure Audit undertaken by the Department of Premier and Cabinet, Division of Local Government, in 2013 confirmed the infrastructure funding crisis finding an infrastructure backlog of $7.4 billion at 30 June 2012.\(^10\)

This is a systemic problem, and not unique to NSW.

According to the National State of the Assets 2015 report commissioned by the Australian Local Government Association, $47 billion of local government infrastructure across Australia – approximately 11% of the total replacement value of an estimated $438 billion - is in poor or very poor state and requires renewal to meet intended service levels and upgrade to meet targets for safety, compliance, social, environmental and economic performance and to support growth trends.\(^11\)

**Additional Challenges**

The question of revenue adequacy extends beyond the size of the pie. It’s also about access to a flexible mix of revenue tools to address the diverse circumstances and challenges facing individual councils. For example:

- Councils experiencing significant population growth but hampered by rate pegging and development contribution caps would benefit from innovative funding tools to support and capture the value increase associated with new development and urban renewal;
- Councils with small rate bases would benefit from opportunities to improve their own-source revenue, making them less dependent on uncertain grant funding; and

\(^7\) See LGNSW’s cost shifting survey for specific examples and shortfall in cost recovery at www.lgnsw.org.au/policy/finance/cost-shifting-survey.


\(^10\) Department of Premier and Cabinet, Division of Local Government, Local Government Infrastructure Audit, (2013).

• Metropolitan councils whose communities demand a wide set of services would benefit from more autonomy and flexibility in terms of the revenue tools available to them.

Revenue raising capacity should also be sufficiently flexible to address broader challenges, including:

• an increasing number and complexity of regulatory and compliance responsibilities;
• rising community expectations for local services in the areas of health, aged care and child care, culture, education, and economic development;
• skills shortages;
• demographic challenges (ageing population, sea and tree changes);
• environmental pressures (climate change, water management, coastal protection); and
• geographic pressures in regional and rural areas (supplementing or back-filling state services).

Cost Shifting

Revenue raising limitations are exacerbated by the practice of “cost shifting” by other spheres of government - a significant burden totalling hundreds of millions of dollars each year which impedes local government’s ability to deliver services and maintain infrastructure. Cost shifting occurs whenever responsibility for or cost of providing a certain service, concession, asset or regulatory function is transferred from one sphere of government to another, without the provision of corresponding funding or revenue raising capacity.

Key cost shifting examples from the NSW Government to councils include contributions to the Fire and Rescue NSW, NSW Rural Fire Services and NSW State Emergency Service; funding for public libraries; and the NSW Government’s failure to reimburse for mandatory pensioner rebates on council rates. Councils are also denied sufficient financial resources for the responsibilities delegated to them to regulate development applications, deal with companion animals, manage contaminated land, control noxious weed, manage flood controls, or administer environmental regulation.

LGNSW research found the Australian and NSW Governments cost shifted $670 million to local government in 2013/14 – around 7% of Local Government’s total income before capital amounts. In absolute terms, cost shifting is estimated to have increased significantly from $380 million in 2005/06 to $670 million in 2013/14.

Source: LGNSW, Cost Shifting Survey.
Gains in Operational Efficiency

The revenue question also becomes more obvious considering the strong local government track record on resource sharing, along with continuous improvement and more effective and efficient service provision achievements.

NSW councils have implemented a comprehensive strategic service planning regime underpinned by robust asset management and long term financial planning (Integrated Planning and Reporting). This regime enables council to undertake genuine community consultation to identify the services and infrastructure the community requires, and what it is willing to pay. The process takes into account the trade-offs associated with delivering and performing a multitude of services and functions, and ensures council infrastructure and service provision are a genuine reflection of community need and demand.

The high rate of success in recent years of applications by councils for special rates over and above the rate pegging limit is evidence of these improvements. The applications are assessed by IPART stringently and require robust needs assessment to be embedded in the strategic service planning regime.

High levels of efficiency and a “doing-more-with-less” approach are not recent phenomena. As early as 2006, the Independent Inquiry into the Financial Sustainability of NSW Local Government found local government displayed high levels of managerial and administrative efficiency. In a benchmarking exercise using a methodology developed by the London Business School, the inquiry found nine sample councils were well placed compared to thousands of other private and public organisations around the world - including many local government bodies.\(^\text{12}\)

NSW councils actually outperformed most state government agencies. A related study applied benchmarks developed by the then NSW Council on the Cost and Quality of Government to 58 NSW councils, examining back office costs in relation to total expenditure. The research found NSW councils outclassed NSW Government benchmarks, and actually outperformed state government agencies to which they apply.\(^\text{13}\)

Councils proactively seek efficiency savings, evidenced by the fact that many councils have successfully entered into shared service arrangements and strategic partnerships - either through their regional organisation of councils or other strategic alliances - to capture economies of scale, improve regional planning and enhance the efficiency and effectiveness of service provision.

For example, council-owned and operated local water utilities have formed regional water alliances, such as the Centroc Water Utilities Alliance or the Lower Macquarie Water Utilities Alliance, to share resource and coordinate regional water supply and demand planning, asset management and workforce development. Meanwhile, many councils jointly manage domestic waste services or undertake joint procurement on a regional scale. Councils also have access to LGNSW’s Local Government Procurement facility to facilitate collective purchasing of goods and services for councils.

Conclusion

Good progress has been made when it comes to councils making expenditure and efficiency gains, but if we are to truly make councils financially sustainable, we must not shy away from the rest of the task. It is time to think beyond the current paradigms, and to open an honest and transparent discussion around the allocation of public functions and services, and how those functions and services are funded.

\(^\text{12}\) Ibid, Allan P et al, pages 245 to 249.
\(^\text{13}\) Ibid, pages 250 to 252.
This foreword highlights that:

- the revenue raising capacity of NSW councils is tightly constrained by rate pegging, the regulation of fees and charges and a narrow taxation base, to the extent that it is damaging the financial sustainability of councils;
- intergovernmental fiscal transfers to local government have failed to keep pace with economic growth and do not achieve full horizontal equalisation;
- there is significant cost shifting from the State and Commonwealth Governments onto local government, further undermining the financial base of councils; and
- NSW local government has a large infrastructure renewal backlog that a significant proportion of NSW councils will not be able to resolve under the current financial model. This finding has been verified through numerous sources.

At the same time, it is broadly agreed that local government is facing:

- ever increasing demands for existing services;
- growing demand for new services in response to changing community expectations, climate change and an ageing population; and
- the continuing imposition of new roles, responsibilities and standards onto local government by the State and Commonwealth Government (for example health and environmental standards).

As previously noted, the challenge is made more difficult to address because of the wide variance in the revenue raising capacity of different councils. This adds weight to the argument that there need to be larger and better targeted intergovernmental transfers.

We can no longer pretend that local government can meet new statutory obligations, deliver new services, or build the new infrastructure our communities desire without a broader and more flexible financial base. This needs to be the subject of a wide ranging debate.

The following discussion paper by Dr Enid Slack was commissioned for just such purpose. It goes beyond politics and parochialism to provide a foundation from which local government and its many stakeholders can finally talk about its revenue problem, and come to a meaningful consensus on the best ways to solve it.
Local councils across Australia face a number of challenges – demographics are changing, expenditure demands are becoming increasingly complex, cost shifting has resulted in increased expenditures at the local level, infrastructure is in need of repair, new infrastructure needs to be built, and more. At the same time, the revenues available to local councils to address these challenges have remained largely the same for decades – rates, user fees, and transfers from the Commonwealth and state governments. In other parts of the world (particularly in the US and Europe), local governments have access to many more revenue sources such as taxes on income, sales, fuel, and hotels.

Should local councils have access to more types of revenue? What are the appropriate sources of revenue for local councils? Are some sources better than others? How do we decide which are the best revenues? This discussion paper sets out a framework for analysing revenues for local councils, reviews existing revenue sources of local councils in New South Wales, and evaluates some potential new revenue options.

The outline of the paper is as follows: the first part provides an overview of local council expenditures and revenues in New South Wales followed by a brief description of local government revenue sources in other countries. The second part sets out a framework for selecting appropriate revenue sources for different types of expenditures and emphasises the need to link revenues to expenditures. The third part focuses on rates and property-related taxes including stamp duties and land value capture taxes. It also looks at development charges to pay for infrastructure. The fourth part focuses on the role of user fees in local government finance, provides some specific examples of where they could be used, and emphasises the need to use marginal cost pricing, wherever possible. The fifth part evaluates a range of other taxes that are levied at the local level in other countries, including taxes on income, sales, business, fuel, vehicles, and hotels. The sixth part discusses the rationale for intergovernmental transfers and identifies some potential problems with relying too heavily on them. The seventh part considers two financing tools: borrowing and public-private partnerships. The eighth part sets out some final observations on revenue options for local councils in New South Wales.

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1 This paper is certainly not the first to tackle the issues around financing local government in New South Wales specifically or Australia more generally. Indeed, there is a myriad of earlier studies, some of which will be referenced in this paper but many that will not, in part, because of length and, in part, because many of the studies are fairly consistent in their message. This paper will try to bring more of an international perspective on local government revenue issues.
1  Overview of Local Expenditures and Revenues

This section provides a brief overview of expenditures and revenues of local councils in New South Wales and then turns to a comparison with tax revenue sources in other OECD countries.

1.1  Local Expenditures and Revenues in New South Wales

Figure 1 shows local expenditures per capita in current and constant (2004) dollars for New South Wales local councils and all local councils in Australia. It shows that expenditures per capita have increased from $897 dollars per capita in New South Wales in 2004/5 to $966 per capita (in constant $2004) in 2013/14 or an annual average increase of 0.8 percent. For all local councils in Australia, expenditures per capita increased from $963 per capita in 2004/5 to $1,001 per capita (in constant $2004) in 2013/14, or an average annual growth rate of 0.4 percent.

The information in Figure 1 and subsequent figures provides averages for all local councils in New South Wales. There is much diversity across local councils, however. In particular, there are differences in geographic and demographic characteristics, the nature of the economy, incomes of residents, preferences for public services, and other factors.

Figure 2 shows that, in 2014, local councils in New South Wales spent the largest portion of their budgets (28 percent) on housing and community amenities (which includes water supply and street lighting) followed by transportation and communications (at 19 percent), and recreation and culture (at 14 percent). Over the period from 2004/5 to 2013/14, the largest increase in expenditures (in constant dollars per capita) was in education, housing and community amenities, and public debt transactions. Most other categories saw decreases over the same period.

Revenue-raising powers of local councils in Australia are set out in state legislation. Under Section 8 of the Local Government Act 1993, local councils in New South Wales have the authority to levy rates, charges, and fees. They are required to levy ordinary rates on an annual

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2 Expenditures per capita were deflated by the implicit price deflator for general government (state and local) final consumption expenditure.
3 The categories of expenditure are a bit misleading. For example, the category of housing and community amenities does not include much expenditure on housing but does include expenditures on land use planning and development control, environmental management services, domestic waste management, and flood mitigation. Transportation and communications primarily refers to roads.
basis but may also levy special rates to cover the costs of specific activities. Local councils are also required to impose an annual charge to fund domestic waste management services.

Figure 3 shows the distribution of revenue sources for local councils in New South Wales in 2014. It shows that sales of goods and services (user fees and charges) are the largest source of revenue for local councils in New South Wales, followed closely by taxes, other receipts, and grants and subsidies. For all local councils in Australia (not shown here), taxes account for 41 percent of local revenues followed by sales of goods and services at 30 percent. User fees and charges tend to be higher in states such as New South Wales where local authorities have responsibility for water supply and wastewater treatment and disposal outside the metropolitan area.

In terms of growth over time, Table 1 compares the distribution of local revenues in 2004/05 and 2013/14. Overall, local government revenues in constant dollars actually fell over the period -- by 0.3 percent per year, on average. Revenues fell in all categories except for sales of goods and services which increased over the nine-year period.

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Figure 2: Distribution of Municipal Expenditures by Category, New South Wales, 2013-14

- General public services: 14%
- Public order and safety: 3%
- Education: 1%
- Health: 1%
- Social security and welfare: 4%
- Housing and community amenities: 28%
- Transport and communications: 19%
- Agriculture, forestry and fishing: 0%
- Mining, manufacturing and construction: 2%
- Fuel and energy: 0%
- Recreation and culture: 14%
- Other purposes: 9%
- Other economic affairs: 3%
- Public debt transactions: 2%

Source: ABS Catalogue No. 5512.0

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4 It is important to note that taxation revenue includes rates (land taxation) as well as some fixed charges for water supply and sewerage and domestic waste services. Technically, these charges should be included under sales of goods and services but they cannot be disaggregated. Sales of goods and services include usage-based charges for water and sewerage and domestic waste as well as charges and fees for regulatory activities. Other revenue includes fines and developer contributions, rents, and other current and capital revenues. Developer charges for water and sewerage services are included in other revenue as well.
Table 1: Distribution of Local Revenue Sources, New South Wales, 2004/05 and 2013/14

| Source: ABS Catalogue Nos. 5512.0, 5206.0, and 3101.0.
<table>
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</thead>
<tbody>
<tr>
<td></td>
<td>2004-05 $m</td>
<td>%</td>
<td>2013-14 $m</td>
<td>%</td>
<td>Annual average growth in per capita constant 2004$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes</td>
<td>2,759</td>
<td>38.0</td>
<td>3,839</td>
<td>34.7</td>
<td>-1.3%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales of goods and services</td>
<td>2,270</td>
<td>31.3</td>
<td>4,062</td>
<td>36.8</td>
<td>1.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grants and subsidies</td>
<td>882</td>
<td>12.2</td>
<td>1,198</td>
<td>10.8</td>
<td>-1.6%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other receipts</td>
<td>1,341</td>
<td>18.5</td>
<td>1,951</td>
<td>17.7</td>
<td>-0.8%</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total revenues from operating activities</strong></td>
<td><strong>7,252</strong></td>
<td><strong>100.0</strong></td>
<td><strong>11,051</strong></td>
<td><strong>100.0</strong></td>
<td><strong>-0.3%</strong></td>
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</tbody>
</table>

Compared to other spheres of government, local governments raise a very small share of total taxes and can only levy a property tax (rates). Table 2 shows that the largest share of taxation revenue in 2013-14 was collected by the Commonwealth government and most of this revenue was from income taxes. For taxes on the provision of goods and services, only the Commonwealth government levies the GST but state governments levy some other taxes in this category as well as taxes on the use of goods and performance activities. State governments raise more property taxes than local governments but these are predominantly stamp duties. Previous estimates of the breakdown of taxes by sphere of government suggest that the local government share has not changed significantly over the last two decades (see Comrie 2013). The local share started to decline in the late 90s but has increased somewhat since 2008/9.
Table 2: Taxation Revenue by Sphere of Government, Australia, 2013-14

<table>
<thead>
<tr>
<th></th>
<th>Federal</th>
<th>State</th>
<th>Local</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes on income</td>
<td>57</td>
<td>0</td>
<td>0</td>
<td>57</td>
</tr>
<tr>
<td>Employer payroll taxes</td>
<td>0</td>
<td>5</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Taxes on property</td>
<td>0</td>
<td>6</td>
<td>3</td>
<td>9</td>
</tr>
<tr>
<td>Taxes on provision of goods and services</td>
<td>21</td>
<td>3</td>
<td>0</td>
<td>24</td>
</tr>
<tr>
<td>Taxes on use of goods and performance activities</td>
<td>2</td>
<td>2</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Total</td>
<td>81</td>
<td>16</td>
<td>3</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Derived from ABS Catalogue No. 5506.0

1.2 Tax Sources in Selected OECD Countries

Local taxes in Australia not only account for a much smaller share of total taxes than in other countries, they account for a much smaller share of Gross Domestic Product (GDP) (see Table 3). Moreover, local governments in Australia depend much more heavily on rates than local governments in other countries – Australian local councils rely on rates for 100 percent of their tax revenues; local governments in many other parts of the world rely on a mix of taxes to pay for local expenditures. The diversity of local tax revenues in eight federal, one regional, and 25 unitary countries in the Organisation for Economic Cooperation and Development (OECD) for 2013 is shown in Table 3.
Income taxes accounted for more than 50 per cent of local tax revenue in 13 of the 34 countries. Sales taxes are the most important local tax source in three countries and they provided 10 per cent or more of local taxes in 12 countries. Although local governments in all countries levy property taxes to some extent, they are the most important local revenue source in only 12 countries. They accounted for more than 10 per cent of local taxes in 30 countries, but only more than 90 per cent of local taxes in six countries (Australia, Canada, Greece, Israel, New Zealand, and the United Kingdom). The only countries with a balanced local revenue structure in the sense that it is not dominated by just one tax (i.e. no tax accounts for 50 per cent or more of total taxes) are Italy, Korea, Portugal, and Spain.

It is not possible to draw definitive conclusions about the patterns of local taxation across countries because access of local governments to a specific tax or taxes depends on several factors including, for example, constitutional and legislative requirements; the willingness of senior governments to assign taxes to local governments; the types of expenditures that local governments need to fund; and the ability of local governments to levy taxes.
governments are required to fund; and the local government’s capacity to administer the tax. Nevertheless, a few observations can be made. With a few exceptions, where local taxes are a comparatively high percentage of total tax revenue and GDP, local governments tend to rely more heavily on local income taxes (Brülhart, Bucovetsky, and Schmidheiny 2014). For example, local governments in Nordic countries rely heavily on income taxes. Local governments in countries that, in the past, were part of the British Commonwealth or significantly influenced by the British Empire, rely almost exclusively on property taxes. Local sales taxes are relatively less important, on average, in federal countries than they are in unitary countries. The relative importance of local taxes in general in a country’s overall tax system and as a percent of GDP is generally less in federal countries than in unitary countries – in federal countries, state or provincial governments collect some taxes which are in the domain of local government in unitary countries.
2 Framework for Selecting Revenue Sources

For governments to operate efficiently, it is important to establish a clear link between expenditure and revenue decisions – those who make expenditure decisions should also make revenue decisions and the revenue tool should match the type of expenditure being funded. Sometimes referred to as the Wicksellian Connection, this linkage should result in more accountable government with taxpayers being less averse to paying taxes as long as they know where their tax dollars are being spent. In the Australian context, for example, Comrie (2013) suggests that increases in rates by some local councils have been accepted without a negative reaction in part because rating decisions have regard for the benefits received (and capacity to pay) of particular property taxpayer classes.

Since the benefit principle in the sense of a link between taxation and expenditures is central to achieving the aims of fiscal decentralisation, charging for public services and earmarking revenues to the services provided should be equally central to a sound local finance system (Bird and Slack 2014). In such a system, expenditure responsibilities would be matched with revenue resources, revenue capacities matched with political accountability, and benefit areas matched with funding areas.

Different revenues are appropriate to pay for different services (Slack 2009). For those services with private good characteristics (such as water, sewers, garbage collection and disposal, transit, and most recreation), user fees and charges are efficient and fair. In general, user fees and charges should be adopted wherever there is a clear link between the fee charged and the benefit received. When this link is in place, the user is able to choose the amount he or she wishes to consume. Equity concerns can be addressed in a couple of ways, either through targeting lower income individuals through federal or state income transfer programs or by lowering or waiving fees for low-income users. This point is discussed further in the section on user fees and charges below.

Services with public good characteristics (for example, fire protection, neighbourhood parks, local streets, and street lighting) generate collective benefits that are enjoyed by local residents. Benefits from these services cannot easily be assigned to individual beneficiaries and therefore it is difficult to levy specific fees or charges. In lieu of fees or charges, then, some form of local benefit-based taxation such as the property tax should be adopted. This type of tax permits individuals to express their collective demand for services. In this respect, the property tax is considered to be a generalised, or non-specific, user charge/fee (Kneebone and McKenzie 2003). A local sales tax or personal income tax could also be used to pay for services with public good characteristics.

There are other services where the benefits (or costs) spill over municipal boundaries but where local provision is still desirable. Positive spillovers (externalities) occur if residents of neighbouring jurisdictions receive a service for free or at less than the cost of providing the service. For example, major roads constructed in one jurisdiction may be used by residents of another jurisdiction without any charge to the latter. The result is an under-allocation of resources for that service because the providing jurisdiction bases its expenditure decisions on the benefits captured within its geographic boundaries alone. It does not take account of the benefits that accrue to those outside the jurisdiction. One way to provide an incentive to the local government to allocate more resources to the service generating the externality is a transfer from the federal or state government. Services that redistribute income should be funded from income tax revenues because it is the most progressive tax available. For local governments, these services include social assistance, for example.

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5 For more on the Wicksellian connection and its application to financing local public services, see Bird and Slack (2014) and Slack and Bird (2015).
6 Other reasons given include that rates reflect community service level preferences and that local councils have been able to communicate the need for rate increases (Comrie 2013). Of course, the unique circumstance of rate pegging in New South Wales breaks the connection between expenditure and revenue decisions and will be discussed further below.
7 Other ways to internalise externalities would be to have the service provided at a metropolitan or regional level or by the state government.
3 Rates and Property Related Taxes

The property tax (rates) satisfies many of the characteristics of a fiscally sound local tax (see Box 1). Land is largely immobile and not very responsive to price, which means that it can be taxed without distorting economic behaviour very much (Mirrlees 2010). It is effective in funding, partially at least, those services whose collective benefits accrue to the local community; hence, it satisfies the fairness based on benefits-received criterion. Revenues are relatively stable and predictable. It is highly visible so it makes local governments accountable for the tax levied. A potential downside of a local property tax is that it may be more expensive to administer than other local taxes (income, sales, fuel, for example) that could be piggybacked onto existing Commonwealth or state taxes. This cost may be a small price to pay, however, if local governments are to have autonomy and flexibility in setting tax policy - important ingredients of responsible, efficient, and accountable local governments (Bird 2011).

Box 1: What are the Characteristics of a Good Local Tax?

- **Fairness based on ability to pay**: the tax is fair in terms of people’s ability to pay the tax;
- **Fairness based on benefits received**: the tax is fair if the burden is distributed in accordance with the benefits received from local services;
- **Efficiency**: distortions in economic behaviour (such as where to live or work, whether to invest in home improvements, where to locate a business, or other economic decisions) are minimised;
- **No harmful competition**: the tax does not result in harmful competition between local governments or local governments and senior levels of government;
- **Sufficient, stable and predictable revenues**: the tax generates sufficient, stable and predictable revenues for local governments plus the tax should not result in changes over time that cannot reasonably be anticipated by taxpayers;
- **Visible, transparent, and accountable**: the tax is visible and transparent to taxpayers so that governments can be held accountable to taxpayers for the cost of government services; and
- **Ease of administration**: the tax is easy to administer locally.

Local councils in New South Wales are required to levy ordinary rates annually and, under certain circumstances, may also levy special rates to cover the costs of specific activities. Properties are divided into four classes to which different rates can apply: farmland, residential, mining, and business. In some cases, local councils can establish sub-categories of properties to allow for differential rates. To calculate rates, councils apply an *ad valorem* charge as a percentage of the unimproved land value of the property. Although rates are primarily determined through the *ad valorem* method, local councils are permitted, if they choose, to set a minimum amount of tax which is a flat charge that applies to properties with a value below a particular threshold. Local councils are also permitted to set a base amount which is a fixed charge that is levied against all rateable properties within a given category or subcategory of land use. Revenue generated from the base amount cannot exceed 50 percent of the total revenue from any particular rating category.

3.1 Tax Base

Rates in New South Wales are levied on land only. Other bases that are used in other parts of Australia and other countries around the world include market value (also known as capital improved value) which includes land and improvements, and rental value. Most OECD

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8 Of course, no one tax can satisfy all of these characteristics.
9 Rate pegging in New South Wales means that local councils have limited autonomy or flexibility to set tax rates. The issue of rate pegging will be discussed further below.
10 For a discussion of the characteristics of a good local tax, see, for example, Bird and Slack (2004) and Vancouver Property Tax Policy Review Commission (2014).
countries levy the property tax on market value. As will be shown below, each tax base has advantages and disadvantages.

3.1.1 Land Value (unimproved capital value or site value)
Going back to Henry George, a tax on land was believed to be the most efficient tax because it does not discourage investment in new buildings. In principle, a tax on land value taxes location rents defined as the returns from a particular location regardless of the improvements to the site. Since improvements to land (such as structures) are not taxed, the owner has an incentive to develop the land to its most profitable use. A land value tax would thus not discourage investment in the same way as a property tax on land and buildings. Assuming the tax base reflects the highest and best use of the property, a land value tax is said to be neutral with respect to timing, location, and density of development.

Assuming the tax base reflects the highest and best use of the property, a land value tax is said to be neutral with respect to timing, location, and density of development. Assuming land is in fixed supply (the supply of land offered for development is unresponsive to price changes), a tax on land falls on landowners and cannot be shifted to others. Increased land value taxes will thus be capitalised into lower property values. Since the tax is borne proportionately more by owners of land than is the case with a tax on both land and improvements, and since landownership is unequally distributed, such a tax should be more progressive (borne relatively more heavily by high-income taxpayers than low-income taxpayers).

Land value is not likely to be as good an indicator of ability to pay tax than a tax on improved capital value, however, especially when it comes to high-density properties (Comrie 2013). For example, under a land value tax, the rates payable by each apartment owner in an apartment block with ten apartments (with the same land value as a single-family house) would be one tenth of those payable by the single-family homeowner. If their capital improved values were the same, however, they would presumably have similar ability to pay taxes and would, indeed, pay similar taxes under a capital improved value system. As a result, many authors have questioned the fairness of land value taxation in this context (see, for example, IPART 2016).

Problems have also been identified with the implementation of land value taxation, particularly in highly developed inner cities. If there were a competitive market for land with a large number of transactions, then the value of land would be directly observable. The reality, however, is that there are few transactions of only land and thus, it is difficult to determine the land value (Mirrlees 2010). In the inner cities of New South Wales, for example, the paucity of sales requires assessors to rely on sales in adjacent neighbourhoods to determine land values: “extrapolation of meager sales evidence over an entire jurisdiction can create problems with uniformity of assessed values and result in taxpayer challenges” (Franzsen 2009, p. 46). Moreover, the few sales of vacant land may mean that the few remaining parcels command unrealistically high comparable values.

Another problem with land value taxation is that the potential revenues that can be collected from the tax are smaller than with a tax on land and buildings because the tax base is considerably smaller. To collect comparable revenues, a higher rate of tax is thus needed. It is likely to be politically easier to levy a lower property tax rate on land and improvements than a higher tax rate on the land portion only. A land tax may also be more volatile than a tax on market value and thus has to be administered more carefully to avoid taxpayer resistance.

11 Empirical evidence on the impact of land value taxation on development in the US is mixed. In Pennsylvania where a split tax rate is used (with a higher tax on land than improvements), some authors found no relationship between the tax and the level of building activity (Mathis and Zech 1982) whereas others found that the split-rate tax had a significant impact on residential building activity in some cities (Bourassa, 1990), and yet others found that a split-rate tax resulted in a 3 to 4 percent increase in residential construction (Plasman and Tideman 2000). One study estimated a positive impact of an increase in the tax rate on land in Pittsburgh on building activity, although most of the increase was probably attributable to a shortage of commercial space (Oates and Schwab 1997). For a description of the use of land value taxation in the US, see Bourassa (2009).
### 3.1.2 Market Value (capital improved value)

Market value (or capital improved value) estimates the value that the market places on individual properties—land and improvements. Market value is defined as the price that would be struck between a willing buyer and a willing seller in an arm’s length transaction. Three methods are commonly used to estimate market value:

- **The comparable sales** approach looks at valid sales of properties that are similar to the property being assessed. It is used when the market is active and similar properties are being sold.
- **The depreciated cost** approach values property by estimating the land value as if it were vacant and adding the cost of replacing the buildings and other improvements to that value. This approach is generally used when the property is relatively new, there are no comparable sales, and the improvements are unique. The cost approach is also normally used to assess industrial properties.
- **Under the income approach**, the assessor estimates the potential gross rental income the property could produce and deducts operating expenditures. The resulting annual net operating income is converted to a capital value using a capitalisation rate. This approach is used mainly for properties that have rental income.

Under a market value system, taxes may be less efficient than under a land value system because they discourage investment in property—as any improvement to the property will result in a higher assessed value and higher property taxes. Nevertheless, market value may do a better job of meeting the benefit principle of taxation. As an example, an apartment block with many residents will derive more benefits from local services for a comparable land value than a single-family home (IPART 2016). It also scores higher on the ability to pay principle because ratepayers living in more expensive properties are expected, on average, to have greater ability to pay property rates. As noted above, market value represents a larger tax base than unimproved land value and thus, to collect the same amount of revenue, will require a lower tax rate. Lastly, market value is more easily understood by taxpayers who generally have a good idea about what their property would sell for; they are less likely to know the value of their land alone.

### 3.1.3 Rental Value

Under the rental value (or annual value) approach, property is assessed according to estimated (not actual) rental value or net rent. One rationale for using rental value is that taxes are paid from income (a flow) rather than from wealth (a stock) and thus it is appropriate to tax the net rental value of real property. In theory, however, there should be no difference between a tax on market value and a tax on rental value: the discounted stream of net rental payments will be approximately equal to market value.

This relationship does not always hold, however, because most countries tend to assess rental value on the basis of current use. A property that is under-utilised—that is, currently used for a purpose less productive than other possible uses—would be assessed at a much lower value under the rental value approach than under the market value approach. From a land use perspective, a tax based on value in highest and best use is more efficient than a tax based on current use because it stimulates use to its highest potential by increasing the cost of holding unused or under-used land (as compared to developed land). Moreover, because vacant land is not taxable under a rental value system (since there is no current use), an incentive is created for low return uses over high return uses and it may even become worthwhile to
withhold rental properties from the market altogether.\textsuperscript{13} Rental value is often difficult to estimate because assessors may not have access to rental income information, rental income is not always in the public domain in the same way as are sales prices, and there is little information on the annual rent of comparable properties for unique commercial and industrial properties such as steel mills, for example.

### 3.1.4 Exemptions

Under Section 555 of the \textit{Local Government Act} in New South Wales, properties that are exempt from rates are listed.\textsuperscript{14} As in many other jurisdictions around the world, exemptions apply to many types of land including religious, charitable, and educational uses; government property;\textsuperscript{15} oyster cultivation and cattle dipping and land leased for mineral claims; Aboriginal land; cemeteries; public places; libraries; and more.\textsuperscript{16}

Exemptions have been criticised on a number of grounds:

- Since many of the exempt properties use municipal services like others who occupy space, they should be taxed (Bahl and Linn 1992).
- Since taxed properties face higher costs than exempt properties, economic competition among businesses and between businesses and government is distorted (Kitchen and Vaillancourt 1990).
- Differential tax treatment affects location decisions, choices about what activities to undertake, and other economic decisions.
- Exemptions narrow the tax base and either increase taxes on the remaining taxpayers or reduce the level of local services.
- Since the proportion of tax-exempt properties varies by local government area, disproportionate tax burdens are created across communities. This result is especially troublesome when higher-level governments determine what is exempt from local taxation.

To the extent that exempt properties are making use of local services, both efficiency and equity dictate that they should pay for those services. Reducing the number of exemptions will increase fairness and reduce rates. For those land uses that do require relief, rebates of taxes would be more transparent than exemptions and would receive greater scrutiny on an annual basis (Deloitte Access Economics 2013).

### 3.1.5 Concessions

Throughout Australia, local governments are mandated to provide concessions on rates to seniors on fixed incomes for their principal place of residence. Although it is generally true that “better off people live in more expensive houses” (Mirrlees 2010, p. 388), property taxes can create liquidity problems for some taxpayers. The tax does not reflect a real cash flow but rather an imputed one that may not necessarily reflect the owner’s current situation (Johannesson-Linden and Gayer 2012). The imperfect association between homeowner incomes and property tax liabilities may create problems for some taxpayers, especially seniors on a fixed income.

One way to address cash-flow problems is to provide tax relief to seniors through tax deferral schemes. Property tax deferrals permit the property owner to defer some or all property taxes. The outstanding amount becomes a lien against the property and is payable when the property is transferred. It is a deferral of taxes and not a tax rebate. In some cases, an interest charge

\textsuperscript{13} As noted above, if rental value were based on highest and best use, then vacant land would be taxable; the value would have to be estimated on the basis of other properties. Even if rental value were based on current use, it might be possible to assign a non-zero value to vacant land.

\textsuperscript{14} Section 556 provides for exemptions of further lands from all rates, with the exception of water supply and sewerage; sections 557 and 558 allow for exemptions from water supply and sewerage special rates, under certain circumstances.

\textsuperscript{15} In Canada and a few other countries, governments make payments in lieu of taxes on their properties; such payments are generally negotiated between governments and are often less than the property taxes would be.

\textsuperscript{16} For a detailed description and analysis of exemptions, see Deloitte Access Economics (2013).
(often below the market rate of interest) applies to the deferred taxes. Although the economic arguments for using tax deferral schemes are strong, such schemes have not been particularly popular among taxpayers and thus not popular politically. The take-up rate in those places that offer them has been extremely low in the past “… largely owing to the strong attachment of the old to their homes and to their desire to leave them unencumbered for their heirs” (Bird and Slack 1978). Some authors have suggested, however, that with an aging population and interest in reverse mortgages, the take-up rate is likely to increase (Haveman and Sexton 2008).

Although rate revenue losses from state mandated concessions are fully rebated in some states, only 55 percent is rebated in New South Wales. Since redistribution is not generally considered an appropriate role for local governments, Local Government NSW and others have argued that local governments should not be required to cover the costs of income assistance programs such as rate concessions. Rather, the foregone revenues should be made up from income tax revenues (ALGA 2015).

Box 2: Property Tax Deferral Program in British Columbia
Some property taxpayers in British Columbia can apply for a low-interest loan to pay for the property taxes on their principal residence.

Eligibility: The taxpayer has to be 55 or older, a surviving spouse of any age, or a person with disabilities. Families with children may also qualify.

How it Works: A portion or all of property taxes can be deferred. The provincial government pays the unpaid property taxes. When a taxpayer carries a property tax deferment balance, the province registers a restricted lien against the property. The outstanding balance must be repaid before the property is sold, the property owner changes (other than adding a spouse), or the property is refinanced. Interest is calculated every month. Interest rates are set every six months and are much higher for the families with children program than the regular program.

The progressivity of rates can also be enhanced by measures designed to reduce or eliminate the tax liability on low-income taxpayers. For example, the tax could apply only to property values above a certain threshold, such as the homestead exemptions provided in parts of Canada and the United States. Homestead exemptions lower the assessed value of owner-occupied principal residences and can be set at a dollar amount or as a percentage of assessed value. If a dollar amount is used, the exemption will be more progressive because it will be a higher percentage of a low-valued property.

Circuit breakers or property tax credits target assistance to low-income and elderly residents whose taxes exceed a certain percentage of their income (Haveman and Sexton 2008). The threshold could be based on income only or combined with age or family requirements. With both homestead exemptions and circuit-breakers, the foregone tax revenues are made up by state or local governments. In the Australian context where income taxes are levied by the Commonwealth government, circuit breakers would reduce Commonwealth taxes.

3.2 Tax Rates

Two major issues arise with respect to tax rates: who sets them? Are they differentiated, and if so, how?

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17 It is not recommended that tax deferrals be expanded to include the non-elderly because the loans would be outstanding for a much longer period of time and it would be necessary to determine eligibility to receive a referral to ensure a reasonable number of beneficiaries. Deferral schemes may be funded by national or state governments if they wish to compensate local governments for revenues forgone.

18 For a detailed discussion of this approach, see Bird and Slack (1978) or Haveman and Sexton (2008).
3.2.1 Who Sets Tax Rates?
Looking around the world, we see that property tax rates are sometimes set by the national or state government; sometimes there is local discretion, within centrally-set limits; and sometimes there is complete local discretion. Even where rates are locally determined, they are often limited by the national government. For a local government to make efficient fiscal decisions, however, it must weigh the benefits (at the margin) of proposed services against the costs of providing them. As noted in section 2, if local governments do not finance services themselves, the connection between expenditures and revenues is lost and the choice of services will not be based on an accurate perception of their cost (Bird and Slack 2014). Setting local tax rates places accountability for tax decisions at the local level, and increased accountability may lead to better local services (Hoffman and Gibson 2005).

Local determination of tax rates is particularly important in countries where a senior government determines the tax base. Local tax rates on non-residential properties may have to be set within limits, however, to avoid distortions. A minimum tax rate may be needed to avoid distorting tax competition. Richer local governments may choose to lower tax rates to attract business. With their larger tax bases, they can provide equivalent services at lower rates than poorer competing regions. Even when the resulting location shifts are not allocatively distorting they are generally politically unwelcome. A maximum tax rate may also be needed to prevent distorting tax exporting, whereby local governments levy higher tax rates on industries in the belief that the ultimate tax burden will be borne by non-residents. Such tax exporting severs the connection between payers and beneficiaries and renders decentralised decision-making about taxing and spending inefficient.

Perhaps the most controversial aspect of rates in New South Wales is rate pegging which limits the amount of allowable increase in council general income. Under section 506 of the Local Government Act, the state government sets the maximum amount that a council can increase its general income for the year based on the Local Government Cost Index (LGCI) which measures price changes for goods, materials, and labour over the year and is adjusted for productivity improvements. For 2016/17, the rate peg is 1.8 percent. The Independent Pricing and Regulatory Tribunal (IPART) sets the rate peg under a delegation from the Minister of Local Government. Councils can apply to IPART for a special variation to allow them to increase general income above the rate peg for reasons such as the need to provide additional services or replace aging infrastructure. The special rate variations may apply for one year or multi-years (between two and seven years).

Rate pegging (referred to as tax levy limits in the US) are common in many US states where a number of state governments set a maximum allowable annual percentage increase in the property tax levy. Although they are popular with taxpayers, they have been highly criticised in a number of studies. Two major problems, in particular, have been identified (Haveman and Sexton 2008): first, tax limits do not target relief to needy taxpayers. Rather, they lower taxes on all types of property. Moreover, if a reduction in local services results from tax limits being imposed, it will impose a burden on those residents that most need those services. Second, because tax limits apply to tax collections throughout the jurisdiction, they do not protect individual taxpayers from higher tax burdens arising from a reassessment nor do they prevent redistribution of the tax burden within and between property classes. If land values increase at different rates, the tax burden will shift towards those properties whose values are increasing most rapidly.

State government restrictions on local tax rates also occur in some North American jurisdictions in the context of tax increases arising from a reassessment of property values. In the 1970s, a tax increase arising from a reassessment without a corresponding decrease in tax rates in California, led to a tax revolt and the subsequent introduction of Proposition 13 in 1978 which...
restricted assessment and tax increases. Today, some state governments require local
governments to roll back the tax rate so that the reassessment is revenue neutral. Other state
governments require fiscal disclosure of tax rate changes. Also known as truth in taxation, fiscal
disclosure requires local councils to put the revenue-neutral local tax rate on the tax bill
following a reassessment.\textsuperscript{21} Any tax rate above that amount would be noted as a tax levy
increase for that year. In other words, an assessment increase has to be met with a
corresponding tax decrease or be recorded on the local tax bill as a tax increase for taxpayers
to see. Fiscal disclosure provides an incentive to local councils to reduce tax rates when
assessments increase. It means, however, that local officials have to forego the “invisible"
revenue increases that can accompany an assessment increase without a corresponding
decrease in tax rates (Youngman 2016).

Although there are merits to fiscal disclosure following a reassessment, rate pegging (tax levy
limits) breaks the important link between tax and expenditure decisions, discussed earlier. It
reduces the accountability of local councils, erodes local government autonomy, and creates an
unrealistic expectation in the community that rates should not increase beyond the peg, even
when larger increases are needed.\textsuperscript{22} Local councils are directly elected and, if the electorate
does not approve of rate increases, they have the opportunity to vote out the council at the next
election. The Henry Review (2009) correctly argued that state governments should allow local
governments a substantial degree of autonomy to set the tax rate applicable to properties within
their local government area.

3.2.2 Are Tax Rates Differentiated by Property Class?
In New South Wales, as noted earlier, properties are differentiated by property class: farmland,
residential, mining, and business. Local councils can also differentiate rates by sub-categories
of properties. Variable tax rates (or other differentiation of property taxes among property
classes) may be justified on a number of grounds. For example, the benefits from local public
services are different for different property classes. In particular, a case can be made on these
grounds for taxing non-residential properties less than residential properties (Kitchen and Slack
1993). Since business capital tends to be more mobile than residential capital, efficiency
arguments also lead to the conclusion that business property should be taxed more lightly than
residential property. In reality, however, lower rates are most often applied to residential
properties, presumably for political reasons.\textsuperscript{23}

There is little economic rationale for higher taxation of non-residential property. Differentially
higher taxation distorts land use decisions and favors residential use over commercial and
industrial use (Maurer and Paugam 2000). Special taxation of one factor of production (real
property) may also distort productive efficiency by inducing a different choice of factor mix in
producing goods and services. However, politics often produces such discrimination:
homeowners are much more likely to vote in local elections than renters and, while the
incidence of non-residential taxes is seldom clear, non-resident owners and consumers who
may bear some of the burden of such taxes have no vote (although political contributions and
connections may give them some voice in the local political process).

Farm properties are favoured in the property tax system in many countries as part of a more
general policy of protecting farmland.\textsuperscript{24} Favourable treatment of agricultural land is usually
designed to preserve it from conversion to urban use. It may be, however, that basing the
property tax on value in current use is not sufficient to preserve farmland because, given the

\textsuperscript{21} In Ontario, for example, municipalities can hold tax rates constant (or increase them) when assessments increase but
they have to report it as a tax increase on tax bills.
\textsuperscript{22} Evidence also shows that rate pegging has dampened the revenue raised from rates in New South Wales
(Productivity Commission 2008).
\textsuperscript{23} At the extreme, the commercial tax rate in Poland is more than 30 times the residential tax rate (Swianiewicz and
Lukomska 2013), although property taxes overall are not very large.
\textsuperscript{24} A common way to favour farm properties is to assess them at the value in current use rather than market value which
reflects the highest and best use. This means that the value of a farm is determined by its selling price if it were to
continue to be used as a farm. Alternative uses of the farm, or its speculative value, are not considered in the
determination of value. Other ways of favouring farm properties include providing exemptions for part or all of the farm
property, lowering tax rates on farms, or providing farm tax rebates.
generally low effective tax rates on land, the resulting tax differential is unlikely to be large enough to compensate for the much higher prices that would be paid if the land were converted to urban use (Maurer and Paugam 2000). Moreover, favourable treatment of rural land can increase speculation at the urban fringe and increase urban land prices.

3.3 Stamp Duties

Stamp duties have a long history in the UK going back to 1694. Also known as land transfer taxes, stamp duties are currently levied only by state governments in Australia. In other parts of the world, however, stamp duties are levied by local governments, generally by piggybacking onto the state/provincial tax. A municipal land transfer tax (MLTT) is levied by some local governments in Canada (by the City of Toronto as well as some municipalities in Nova Scotia and Quebec and Manitoba). Although a stamp duty could potentially bring in significant revenues for local councils if they were allowed to adopt them, it is not considered to be a good local tax because it:

- bears no relationship to the benefits received from local services;
- provides a disincentive for people and businesses to move, thereby resulting in potential inflexibilities in the labour market and encouraging people to stay in properties of a size and location that they may not have otherwise chosen (Mirrlees 2010);  
- is not equitable because those who move frequently face higher costs than those who stay in the same property (Australian Government 2015);
- imposes a burden on those who buy property while placing no burden on those who remain in their existing property;
- provides an incentive for those who remain in their homes to demand municipal services, knowing that those residents who buy homes will disproportionately pay for those services; and
- can, unlike the property tax, result in revenues that are volatile and unsustainable (Australian Government 2015).

Governments that are concerned with efficient land use and where land transfer taxes are imposed at high rates would seem well advised to consider lowering such taxes and making up any revenue loss by, for instance, strengthening basic property taxes. The Henry Review (2009) in Australia, the Mirrlees Review in the United Kingdom, and a number of authors in Canada have suggested that increased reliance on property taxes would be much preferable to stamp duties. Stamp duties can be very lucrative, however, and difficult for politicians to eliminate once they are in place.

3.4 Land Value Capture Taxes

The idea behind land value capture is to recoup some or all of the unearned increment in private land values arising from public investment or a change in regulations. According to the benefits received principle, this tax is levied on those who benefit from the public investment in roads, transit, water and sewerage systems, and other major infrastructure through increased land values. It has been argued that, at least some of that increase in land value should be captured by governments to pay for the infrastructure. Similarly, land value capture can be used

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25 Stamp duties are the second largest source of tax revenue for Australian states and territories.

26 Toronto’s municipal land transfer tax rate is 0.5 per cent on homes valued from $0 to $55,000; 1.0 per cent on homes valued from $55,000 to $400,000; and 2.0 per cent on homes in excess of $400,000. In 2014, revenues from the tax were more than $400 million.

27 Two empirical studies on housing prices and household mobility in Toronto concluded that sales of single-family homes in the city fell by 16 per cent after the implementation of the MLTT with the most pronounced effect in areas with relatively low sales values. One study also concluded that homeowners chose to renovate rather than relocate (Dachis et al. 2008; Dachis 2012). It was estimated that the MLTT resulted in reduced household mobility, with about 3,500 families that would have moved not doing so because of the tax (Dachis et al. 2008). Another study suggested, however, that the decline in housing sales in Toronto in 2008 can also be attributed to macro-economic factors and market regulations (Haider, Anwar, and Holmes 2016).

28 The Australian Capital Territory (ACT) Government is currently in the process of abolishing stamp duties and expanding the property tax base.
when there is a change in regulations, such as allowing increased density, which will also have a positive impact on land values.

Land value capture has been recommended to pay for infrastructure in Australia (see, for example, the Business Council of Australia, PwC, and the Productivity Commission). Although studies have shown that there are financial windfalls from transportation investments in various parts of the country, there is currently no mechanism to capture these gains to pay for the infrastructure (Langley 2015). Indeed, it has been estimated that a land value capture program could contribute between 10 and 30 percent of directly related infrastructure costs within a defined improvement district (Langley 2015). Council rates may not be suitable for value capture methods in New South Wales, however, because of the restrictions created by rate pegging.

There are several methods to capture land value increases arising from public investment or a change in regulations; three examples follow—betterment levies, tax increment financing, and the sale of building rights. In all cases, it is necessary to measure the increase in land value arising from an investment or from the change in regulations relative to other factors that also impact land value, and that is not always a straightforward exercise (ALGA 2016).

### 3.4.1 Betterment Levies

Betterment levies (also known as special assessments) are direct charges on owners of select properties to pay for infrastructure or services that benefit their properties. The charge can be levied upfront as a one-time levy or on an annual basis. London, for example, introduced a business rate supplement of 2 percent to the value of non-domestic properties over a 30-year period to pay for a portion of the $7.6 billion total cost of the Crossrail project, a new high frequency, high capacity railway for London and the South East (Langley 2015).

In New South Wales, local councils are permitted to levy special rates in certain circumstances. Under section 495 of the *Local Government Act, 1993*, the special rate is to be levied on such ratable land in the council’s area that it deems to benefit or will benefit the “works, services, facilities, or activities” or contributes or will contribute to the need for them or has or will have access to them. Councils can levy different special rates for different kinds of works or for the same works in different parts of its area. These works include, for example, the extension of water supply networks and drainage systems. Special rates are part of the general income that is subject to rate pegging, however, so they cannot be used to increase revenue unless NSW councils successfully apply for a special rate variation (SRV). The exception is water and sewerage rates which are excluded from general income and could be used for land value capture purposes.

### 3.4.2 Tax increment financing

Tax increment financing (TIF) is widely used by US cities as an economic development tool to encourage the redevelopment of areas in need of revitalisation and brownfield remediation. TIFs were first introduced in California in 1952 and, since that time, they have spread to almost all US states (except Arizona). They are probably most widely used in Chicago where, by 2005, 10 percent of all property taxes were earmarked for TIF purposes and TIF districts covered more than 25 percent of the geographic area of the city (Quigley 2007).

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29 Brownfields are urban sites that are under-utilised, often vacant, and sometimes contaminated. Because of their proximity to downtown areas where infrastructure is generally in place, brownfields hold a great deal of potential for redevelopment. The realisation of this potential is hindered, however, by cleanup costs of contaminated lands, the costs of upgrading or replacing existing but older infrastructure, and the liability. In many cases, traditional sources of private financing are hesitant to invest in brownfield sites because of the risks associated with their redevelopment. Although there is the potential for future rewards, these lands often remain unused because of a lack of upfront redevelopment financing.
Box 3: How do TIFs work in the US?
Cities designate a TIF district for capital improvements and then earmark any future growth in property taxes to pay for investments in infrastructure and other economic development initiatives. TIF districts are often the beneficiaries of federal and state grants and tax incentives. TIFs are governed by state legislation and are thus applied differently in different states. They do, however, follow a similar approach (Merk et al. 2012):

- A TIF district is proposed based on planning criteria and what is permitted in the enabling legislation. The geographic boundaries of the TIF district are supposed to reflect the area that is need of redevelopment. Public consultation is held and a redevelopment plan is developed for the district.

- Once the area has been given official status, the annual property tax revenue accruing to all taxing authorities within the district (the municipality, the county, school districts, etc.) is frozen at pre-revitalisation levels. These property taxes are known as the “base level” taxes. For a period of between 15 and 35 years, all or some portion of the incremental tax generated (above the base level) accrues to the redevelopment agency (or the municipality) to be used for the redevelopment.

- To kick start the redevelopment, the municipality or redevelopment agency invests in infrastructure and/or acquires land. In some US states, TIFs are even used to offset private development expenses such as site preparation and construction.

- Capital investments are usually funded through borrowing or issuing bonds against the expected incremental tax increases (TIF bonds). TIF funds are used to pay back these bonds.

- After the TIF period expires, tax revenues from the expanded assessment base again flow through to the taxing authorities.

TIFs are not subsidies or tax abatements. Under a TIF, the development is financed from increases in tax revenue that are generated by the development and not from a local government subsidy. There is no transfer of funds from the local government to businesses nor is there a transfer from one business to another. Taxes from the increase in the assessment base are used to finance public improvements in the district.

There are some potential problems with TIFs. Most significantly, TIFs may not be able to generate the predicted tax revenues and the resulting lack of funds could threaten efforts to revitalise the designated area. When TIFs do not cover the investment, local governments have to turn to local tax revenues to pay back the loans. A second problem arises because, in most US states, there are multiple overlapping local governments, e.g., the local government, school district, community college district, county, township, park district, library district, and other special districts (Dye and Merriman 2006). These taxing authorities resent that their property taxes are frozen at a time that they are experiencing growth in demand as a result of the revitalisation. Moreover, the ability of one TIF district to draw on the property tax base of other taxing authorities provides an incentive to spend more than would be approved by the local government if it had to rely entirely on its own resources. Furthermore, TIFs target funds to a designated area and this targeting may be at the expense of areas on the periphery of the TIF district or at the expense of overall urban growth.

In recent years, TIFs in the US have been diverted from their original purpose. Originally designed to stimulate private investment in urban cores and assist these areas to compete with outlying suburban and exurban areas, they are now being used in many states as simply a way to raise revenues. For example, since TIFs are more likely to be successful on undeveloped

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30 In some states, the TIF can also apply to the local portion of the sales tax.
31 In some states, the base level of taxes is indexed by the rate of inflation.
32 The widespread use of TIFs in the US is, in part, because they offer a way for local governments to get around borrowing limits; tax increment bonds are not subject to municipal debt limits or public referendum requirements in most states.
33 Earlier studies of TIFs that expand on their benefits include, for example, Wassmer (1994) and Anderson (1990). More recent studies question the use of TIFs. See, for example, Youngman (2011) and Briffault (2010).
land such as agricultural land that is eligible for preferential farmland programs, the use of TIFs to develop farmland is on the rise (Youngman 2011). Farm properties offer the greatest potential for property value increases in part because they are undeveloped but also because of the reclassification from farmland (levied at a low tax rate) to commercial or industrial properties (levied at a high tax rate).

There has been much discussion recently in Australia, as in other parts of the world, about the potential use of TIFs to pay for major transit investments. Although there are a few examples of TIFs to pay for transit, Table 4 suggests that TIFs in North America are generally used for projects in the millions of dollars but not billions of dollars. In other words, although they might be used to pay part of the cost of new transit lines, they probably cannot cover the entire cost.

A notable exception is the transit system in Hong Kong where land value capture at transit stations brings in significant revenues for the mass transit system. Of course, the high density and corresponding high land values in Hong Kong contribute to making this model a success. It is not clear how replicable this model would be in other locations, however.

Table 4: The Size and Scope of TIF Bonds

<table>
<thead>
<tr>
<th>Tax Increment Financing District</th>
<th>Location</th>
<th>Date established</th>
<th>Size (acres)</th>
<th>Total TIF bond issued</th>
<th>Length of TIF in years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Burlington Waterfront</td>
<td>Burlington, Vermont</td>
<td>January 1996</td>
<td>70</td>
<td>$16.8 million</td>
<td>20</td>
</tr>
<tr>
<td>River District</td>
<td>Portland, Oregon</td>
<td>June 1998</td>
<td>351</td>
<td>$224.8 million</td>
<td>20</td>
</tr>
<tr>
<td>North Macadam</td>
<td>Portland, Oregon</td>
<td>June 1999</td>
<td>402</td>
<td>$288.6 million</td>
<td>20</td>
</tr>
<tr>
<td>Arundel Mills Mall (Route 100 TID)</td>
<td>Hanover, Maryland</td>
<td>November 1999</td>
<td>394</td>
<td>$28 million</td>
<td>10</td>
</tr>
<tr>
<td>Parole Towne Center</td>
<td>Annapolis, Maryland</td>
<td>December 1999</td>
<td>1,500</td>
<td>$8.3 million</td>
<td>10</td>
</tr>
<tr>
<td>Sullivan Center</td>
<td>Chicago, Illinois</td>
<td>2000</td>
<td>2.35</td>
<td>$24.4 million</td>
<td>10</td>
</tr>
<tr>
<td>Interstate Corridor</td>
<td>Portland, Oregon</td>
<td>August 2000</td>
<td>3,990</td>
<td>$335.0 million</td>
<td>20</td>
</tr>
<tr>
<td>Lewiston Walmart Distribution Center</td>
<td>Lewiston, Maine</td>
<td>January 2002</td>
<td>13</td>
<td>$5.8 million</td>
<td>25</td>
</tr>
<tr>
<td>Beltline Tax Allocation District</td>
<td>Atlanta, Georgia</td>
<td>2005</td>
<td>6,500</td>
<td>$1.7 billion</td>
<td>25</td>
</tr>
<tr>
<td>Hudson Yards</td>
<td>New York, New York</td>
<td>2005</td>
<td>28</td>
<td>$2.4 billion</td>
<td>30</td>
</tr>
<tr>
<td>East Village</td>
<td>Calgary, Alberta</td>
<td>Spring 2007</td>
<td>49</td>
<td>$357.0 million</td>
<td>N/A</td>
</tr>
<tr>
<td>Downtown Berlin</td>
<td>Berlin, Wisconsin</td>
<td>September 2008</td>
<td>21.3</td>
<td>$14.6 million</td>
<td>27</td>
</tr>
<tr>
<td>Sports, Hospitality and Entertainment District</td>
<td>Winnipeg, Manitoba</td>
<td>April 2012</td>
<td>11 blocks, downtown Winnipeg</td>
<td>$25.0 million</td>
<td>5</td>
</tr>
<tr>
<td>Investors Group Field</td>
<td>Winnipeg, Manitoba</td>
<td>June 2013</td>
<td>2 properties</td>
<td>$75.0 millions</td>
<td>25</td>
</tr>
<tr>
<td>University of Winnipeg Commons Housing Complex</td>
<td>Winnipeg, Manitoba</td>
<td>February 2015</td>
<td>1 property designated</td>
<td>$2.6 million</td>
<td>15</td>
</tr>
</tbody>
</table>

Source: Haider and Donaldson (2016)

3.4.3 Sale of Building Rights

The sale of building rights is a method to capture land value resulting from a change in land use regulations. In New South Wales, some local councils enter into Voluntary Planning Agreements (VPA) whereby additional development rights over and above existing zoning are sold to developers and the revenues are used to pay for community infrastructure (Langley

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34 Two recent studies on the potential of TIFs to pay for transit in Toronto came to different conclusions. Haider and Donaldson (2016) suggest that if TIFs had been used to fund the Sheppard transit line, they would not have covered all of the costs. Found (2016) used a theoretical model to conclude that TIFs could potentially finance a significant share of the City’s costs of a proposed SmartTrack transit plan.
Under these agreements, developers can make cash contributions, works-in-kind, land dedication, or provide other material public benefits.

The sale of building rights, more commonly known as density bonusing, is common in cities across North America. In Ontario, for example, Section 37 of the Planning Act allows local governments in the province to secure “facilities, services or matters” (benefits) from developers in return for heights and densities that would otherwise exceed existing zoning by-law restrictions (Moore 2013). Similarly, the City of Vancouver exchanges density for benefits through Community Amenity Contributions agreements (CACs). In both cities, the local government negotiates the amount of density and the value of a variety of benefits secured on a case-by-case basis (Moore 2013).

According to Moore (2013), there are at least three justifications for density bonusing – to cover the cost of infrastructure necessary to support the increased density, to share the windfall profit when local governments grant developers higher densities, or to compensate local residents negatively affected by the increased density (e.g. shadows or increased congestion created by the new development). Regardless of the justification, the value of the uplift generated by the additional density has to be determined and the resulting benefits negotiated. Calculating the uplift can be complicated and difficult for the public to understand – transparency has become an issue.

In Brazil, they have designed a system to get around the problems of estimating the change in land values arising from building rights by relying on what developers are actually willing to pay under competitive market conditions (Smolka 2013). In São Paulo, for example, Certificates of Additional Construction Potential (CEPACs) are issued by the city and sold in electronic auctions on the São Paulo Stock Market Exchange. The bearer of the bond obtains additional building rights (for example, larger floor area ratio and footprint and the ability to change the use of the land) and CEPACs provide compensation to the city (Sandroni 2010). São Paulo (and a few other Brazilian cities) has been able to generate a considerable amount of revenue from selling building rights – the April 2012 auction of CEPACs in São Paulo added $USD 420 million to local revenues on top of the $US 2.5 billion from previous auctions (Smolka 2012).

3.5 Development Charges

A development charge is a one-time levy on developers to finance the growth-related capital costs associated with new development or, in some cases, redevelopment. These charges are levied for works constructed by the local council and the funds collected have to be used to pay for the infrastructure made necessary by the development. Development charges are appropriate to finance infrastructure in areas experiencing new growth; they are not generally used to pay for the maintenance and replacement of old services.

Under Section 94 of the Environmental Planning and Assessment Act, local councils in New South Wales are permitted to require development contributions for new development, in particular for subdivision applications, residential flat development, and some smaller developments. Developers may be required to contribute land free of cost, make a monetary contribution, or both. Local councils are permitted to charge development charges for basic infrastructure such as roads but also for parks, public transport, child care centres, libraries, community centres, recreation facilities, and sports grounds.

The contributions are determined on the basis of a number of principles, including reasonableness in the amount and timing of contributions and recovery of anticipated future costs, accountability, appointment, and nexus between the development and the demand for infrastructure created by the development. In practice, contributions can only apply to development that increases the density of the site (and is apportioned to that increase) and contributions have to be spent on infrastructure that is in close proximity to the proposed

35 According to a recent media release from Urban Taskforce, Australia (March 30, 2016), a number of Sydney councils have been using this mechanism to raise funds for infrastructure.
In 2010, the NSW Government introduced a cap of $30,000 per residential lots in greenfield areas, $20,000 in other areas, and a five-year holding limit on the expenditure of funds.

Local governments throughout North America levy development charges to pay for infrastructure in new developments. Impact fees, as they are known in the US, are levied by nearly 1,000 local governments (Burge 2010). The rationale for charging developers for off-site growth-related costs is that “growth should pay for itself” and not be a burden on existing taxpayers (Slack 2002). "Growth-related" costs have traditionally included “hard” costs for roads, water and sewage systems and, in some jurisdictions, also include “soft” costs for services such as libraries, recreation centres, and schools. Increasingly, impact fees are being used to pay for infrastructure because of political resistance to increasing property taxes.

Several studies that have investigated who ultimately pays the development charge conclude that who bears the burden of development charges – the new homebuyer, developers, or pre-development landowners – depends to a large extent on the demand and supply conditions in the market for new housing (Slack and Bird 1991). Most studies conclude that, over the long-term, development charges are borne by the new homebuyer. In some cases, the predevelopment landowner, or some combination of the homebuyer, predevelopment landowner, and the developer, may bear the cost. To the extent that the new homebuyer bears the cost, those who receive the benefits from infrastructure are paying for them.

If properly implemented, development charges can lead to efficient development patterns (and discourage urban sprawl). To do so, developments that impose higher infrastructure costs on local government pay higher development charges than developments that impose lower costs. For example, costs tend to be higher for developments located further away from major facilities and for low-density developments. If development charges are not differentiated accordingly, then low-cost areas will subsidise high-cost areas. Development charges that reflect the true cost of providing services can buttress planning tools by guiding development away from high-cost areas to more efficient locations (Tomalty and Skaburskis 2003).

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36 The legislation (section 94A) also allows for levies based on the proportion of the value of the proposed development and these levies are generally lower, apply to smaller and simpler developments, and do not have to have to meet the criteria set out above (Productivity Commission 2008). Local governments and developers may also agree to an alternative contribution amount as part of a voluntary planning agreement in addition to or instead of the above contributions.

37 There are other exactions (formal or informal) on the developer that are part of the subdivision approval process but that are not strictly development charges. These include, for example, land dedications that require the developer to set aside land for roadways, other public works, school sites, or for environmental reasons; parkland dedications that require a portion of the land used for development to be set aside for parkland or that a cash payment in lieu of parkland be made; density bonusing whereby developers are granted higher densities in return for meeting conditions such as providing day care, preserving an historic building etc.; connection fees to permit developers to buy into existing capacity of water and sewer facilities; and over-sizing provisions (sometimes called front-end financing) that require developers to provide more infrastructure than is required for their development. The municipality, in some cases, agrees to recover part of the costs on behalf of the developer from future benefitting owners.
4 User Fees and Charges

The local public finance literature suggests that, local governments should, wherever possible, charge directly for services. The Henry Review (2009) also suggested that proper pricing is appropriate for funding private goods and services delivered by local councils. Local councils in New South Wales are permitted to levy charges for water supply, sewerage, drainage, waste management, and stormwater management. Other fees and charges are also permitted for services such as leisure centres and libraries. Charges can be levied either as an annual charge or as a charge against actual use.

What is meant by proper pricing? Economic efficiency dictates that prices should be set at marginal cost—where the price per unit of output equals the extra cost of the last unit consumed. Proper pricing rations the use of existing facilities and gives appropriate capital investment signals. Under-pricing a service, on the other hand, results in over-consumption. When users do not pay for a service or do not pay its full cost, they demand more than if they had to cover costs. The resulting over demand is a signal that more of the underpriced service should be provided, which leads to more expensive infrastructure investment than is economically efficient and justified (Kitchen and Lindsey 2013; Bazel and Mintz 2014). For example, underpricing water does not encourage conservation and leads to over use and over investment in infrastructure (Fenn and Kitchen 2016). Correct pricing, on the other hand, will reduce water use. Thus, proper pricing not only brings in revenues for local governments, it also reduces pressure on municipal finances by reducing the apparent need for more investment in underpriced infrastructure.

Box 4: Are User Fees Regressive?
Efforts to increase reliance on user fees are often rebuffed with the statement that user fees are regressive. In reality, the opposite is often true—those who benefit most from underpriced services are often those who use them the most, and these beneficiaries are often in higher income groups. By not charging the marginal cost of water, for example, those who are heavy consumers of water—for watering lawns, washing cars, filling swimming pools, and so on—are frequently in the higher income groups. Moreover, relatively simple pricing systems, such as low initial “life-line” charges, often deal adequately with any remaining perceived inequity from introducing more efficient pricing systems.

Current practice in setting user fees/charges around the world, however, almost always deviates from marginal cost (Kitchen and Tassonyi 2012; Fenn and Kitchen 2016). The tendency is to set fees/charges to generate revenue rather than to allocate resources to their most efficient use. Some examples of pricing follow.

4.1 Road Pricing

Efficient road prices offer a number of advantages. They are widely recognised as an effective travel demand management tool because they influence all aspects of travel choice: trip frequency, destination, travel mode, time of day or week, route, and so on. To the extent that traffic demand is managed, cost pressure on local budgets is lowered because traffic-related costs should be reduced and infrastructure demands lowered. Furthermore, if revenues are dedicated to public transit and roads, they are more likely to gain public acceptance. Without proper road pricing, drivers lack incentives to make efficient decisions about how often to use the road, where to live and work, and other economic decisions. This lack of efficient pricing has been a primary cause of excessive highway congestion, environmental degradation, lost productivity, and reduced economic activity in many large cities and urban areas (Kitchen and Lindsey 2013).

Evidence from New Zealand, for example, shows that the introduction of water metering by the Tauranga council in 1999 resulted in a 25 percent reduction in water use (LGNZ 2015).
A variety of road pricing schemes are in place around the world, however, but only two are likely to be serious candidates for implementation by local councils in Australia and generally only in the larger cities. Road pricing charges tend to be most effective if they are applied at a metropolitan or regional scale where there is a greater likelihood of managing inter-municipal traffic and a greater opportunity to minimise distortions that often arise from taxes or charges that are restricted to smaller geographic areas.

One pricing possibility is a network of High Occupancy Toll (HOT) lanes, used in some metropolitan areas in the US. Tolling is only applied to vehicles that are below a minimum occupancy requirement — typically two or three people. Tolls can vary by time of day and location in order to maintain high speeds in the HOT lanes. The tolled infrastructure would be new, and it would offer drivers a choice of paying for a quicker trip or using the existing toll-free lanes. HOT lanes could also be constructed on some major local and arterial roads and highways that enter into or pass through large cities. Tolling can now technically (if not often politically) be feasibly imposed through electronic registration of vehicle use.

A second, larger-scale possibility is to toll major highways and possibly some major arterial roads and highways that run into or through cities. Tolling is more common than HOT lanes in most countries where road pricing is used. Tolls may be set as a flat charge or may vary by time of day (as is done on Highway 407 in the Greater Toronto Area and the Autoroute 25 expressway in Montreal). Tolling all lanes at different rates is more efficient than tolling only some lanes because it is easier to control the total number of vehicles using the road as well as the distribution of traffic across lanes on the road. Advances in technology have made it much easier for local governments to impose road tolls. In Singapore, for example, in-vehicle units affixed to car windshields allow drivers on toll roads to be charged according to location and time of day.

4.2 Pricing Parking

Parking in large cities includes a mix of residential and non-residential spaces on private land, the street (kerbside), surface lots, and parking garages. Parking is often inefficiently priced, encouraging more people to drive. On-street parking in high-demand areas is often priced well below its scarcity value. As a consequence, drivers spend considerable time looking for a vacant spot. Excessive cruising leads to considerable traffic congestion, pollution, as well as inefficiencies and lost productivity (Grush 2013). In the US, for example, it has been estimated that cruising for parking accounts for roughly 30 percent of traffic in some cities at certain times of day (Shoup 2006). Meanwhile, privately owned garage parking tends to be overpriced because operators possess a degree of monopoly power due to their unique locations. Overpricing of garage parking contributes further to the stock of cars cruising for parking (Arnott and Rowse 2009), thus increasing traffic-related costs.

Local councils in Australia can charge for car parking on local roads. Inner-city councils, as well as local councils in outer metros and non-metropolitan areas, do charge for parking. Parking charges are frequently levied in central business districts (CBDs) and around major tourist and visitor destinations. Councils also own and operate many paid off-street parking stations. Many rural and regional centres as well as suburban councils without significant commercial hubs do not have the same opportunity to charge for parking, however. Comrie (2013) notes that, wherever the demand for a service that offers private benefits to recipients exceeds the supply, there is an opportunity to price that service.

Efficient parking levies/taxes could help reduce the volume of traffic, lead to less congestion, faster trips, fewer traffic enforcement costs, and reduced demand for new and expanded roads and highways (Kitchen and Lindsey 2013). It could also generate much-needed revenue for improving and expanding public transit. Indeed, it has been argued that “underpriced parking does more to promote automobile use than good transit does to discourage it” (Grush 2013 at 132). To overcome these concerns, three policies could be considered: a commercial

39 A HOT lane is a variant of a high occupancy vehicle lane (HOV).
parking sales tax which is a special tax imposed on parking transactions; a parking levy which is a special property tax applied to non-residential parking spaces; and changes in on-street and off-street parking practices.  

4.3 Fees/Charges for Waste Collection

Local councils in New South Wales are required to levy an annual charge on rateable value for domestic waste management (Section 496 of the Local Government Act). It is entirely within the discretion of local councils to differentiate charges on the basis of the volume of the service. Not all Australian local councils levy charges for kerbside waste and recyclables collection, however (Comrie 2013). Indeed, it has been suggested that kerbside waste and recyclables collection represents the best opportunity for local councils in Australia to increase the application of user fees/charges (Comrie 2013). User fees/charges require customers to pay for waste pickup on the basis of volume or weight whereas tax revenues are unrelated to how much waste is put out on the kerb. When waste collection is paid from taxes, the price per kilogram of waste discarded is zero which certainly does not reflect the marginal cost of the service (Dewees 2002). Marginal cost pricing would result in efficient waste management.

User fees/charges not only provide a source of revenue to local governments but they also provide a financial incentive to reduce, reuse, and recycle. User fees/charges are generally charged in areas where there is a recycling program so that residents have an alternative to putting out waste. In some jurisdictions, customers are required to purchase special tags to be attached to each garbage bag—in some cases, each bag carries the same price; in other cases, customers receive one free tag per week per household and can purchase additional tags. A second method is to require customers to place all garbage in a special container and pay a fee for each container. The price may vary with the size of the container (as in Toronto, for example). A third method is where the municipality weighs the waste as it is picked up and bills the customer according to the actual weight of the garbage.

A number of studies have examined the effects of user-pay systems in municipalities in Canada and the US—most compared property tax supported garbage pickup with a per-bag fee. In general, they reported reductions in solid waste tonnage because consumers increased recycling, generated less waste, and increased the use of other options such as composting (for a summary of these studies, see Kelleher, et al. 2005). Moreover, the resulting lower costs for cities freed up property taxes for other services.

4.4 Stormwater Management Levies

User fees/charges make a lot of sense to pay for stormwater management (Aquije 2016). They are fair because they are based on runoff contribution rather than property values and are thus more closely related to benefits received than a property tax: owners of properties (residential or commercial/industrial) with a large impervious area pay higher user charges than those who do not burden the drainage system to the same degree. Stormwater levies provide dedicated and stable funding. Revenues are predictable because they are based on stormwater needs of the local government.

Local councils in New South Wales have the option to levy an annual stormwater management service charge on eligible residential or business rateable land for improved stormwater management. It is a flat amount, however, and limited to $25 for residential properties.

Although there is only limited experience with stormwater levies in Canada, a very recent example of the imposition of a stormwater levy based on the impervious area of the property is in Mississauga, Ontario in 2016 (see Box 5). Funding the stormwater program had, historically,

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40 See Kitchen (2014) for a more detailed discussion of parking practices and changes that could be made to improve them.
41 One of the downsides of charging for waste collection is littering and illegal dumping but these problems have largely been controlled in jurisdictions using pricing (Dewees 2002).
been based on development charges and property taxes. Since the city is largely built out (which means development charge revenues are declining) and because the costs associated with the operation, maintenance, or replacement of existing infrastructure cannot be covered by development charges, the city needed to find other ways to pay for stormwater infrastructure.

**Box 5: Stormwater Levy in the City of Mississauga**

Under the new levy, the City prices the service according to the amount of impervious area of the property. There are two methods of assessment. For single residential properties, the rate is based on the remote sensing of each property. The roofprint area (total surface area covered by the rooftops of all buildings on the property) is used to predict the total impervious area of the property and is used to assign a property to one of five tiers (smallest, small, medium, large, or largest). A fixed number of billing units is then assigned to each tier. For multi-residential and non-residential properties, the rate is based on an individual assessment of the total impervious area on each property using aerial imagery. The number of stormwater billing units assigned to each property is calculated by dividing the total impervious area by the area of one billing unit (267m$^2$). To calculate the charge for each property, the number of billing units for each property is multiplied by a universal rate ($100).

A credit program for multi-residential and non-residential properties rewards those property owners that reduce stormwater runoff volumes or peak flow rates, or improve the quality of the runoff before it enters the municipal system. Finally, the City has a subsidy program for places of religious worship to offset their stormwater charges to address the concern that these properties are exempt from taxes and have not factored payments to the City in their budgets.

*Source: Aquije (2016)*

### 4.5 Regulatory Fees/Charges

Regulatory charges, in contrast to user fees which are fees charged by governments for the use of services, are generally imposed for the rights or privileges granted by governments (Farish and Tedds 2014). In the Canadian context, regulatory fees may simply defray the costs of a regulatory scheme or the fee may be set at a level that alters behaviour (for example, waste management fees are levied to discourage the production of waste). In the first case, fees are required to match the cost of service. In the second case, the legislation appears to allow for increased revenue beyond the cost of service if it is meant to alter behaviour.

In New South Wales, the NSW Independent Local Government Review Panel (2013) recommended the removal of restrictions on statutory fees, such as development application processing fees, which prevent local councils from recovering the full costs of those services. This recommendation makes sense because, if full cost recovery is not used, these services are being subsidised by someone else. It is rarely made clear or transparent who is subsidising these services and even when it is, the subsidies often cannot be justified.
5 Other Taxes

As noted in section 1, local governments around the world levy a wide range of taxes – income, sales, business, fuel, motor vehicle registration, and hotel and motel occupancy taxes. For each of these taxes, there are clear advantages in terms of administration and collection costs to piggyback onto existing Commonwealth or state government taxes. Even though local councils would have no control over the tax base and may have to wait to receive tax remittances from other governments, there can still be significant local autonomy if local councils have the ability to set the rate of tax to meet their revenue requirements. The advantages and disadvantages of these taxes are discussed below (and summarised in Table 5).

5.1 Income Tax

Income taxes can be justified on the grounds that local councils are increasingly being called upon to provide social services and a personal income tax is more closely related to ability to pay than a property tax. Although an income tax is more progressive than a property tax, it may not be as closely related as the property tax to the benefits received from municipal services. The income tax is a more elastic source of revenue than the property tax because the tax base grows with growth in the economy, more so than with a property tax. In the Australian context, only the Commonwealth government levies taxes on income so local councils would have to piggyback on to the national tax. Alternatively, the Commonwealth government could share income tax revenues with local councils but this would not be the same as local taxation. Tax sharing leads to little or no local autonomy because the local councils have no control over the tax base or the tax rate. For that reason, tax sharing is more like an intergovernmental transfer than a tax.

An income tax can be residence-based or payroll-based. A payroll tax would be paid by employees who are resident in the local jurisdiction as well as those who live outside the jurisdiction but work in it. A major advantage of a payroll tax is that it captures revenue from commuters who work in the local jurisdiction, use local services but live outside the jurisdiction and might not otherwise contribute to the cost of the services. In neither case is the tax applied to visitors. A residence-based income tax at the local level, depending on the tax rate, provides an incentive for people to live in areas that do not levy a similar tax. Similarly, a payroll tax provides an incentive for employers to locate in areas that do not levy the tax or levy it at a lower rate. The extent to which these kinds of distortions are important for local councils would depend on the extent of the tax differentials and how responsive taxpayers are to differentials.

The impact on location and employment decisions are likely to be reduced if the tax rate is levied on a metropolitan or region-wide basis. Some cities in the US that levy a payroll tax set a lower income tax rate on commuters than on residents. The rationale for this split tax rate is that non-residents who commute for work use city services (streets, sidewalks, fire and police protection, perhaps neighbourhood parks and so on) and therefore, should contribute to the funding of these services, although less than local residents. If the tax were residence-based, non-residents would escape any income tax contribution to funding local services.

5.2 Sales Tax

A case can be made for a general sales tax to address some of the externalities in local services when some beneficiaries of services, such as commuters and visitors, do not

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42 This section on other taxes relies heavily on Kitchen and Slack (2016).
43 A municipal corporate income tax is not appropriate, however. First, corporate income taxes have fallen in major trading countries so there does not appear to be any justification for making it more costly for Australian corporations to compete. Second, taxing mobile corporate capital and corporate profits encourages firms to shift their investments and profits to lower taxed jurisdictions (Dahly 2012). Furthermore, taxes based on a mobile tax base are not good candidates for local taxation. Third, property taxes on the commercial/industrial sector already overtax business and thus, there is no reason for an additional tax burden that bears no relationship to the cost of local services consumed.
otherwise have to pay for them. Sales taxes would both give local governments more choices in determining their own tax structure and allow them to benefit more directly from growth in local economic activity than would a property tax, while at the same time discouraging savings and growth less than an income tax. Sales taxes are sometimes considered to be regressive but the use of sales tax credits for low-income taxpayers can improve equity. However, since evasion is both economically distorting and erodes the tax base, large rate differentials between neighbouring jurisdictions are unlikely to be sustainable over long periods of time.

In Australia, the GST, first levied in 2000, is collected by the Commonwealth Government and distributed among the states and territories on the basis of horizontal fiscal equalisation. Since there is no state GST, local councils would have to piggyback onto the national tax. Alternatively, the Commonwealth government could share a portion of the GST revenues with local councils but, as with sharing of personal income tax revenues, tax sharing is not the same as local taxation.

5.3 Business Taxes

Many countries have regional and local business taxes in the form of corporate income taxes, capital taxes, non-residential property taxes, transit taxes in India (octroi), license fees (patente), and various forms of industry and commerce taxes (Bird 2003). Most of these taxes would not score highly on most reasonable criteria. Few such crude local business taxes are equitable. Almost none are neutral. Most accentuate the disparities between localities, giving most to those who have. Most also lend themselves to tax exporting, thereby violating the correspondence principle that those who pay should be those who benefit. Such taxes are sometimes costly to administer.

Despite such defects, taxes on local business are popular with officials and citizens for several reasons. They can produce substantial revenue and are more responsive to economic growth than property taxes. Moreover, local councils often have more discretion over the rate, base, and application of such taxes than of any other form of taxation. Since no one is quite sure of the incidence of such taxes, it is easy to claim that they are paid by someone other than local residents, which makes them more politically palatable – though less accountable – than other taxes such as the property tax.

A good economic case can sometimes be made for local business taxation as a form of generalised benefit tax. Ideally, specific public services benefiting specific businesses should be paid for by appropriate user fees/charges; however, if such charges/fees are not feasible, some form of broadly-based, general levy on business activity may be warranted. This argument suggests that a broadly based levy neutral to factor mix, such as a tax on value added, is likely the best form of local business tax (Bird 2014).

5.4 Fuel Tax

Many US cities levy fuel taxes. In the Canadian context, the federal and provincial governments share fuel tax revenues with local governments. As noted earlier, however, tax sharing is not the same as local taxation because local governments do not determine the tax base or set the tax rate. In Australia, neither state governments nor local councils have the power to levy fuel taxes (Comrie 2013).

A local fuel tax has a number of advantages. It is a benefit-based tax as long as revenues are earmarked for funding local roads and public transit. It can be an appropriate tool for internalising the costs of greenhouse gas emissions (GHGs) because emissions increase as

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44 U.S. evidence suggests that the cost of inner city services used by people who live in the suburbs and commute to work (in the city centre) exceeds, sometimes substantially, what they pay for inner city services. Local income and consumption-based taxes could be used to alleviate this disparity. See Chernick (2002) and Chernick and Tkacheva (2002).

45 Such a tax was introduced in 1998 in Italy, and was adopted in 2004 in Japan, and in 2010 in France. See Bird (2014) for more details.
the amount of fuel burned increases. It can impact the cumulative or total distance driven, thus reducing unnecessary driving or engine idling. It provides an incentive for switching to more fuel-efficient cars and public transit. It assists in reducing urban sprawl – one Canadian study found that a 1 percent increase at the pump in the 12 largest Canadian metropolitan areas between 1986 and 2006 resulted in a 0.32 percent increase in population living in inner cities and a 1.28 percent reduction in low-density housing units (Tanguay and Gingras 2011). As with other potential local taxes, cross border distortions will be minimised if the tax is levied at a metropolitan or regional level rather than at the local level. Finally, a tax increase could be viewed as a crude form of carbon tax (one that is growing in popularity in a number of countries).

Although a local fuel tax could have significant benefits in the short run, however, it is unlikely to be effective in the long run (Kitchen 2014). Fuel tax revenues are projected to decline because of a growing trend towards more fuel-efficient and hybrid vehicles as well as an increasing reliance on non-fuel vehicles such as electric cars. Moreover, younger adults, especially those living in highly urbanised areas, are driving less and the retiring baby boomers are driving less than when they were younger.

5.5 Motor Vehicle Registration Tax

Vehicle taxes are fixed charges on vehicle ownership that do not vary with usage. Vehicle taxes could be based on features such as age and engine size – older and larger vehicles generally contribute more to pollution – or emissions with low emission vehicles charged less than high emission vehicles. Location could also be a factor (cars in cities add more to pollution and to congestion) as could axle weight (heavier vehicles do substantially more damage to roads and require more costly roads to be built) (Slack 2011). Vehicle taxes are relatively easy to administer if piggybacked onto a national or state tax and generally perceived to be fair on the basis of benefits received.

There is little research on the impact of vehicle levies on vehicle ownership or usage. A modest levy (such as the former $60 Personal Vehicle Tax in Toronto) is unlikely to have much effect on ownership, and virtually none on usage. A fee based on fuel efficiency might have some influence on the choice of vehicle type as would an ad valorem fee based on vehicle purchase cost. Nevertheless, small and fixed levies do little to modify travel behaviour because they are unrelated to usage. A levy could be limited to residents living in areas that are well served by public transit. Such a levy might increase the incentive to use transit, but it would have a narrower base.

Vehicle levies are transparent because of the clear link between payment and the right to drive and they are accountable if the revenues are dedicated to transportation. A vehicle tax is a crude instrument for handling traffic congestion, however, because it does not vary with time of use, traffic volume, distance travelled, or area in which vehicles travel (central city versus long distance out of city). On the other hand, it is a charge on those who use roads, at least in some capacity. To minimise tax avoidance, state requirements could be in place to prevent owners from registering their vehicles in a jurisdiction other than their principal place of residence.

5.6 Hotel and Motel Occupancy Tax

An occupancy or room tax is a levy imposed on hotels and motels. This tax, it can be argued, could compensate local councils for services provided to tourists and visitors (for example, the additional fire protection, and roads and public transit capacity needed to meet weekend or peak convention and tourist demands). The tax falls primarily on visitors.

Several cities in Canada and the US levy hotel or motel occupancy taxes. In some cities, the tax is mandatory but, in other cities, a voluntary destination marketing fee is levied by those hotels that wish to participate. As with other taxes, local councils could ‘piggyback’ onto the existing sales tax on hotel and motel rooms through the addition of a few percentage points (the most common method used in Canadian cities) or set up their own administrative structure.
A tax on hotel and motel rooms in selected jurisdictions and not in competing communities provides an incentive for individuals to stay in hotels and motels in those cities without the tax. The extent to which differential tax rates would actually deter visitors from renting rooms is uncertain, however. If the demand for hotel and motel rooms is sensitive to price, then noticeable losses may occur. Since convention arrangements are often highly cost-sensitive, the impact on the convention business might be significant.

### Table 5: Summary of Potential New Tax Options for Local Councils

<table>
<thead>
<tr>
<th>Potential Revenue</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal income tax (residence based or payroll based)</td>
<td>• More closely based on ability to pay than other taxes&lt;br&gt;• Taxes commuters and visitors if payroll based&lt;br&gt;• Broad-based tax with significant revenue potential</td>
<td>• Creates incentive to locate outside taxing area, but less so, the larger the geographic size of the taxing jurisdiction&lt;br&gt;• Would have to be piggybacked on national income tax</td>
</tr>
<tr>
<td>Municipal sales tax</td>
<td>• Satisfies most criteria for a good local tax&lt;br&gt;• Taxes commuters and visitors&lt;br&gt;• Broad-based tax with significant revenue potential</td>
<td>• Creates incentive to purchase outside taxing area but, less so the larger the geographic size of the taxing jurisdiction&lt;br&gt;• Would have to be piggybacked on to national GST</td>
</tr>
<tr>
<td>Business tax</td>
<td>• If broadly based, good way to pay for services where user fees cannot be charged</td>
<td>• Not always related to benefits received&lt;br&gt;• Often not neutral</td>
</tr>
<tr>
<td>Fuel tax</td>
<td>• Satisfies most criteria for a good local tax&lt;br&gt;• A benefit-based tax if revenues are earmarked for funding local roads, highways, and public transit&lt;br&gt;• Relatively inexpensive and simple to implement and administer</td>
<td>• Blunt instrument for targeting congestion&lt;br&gt;• Creates incentive to purchase fuel outside taxing area, but less so the larger the geographic size of the taxing jurisdiction&lt;br&gt;• Revenues will be difficult to sustain with the increase in fuel-efficient and non-fuel vehicles</td>
</tr>
<tr>
<td>Vehicle registration tax</td>
<td>• Satisfies the minimum criteria for a good local tax for roads and transit&lt;br&gt;• Inexpensive to implement and administer&lt;br&gt;• More likely to be accepted if funds are dedicated to roads and transit</td>
<td>• Does not tax commuters and visitors&lt;br&gt;• Not effective for handling congestion</td>
</tr>
<tr>
<td>Hotel and motel occupancy tax</td>
<td>• Taxes visitors</td>
<td>• May create a disincentive to visit or host conventions in taxing jurisdiction&lt;br&gt;• Small potential revenue</td>
</tr>
</tbody>
</table>

Source: Based on Kitchen and Slack (2016)
6 Intergovernmental Transfers

Intergovernmental transfers take many different forms. The two major categories of transfers are unconditional or untied (those that have no restrictions attached to their use) and conditional or tied (those that require certain conditions to be met by the recipient government). Tied grants can be further broken down into matching and non-matching grants. A matching grant is one in which the donor pays a certain specified percentage of expenditures on a particular function. For example, the state government may offer to pay 40 percent of expenditures on a particular road, leaving the remaining 60 percent to be financed by the local council. Non-matching grants are lump sum transfers that do not require the recipient to put up any funds of their own. An example of a non-matching transfer is a per capita grant.

The traditional literature on fiscal federalism sets out three main rationales for intergovernmental transfers: vertical fiscal imbalance, horizontal fiscal imbalance, and externalities (see, for example, (Shah 2007) or (Slack 2007)). The appropriate type of grant (tied versus or untied; matching versus non-matching) depends on the underlying rationale:

- **Vertical Fiscal Imbalance:** Vertical fiscal imbalance (VFI) occurs when local governments have inadequate own-source revenues to meet their expenditure responsibilities. To close the fiscal gap, senior governments can transfer additional revenue-raising powers to local governments or they can reduce the expenditure responsibilities that local governments are required to undertake. As a last resort, the fiscal gap can be closed with an untied transfer. The amount of the transfer allocated for this purpose can be determined in three ways (Bird and Smart, 2002 at 900): as a fixed proportion of the revenues of the donor government (known as revenue sharing); on an ad hoc basis; or on the basis of a formula (for example, as a percentage of specific local government expenditures or population).

- **Horizontal Fiscal Imbalance:** Horizontal fiscal imbalance (HFI) refers to the difference in resources among governments at the same level: some local councils are unable to provide an adequate level of service at reasonable rates whereas other local councils can. This inability to provide an adequate level of service may occur because the costs of services are higher, the need for services is higher, and/or the tax base is smaller. Equalisation grants, based on expenditure needs and fiscal capacity, can ensure that those local councils with small tax bases and greater costs and needs are able to levy tax rates that are comparable to other jurisdictions. Generally, the formula calculates the difference between a standardised expenditure and a standardised revenue base.

- **Externalities:** The benefits (and costs) of some services spill over municipal boundaries and may result in an under-allocation of resources because the local jurisdiction providing the service bases its expenditure decisions on the benefits captured within its jurisdiction and not the benefits to those outside. One way to provide an incentive to allocate more resources to the service generating a positive externality is with a tied, matching grant. The grant should be earmarked for the service which generates the externality. It should be matching to reflect the extent of the externality. The matching rate may be different in different jurisdictions reflecting that there are greater externalities in some places than in others (Bird and Smart 2002).

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46 Unconditional transfers are also referred to in the literature as general purpose grants and conditional transfers as specific purpose grants.

47 In Australia, total own-source revenue as a percentage of own-purpose expenses were estimated to be over 1.3 for the Commonwealth Government, 0.57 for State Governments, and 1.06 for local councils (see Comrie 2013).

48 Needs and/or costs may be greater than the average because of geographic location, population density, or other factors. For example, wages and rents are usually higher in places with high population density and the cost per unit to provide services increases with increasing population because of congestion (Fenge and Meier 2001). Needs may be higher for local councils with a high proportion of low-income households who require social services. Of course, expenditures per capita could be higher because of inefficient spending by some municipalities. If inefficiency is the reason for higher expenditures, then this inefficiency will also be rewarded by the grant. Measuring need can be difficult and requires considerable data (Kim and Lotz 2008).

49 Another way to internalise the externalities is to expand the municipal boundary to include all of the beneficiaries of the service. Boundaries would likely be different for different services, however (Slack 2007).
Although the notion of a tied matching rate to reflect spillovers works in theory, the extent to which the grant will induce local councils to spend more on the subsidised service depends on the matching rate, the responsiveness of spending to a lower price, and whether the grant stimulates new spending or replaces spending that would have occurred anyway (Bahl 2000).\textsuperscript{50} In practice, governments do not know the magnitude of spillovers for specific services (Bird 2000) and empirical evidence suggests that the scope of externalities is limited and thus cannot justify the high matching rates that are generally used (Blöchliger and Petzold 2009).

Matching grants require local councils to contribute a portion of the funds for the service. A uniform matching rate tends to favour richer local councils because they are more able to match funds than poorer local councils, unless there is an equalisation component to the grant. Moreover, a matching grant will only stimulate spending if the local council has the power over expenditures and the ability to increase taxes (Bird, Ebel, and Wallich 1995).

In addition to the three rationales outlined above, there may be other reasons why grants are given. For example, grants are sometimes given for political reasons in response to successful lobbying by local governments. Transfers have also been introduced in response to a public outcry over deteriorating services or infrastructure. But, more fundamentally, senior governments often use transfers as a way to exert control over how local councils deliver services. Non-matching, tied grants are appropriate to subsidise activities that are a high priority for the donor government but a low priority for the recipient government (Boadway and Shah 2009). These transfers provide incentives for local governments to act as agents of the donor government. The donor government benefits from local management in providing a service but gets to determine how the service will be delivered.

6.1 Intergovernmental Transfers in New South Wales

As noted earlier, transfers account for about 15 percent of total local revenue but there are wide variations across local councils. Grants per capita are significantly higher, on average, in rural areas compared to urban areas, for example. The Commonwealth Government provides unconditional (untied) grants and tied grants for expenditures on infrastructure (mainly roads), child care programs and disability, as well as other services administered by local councils. The states and territories provide specific purpose (tied) grants mainly for infrastructure spending (roads, water and sewerage facilities, and regional airports), waste management, environmental programs, cultural programs and library funding, and reimbursement for pensioner concessions.

Horizontal fiscal imbalance has historically been handled through federal Financial Assistance Grants (FAGs). The Commonwealth Government determines the overall amount of FAGs which include general purpose grants (70 percent of FAGs) and local roads grants (the remaining 30 percent.).\textsuperscript{51} Distribution of the grant to state governments has been indexed to reflect changes in inflation and population but indexation has been frozen from 2014/15 to 2017/18. Local government grants commissions in each state and the Northern Territory determine the distribution of grants among local councils on the basis of national principles of horizontal equalisation and an assessment of the ability of local councils to raise revenues from rates.

Allocations under the equalisation component are calculated on the basis of detailed expenditure need and revenue capacity measures weighted by a broad range of indicators to account for differences in local conditions (known as “disabilities” or “cost adjustors”). Expenditure needs are defined as “differential costs, relative to standard, that a council needs

\textsuperscript{50} If the grant replaces spending that would have occurred anyway, the grant is said to be fungible. In that case, local councils have the choice about where to spend own-source revenues that it does not have to spend on the grant project and the grant is virtually untied.

\textsuperscript{51} Local roads grants are separate grants designed to help local authorities pay for the cost of maintaining roads, even though the grants are unconditional in terms of how they are spent.
to provide a standard level of service” (Worthington and Dollery 2000, p. 30).\textsuperscript{52} Revenue needs are defined as the “differential revenues a council would raise if the standardised revenue effort was applied to its revenue base” (Worthington and Dollery 2000, p. 30). A separate road grant is calculated by the road length multiplied by the standardised asset preservation cost multiplied by a cost adjustor factor which includes freight travel volumes, climate, availability of pavement materials, sub-grade conditions, and higher-cost strategic routes.

6.2 Potential Problems with Intergovernmental Transfers\textsuperscript{53}

The literature identifies a number of potential problems with intergovernmental transfers:

- \textit{Transfers can interfere with the efficient delivery of services:} efficient service delivery requires that those responsible for providing services have a clear mandate, adequate, sufficient flexibility to make decisions, and accountability for their decisions (Bird and Vaillancourt 1998). Transfers often violate these conditions and discourage local councils from charging the right price for services: “the basic task in transfer design is thus to get the prices ‘right’ in the public sector – right, that is, in the sense of making local governments fully accountable – at least at the margin of decision-making – to both their citizens and, where appropriate, to higher levels of government” (Bird and Smart 2002, p. 899).

- \textit{Transfers can distort local decision-making:} Specific purpose transfers require local councils to spend the funds according to state guidelines and often require local matching funds. A matching transfer, by lowering the price of some services, encourages local councils to spend more on those services. In the presence of externalities, this change in behaviour may be appropriate. Where there are no externalities, however, or where the amount of the grant vastly exceeds the amount of the externality, the resulting distortion in local behaviour is inappropriate. As Comrie (2013) suggests, councils need to consider questions such as whether the subsidised service is needed and whether the service will continue beyond the grant funding.

- \textit{Transfers can reduce accountability:} When two or more spheres of government are funding the same service, accountability problems are sure to arise. When residents want to complain about the service, they are not sure which government is responsible for the problem. Accountability is blurred when the sphere of government making the spending decisions (local councils) is not the same as the sphere of government that is raising the revenues to pay for them (state government). The more closely spending and taxing decisions are linked by being made by the same body at the same time, the better government will function in its role as a service provider (Bird and Slack 2014). Experience suggests that people are more careful spending their own money (taxes they have to raise) than spending someone else’s money (transfers) so transfers need to be supplemented by local contributions.

- \textit{Transfers are rarely stable and predictable:} The amount of money local governments receive varies from year to year, in part depending on the fiscal state of the donor governments. Lack of predictability makes it difficult for local councils to plan expenditures and, when grants decline, local councils have to make up the lost revenue by increasing own-source revenues or reducing expenditures. The recent indexation freeze for FAGs illustrates this point. The Commonwealth and State Governments are facing their own expenditure pressures arising from increased demands, rising health care costs, and additional welfare and education expenditures (Comrie 2013). The result is a cutback in transfers that is unlikely to be reversed in the near future (Comrie 2013).

- \textit{Transfer formulas often lack transparency:} A common criticism of the Australian transfer system is its complexity, especially with respect to the determination of expenditure need.

\textsuperscript{52} FAGs have been criticised for only basing the formula on disabilities relating to operating expenditures and not capital infrastructure (Independent Inquiry 2006).

\textsuperscript{53} This discussion relies heavily on Slack (2015).
The formula starts with a measure of the standard expenditure per capita which is usually taken to be the average expenditure per capita in the state. The complexity arises in trying to determine those factors, beyond the control of local councils, which result in them having to spend more or less than the standard amount. These so-called disability factors or cost adjustors can become very detailed and complicated. This complexity reduces transparency for both local councils and the public.

- **Equalisation transfers can have other incentive effects:** Because grants are inversely related to fiscal capacity, they can discourage local councils from increasing the size of their tax base – a local council that increases its tax capacity will inevitably receive fewer grants (Blöchliger and Petzold 2009). Grants may thus undermine the willingness of local councils to strengthen their tax base and thereby prolong, rather than eliminate, fiscal disparities.

In addition to the problems with transfers outline above, the FAGs in Australia have been criticised for not adequately allocating funds on the basis of horizontal equalisation because every council is entitled to receive a minimum grant. The result is that some councils receive more than the equalisation formula would dictate and the remaining councils receive less than they would have in the absence of the minimum grant. The minimum per capita grant thus compromises the principle that each local council should be able to deliver an average level of service by levying an average tax rate. The Productivity Commission (2008) noted that relaxing the minimum per capita grant would narrow the gap in own-source revenue raising efforts between smaller rural and larger urban local councils and help those local councils with the greatest fiscal challenges.

Before leaving the topic of intergovernmental transfers, it might be useful to think about the future of state-local relationships overall in New South Wales. In this context, a recent study in Ontario, Canada may shed some light. The study suggests that provincial-local relations in that province have reached an inflection point and are in need of fundamental reform (Côté and Fenn 2014). The authors make the case that the relationship is approaching an inflection point because the role of local governments in economic growth has been expanding, provincial-local relations have grown increasingly complex, and there are threats to the fiscal health of local governments. Looking back in history, they found that when the relationship had reached an inflection point in the past, significant changes were made.

For Ontario, Côté and Fenn (2014) conclude that more provincial funding for local governments is unlikely, given the province’s increasingly challenging fiscal situation, and perhaps it is even unwarranted. Rather, they suggest that what is needed going forward is a diversification and enhancement of local revenue sources to allow local governments to rely less on provincial grants and more on their own resources. Of course, they also recognise that only larger local governments will be able to depend more heavily on own-source revenues and smaller and rural communities will still need intergovernmental transfers.

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54 On the revenue side, questions have been raised about the use of property values as the measure of revenue-raising capacity because it does not include characteristics of property rates such as the use of minimum tax rates, concessions for pensioners, the use of differential tax rates by property class, and rate pegging. These omissions reduce the potential complexity of the formula but also potentially reduce the fairness of the grant.
7 Financing Tools – Borrowing and Public-Private Partnerships

Borrowing and public-private partnerships are both financing tools and, as Comrie (2014) and others have noted, funding and financing are different. Funding refers to raising revenues, for example, through user fees/charges and taxes. Financing, on the other hand, refers to how the payment for an outlay is accommodated, for example, by borrowing the funds, using reserves, or turning to the private sector. Financing and funding, although different, are nevertheless related. When projects are financed through borrowing, for example, revenues need to be raised to pay back the borrowings.

7.1 Borrowing

Australian local governments are permitted to borrow to fund council operations and provide infrastructure. Borrowing powers are defined in legislation and state governments often impose restrictions on the amount of money that can be borrowed, the purpose of the borrowing, and the source of funds (Productivity Commission 2008). In New South Wales, under Section 621 of the Local Government Act, councils can borrow at any time for any purpose. Section 624 of the Act empowers the Minister to impose limitations or restrictions on borrowings raised by a council. Currently, the order specifies only that councils cannot borrow from any source outside of the Commonwealth of Australia nor in any currency other than Australian currency. Section 622 stipulates that councils can borrow by overdraft, loan, and other means approved by the Minister. Under the local government reform program, (Fit for the Future), councils assessed as “fit” are eligible to borrow from the NSW Treasury Corporation (TCorp) at favourable interest rates (which are considerably below commercial market rates).

Typically, local councils in Australia have low levels of borrowing. It has been suggested that low levels of borrowing are the result of an aversion to the use of debt and problems with repayment arrangements (Comrie 2014). Yet, borrowing is an appropriate way to pay for capital expenditures. Where the benefits of a capital investment (for example, the construction of a water treatment plant) are enjoyed over a long period of time, say 25 to 30 years, it is both fair and efficient to pay for the project at least in part by borrowing so that the stream of benefits matches the stream of costs through the payment of debt charges. This matching results in intergenerational equity.

Borrowing allows a local council to enjoy the immediate benefit from the capital improvement, which is not always possible when relying on current revenues (rates and user fees/charges) which are in any case seldom sufficient to fund large expenditures on a pay-as-you-go basis. Since the pattern of capital expenditures is lumpy, a local council may need substantial funds to finance an infrastructure project in one year and then much less in subsequent years. Borrowing allows local councils to avoid large year-to-year fluctuations in rates. It is impossible for local councils to meet infrastructure needs without extensive use of debt (Comrie 2014).

The main disadvantage of borrowing from a local perspective is that loans not only have to be repaid at some point but they also generate interest obligations that must be serviced annually. Revenues dedicated to debt repayment cannot be used to meet other current expenditures. The costs of the capital project are spread over time, but the need to service the debts can constrain local fiscal flexibility. This problem may be particularly important when local revenue
streams are volatile. Local councils that have less debt and hence lower debt service obligations obviously have more flexibility to respond to unanticipated future events. One way to lower the cost of borrowing is to pool municipal debt. In the Canadian context, municipal finance authorities have been established in most provinces (such as the Municipal Finance Authority in British Columbia, the Municipal Capital Borrowing Board in New Brunswick, Municipal Finance Corporation in Nova Scotia, and the Newfoundland Municipal Financing Corporation).

Box 6: Municipal Finance Authority of British Columbia
The Municipal Finance Authority of British Columbia (MFABC) was created in 1970 by provincial legislation but it stands independently of the provincial government. The obligations of MFABC are not the obligations of the province and are not guaranteed by the province. MFABC is owned by the municipalities in British Columbia. The 35-member Authority comprises elected officials appointed by the boards of each of the regional districts.

MFABC operates as a cooperative municipal bank for local governments in BC. It pools borrowing and investment needs of communities through a collective structure and provides long and short term financing, investment management, leasing, and other financial services to communities and public institutions in the province. It finances infrastructure such as water and sewer projects, roads and highways, municipal equipment and facilities, and hospital equipment and facilities. MFABC’s available liquidity to respond to payment interruptions includes a debt reserve fund, sinking fund set aside, and unrestricted retained earnings. The authority also maintains a line of credit for short-term disruptions and can (by legislation) levy a province-wide property tax if it needs to replenish the debt reserve fund. Three rating agencies independently rate MFABC. In early 2014, Standard and Poor’s and Fitch Ratings issued a rating of AAA with a stable outlook; Moody’s Investors Service issued a rating of Aaa, also with a stable outlook.

Municipal financing authorities are able to gain greater access to national and international capital markets and to benefit from higher credit ratings. The credit risk of all local governments combined is almost always less than that for each individual local government. Pooling local government debt reduces borrowing costs both by reducing the cost of capital and lowering the administration costs to issue debt. A municipal finance authority substitutes one contract with an underwriter for separate contracts between each borrower and debt issuer. It should be able to economise on transactions costs because it issues debentures more frequently than most individual municipal borrowers and it operates in a volatile capital market that is subject to a large amount of uncertainty. It can exercise a greater degree of flexibility over issue terms and costs to municipal clients.

State Infrastructure Banks in the U.S. operate along the same lines as provincial financing authorities in Canada by borrowing on behalf of many local governments to secure lower interest rates. These state-run banks, created with federal grants, operate like private banks and provide local governments with seed money to start a project and provide a range of low-interest loans and credit enhancement products (TD Economics 2004, p.16). As the assistance is repaid, the funds are given out for another purpose. These are known as “revolving funds.” Funds from these infrastructure banks have been used for transportation, water, and sewers.

59 In some provinces, such as Nova Scotia and New Brunswick, all municipalities have to borrow through the provincial authority. In other provinces, larger cities are not required to borrow through the provincial authority. For example, the cities of Winnipeg, Regina, Saskatoon, Edmonton, Calgary, and Vancouver issue their own debt rather than using the provincial agencies.

60 One of the rating agencies does suggest, however, that there is a high likelihood of support from the provincial government given the strategic importance of the MFABC in providing financing for municipalities in the province (Moody’s 2014).

61 There are 162 municipalities in BC. Municipalities form part of the regional district system. Municipal councils appoint one or more members to sit as municipal representatives on their respective regional board. Municipalities in BC, with the exception of the City of Vancouver, are prohibited from issuing debt directly. Rather, they borrow through their respective regional districts which, in turn, borrow from MFABC.
Unlike municipal finance authorities in Canada, state infrastructure bank loans are backed by the reserves of the bank and not the credit of the local government.

7.2 Public-Private Partnerships (PPPs or P3s)

A P3 is a contractual arrangement between the public sector and a private provider. The public sector’s role is to facilitate, regulate, and guarantee provision of an asset and services, and the private sector’s role is to do one or more of the following with the public sector picking up whatever the private sector does not do – design, finance, build, operate, and maintain the infrastructure in a formalised partnership agreement (Vining and Boardman 2008).

P3s vary widely in structure, but the most common models or variations include:

- Design-Build (DB): The private sector designs and builds the infrastructure for a fixed fee and transfers it to the public sector. The risk of cost overruns is borne by the private sector.
- Operation and Maintenance (O&M): The public sector owns the infrastructure, but the private sector operates it for a specified term.
- Design-Build-Finance-Maintain-Operate (DBFMO): The private sector looks after everything including design, building, financing, and provision of management services and operations under a long-term agreement.

As noted earlier, P3s are a form of financing and not funding – the private partner has to be repaid for any financing it provides either from revenues generated from the project (e.g. tolls on roads) or from an availability payment from government. Nevertheless, policy makers and practitioners generally acknowledge that P3s can generate significant efficiencies, better cost controls, stronger operational knowledge, and greater operational flexibility when used to deliver projects that have passed a rigorous and thorough value for money assessment (VfM) (Conference Board 2008).  

Recent studies on P3s in Canada conclude that P3s may work well under certain circumstances—where governments have not attempted to transfer revenue risk (uncertainty over future revenue streams) to the private sector; where projects have required specialised knowledge that the public sector lacks; and where governments have been able to transfer construction risks (cost overruns and construction delays, for example) at something close to a fixed price. These projects are close to design-build or build contracts, thus suggesting that governments should limit their P3 initiatives to infrastructure projects of this type or else do a much better job of reducing transactions costs in contract design (Vining and Boardman 2008).

A study of 28 P3 projects in Ontario from 2007 to 2010 found that the base cost of P3s was actually 16 percent higher, on average, than conventional tendered contracts (Siemiatycki and Farooqi 2012). The reasons were that private borrowers paid higher interest rates and required a premium for taking on greater project risks arising from potential cost overruns, construction delays, and so on. Transaction costs for lawyers and consultants added another 3 percent to private-sector costs. Of course, conventional government procurement practices also face a number of risks such as cost overruns, construction delays, design flaws, and fluctuating revenues. When a risk premium was added to the more conventional alternatives, the VfM came out in favour of a P3 for each project. A major concern here is that there is no empirical evidence to support such a large risk premium, however.

Municipal infrastructure projects that may be suitable for a P3 include roads and public transit, water and wastewater treatment systems, and solid waste disposal. A P3 may be most

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61 A VfM compares the net present value (NPV) of the P3 option with the NPV of a comparable project delivered through conventional procurement methods (Conference Board 2008). While not a straightforward or easy task, the VfM is intended to capture all quantitative and qualitative factors affecting both costs and benefits. Partnerships Canada is a federal agency that assists federal infrastructure authorities in the calculation of VfM assessments. Infrastructure Ontario performs the same role for potential P3s at the provincial and municipal level. A critical issue in this calculation is the way in which risks are assigned to the public and private operators.

62 For a comprehensive study of cost overruns in public projects, see Siemiatycki (2015).
appropriate when outputs can be clearly defined (Grimsey and Lewis 2004), where risks are correctly assigned to each party, where proper incentives can be introduced to encourage private partners to get better value, and where there is clear communication and accountability between the private and public partners. Where P3 contracts are properly structured and based on performance measures, they can lead to improved local governance including increased accountability, transparency, and value for money.

Governments should set the terms and conditions for service delivery, funding and quality of service, and establish performance standards. Government could even provide the pricing structure to be used for services provided by the infrastructure (volumetric pricing for water and sewers, tolls and other charges for roads and public transit, user fees/charges for solid waste disposal) or set up a price regulation or monitoring system (Kitchen 2006). Letting a private partner operate a P3 can raise transactions costs because of the need to monitor service quality. It has the potential advantage, however, that user fees/charges are more politically acceptable because the public expects services delivered by the private sector to be priced (Vining and Boardman 2008).
8 Final Observations and Conclusions

Local councils in New South Wales have few revenue sources when compared to many other local governments around the world. Local taxes in all of Australia represent only 3 percent of the total taxes collected by all spheres of government and less than one percent of GDP. The only tax that local councils can levy is the property tax (rates). This discussion paper has evaluated the use of rates and other sources of revenue by local councils in New South Wales and described some potential new options.

For governments to operate efficiently, it is important that there be a clear link between expenditure and revenue decisions – those who make the expenditure decisions should also make the revenue decisions and the type of revenue (user fees, rates, income taxes, for example) should match the type of expenditure being funded (transit, recreation, child care, for example). A direct linkage should result in more accountable government and in taxpayers being less opposed to paying taxes when they know where their tax dollars are going.

This final section of the paper does not summarise all of the ideas and options presented but rather it highlights five key findings:

- The property tax is a good tax for local governments but reform is needed in New South Wales.

The property tax satisfies many of the characteristics of a fiscally sound local tax: land does not move so it can be taxed without distorting economic behaviour very much. It satisfies the benefits-received criterion because it funds those services whose collective benefits accrue to the local community. Revenues are relatively stable and predictable and the tax is highly visible so it makes local governments accountable for the tax levied. Where tax rates are set locally, local governments have a fair degree of fiscal autonomy.

Three areas in New South Wales are in need of reform, however: the use of unimproved capital value as the tax base, the breadth of exemptions, and rate pegging. Unimproved capital value may not be the best tax base for rates for a number of reasons: it is not as closely related to ability to pay as capital improved value, particularly for multi-residential units where the land value is divided among the units. Estimating the value of land only is problematic in highly developed inner cities where there are few transactions of only land. The potential revenues from a land only tax are less than from a tax on capital improved value and thus, to raise the same amount of revenue, a higher tax rate is needed.

Exemptions to property taxes need to be reviewed with a view to reducing the distortions created by taxing some properties and not others. Differential tax treatment of different types of properties affects many economic decisions such as where to locate and what economic activities to engage in. If properties use municipal services, they should not be exempt from taxes. If they do not, it is necessary to increase taxes on the remaining taxpayers or reduce services.

Rate pegging has been widely criticised by many previous reports and should be phased out. It breaks the link between tax and expenditure decisions and thereby reduces the accountability of local councils, erodes local government autonomy, and creates an unrealistic expectation in the community that rates should not increase beyond the peg, even when warranted. Moreover, since rate pegging applies to all properties, it does not target relief to needy taxpayers. Rather, it lowers taxes on all types of property.

- Local councils could make better use of user fees/charges.

Local councils should charge for services wherever possible. User fees/charges are an important source of revenue for local councils and also have an important role in altering economic behaviour. Properly designed fees (based on marginal cost) enable citizens to make efficient decisions about how much of a service to consume and governments to make efficient
decisions about how much of the service to provide. Under-pricing (or not charging) leads to over-consumption and demands to build more under-priced infrastructure.

Road pricing is used in many jurisdictions around the world. Pricing reduces congestion and increases revenues to pay for transportation. It affects trip frequency, destination, travel mode, time of travel, route, and other factors. New technology makes pricing relatively easy to implement. In addition to considering road pricing, improvements to the pricing of other services could be considered (for example, basing waste collection fees on volume of waste generated and stormwater levies on the basis of the impervious area of a property).

- **Local councils would benefit from a mix of taxes.**

The property tax, as noted earlier, is a good tax for local governments but, given that it is relatively inelastic (does not grow automatically as the economy grows), highly visible, and politically contentious almost everywhere, it is likely to be insufficient to fund the complex and increasing demands of local councils (even in the absence of rate pegging). A mix of taxes would give local councils more flexibility to respond to local conditions such as changes in the economy, evolving demographics and expenditure needs, changes in the political climate, and other factors.

Access to a range of taxes would provide local councils with stability (through the property tax) and elasticity (through income, sales, or business taxes, for example). Moreover, relying on many sources means that a local council can set lower tax rates for any single tax to levy a given amount of revenue. Since the excess burden of a tax increases with the tax rate (i.e. the distortions increase as the tax rate increases), a more diversified system should yield any given amount of revenue more efficiently with a smaller negative impact on the overall tax base (Chernick, Langley, and Reschovsky 2010).

Taxes on income, sales, vehicle registration, fuel, and hotel occupancy are common in other local jurisdictions around the world and are an effective and efficient way of diversifying taxes at the local level. For new taxes, it would be administratively cost efficient if local councils ‘piggybacked’ onto the Commonwealth or state tax. It is critical, however, that local councils set their own tax rates. In this way, they would be accountable to taxpayers through the linking of taxes to the services consumed.

- **Land value capture may have a role to play in financing infrastructure.**

Land value capture is a way to recoup some or all of the unearned increment in private land values arising from public investment or a change in regulations. There are several ways that land value increases have been captured in other jurisdictions around the world including betterment levies, tax increment financing, and the sale of building rights.

Experience around the world suggests that land value capture has been a good tool to raise at least part of the costs of major infrastructure projects but they cannot always be relied on to do the whole job. Moreover, it can be difficult to forecast the increase in land values arising from an infrastructure investment and, if the forecasted increase does not materialise, local councils will be on the hook to cover the investment and may have to increase in taxes. Although a good way to pay for infrastructure, land value capture needs to be carefully designed.

In the context of New South Wales, the use of land value capture is restricted by rate pegging. Only special rates for water and sewerage do not constitute general income that is subject to rate pegging; other special rates are included in the peg. In order to make use of land value capture, rate pegging would need to be phased out.

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63 For example, a residential property tax discourages investment in housing improvements; a retail sales tax discourages consumption of goods, etc. A mix of taxes can reduce the distortion of any one tax by keeping the tax rate low.
• Equalisation transfers need to be targeted to those local councils most in need of assistance.

Financial Assistance Grants should fulfil their equalisation role by targeting funds to those local councils most in need of assistance. The minimum grant stands in the way of achieving that objective by diluting the equalisation role. Given that smaller, rural areas are less fiscally sustainable than the larger metropolitan areas, it might also be worth considering differential treatment – higher grants for the small and rural local councils and more revenue-raising tools for the large councils.
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Improving Local Government Revenue in NSW: What are the Options?


