Local Government Taxes and Charges

Peter Abelson[1]

1 Issues

Local governments in New South Wales receive revenue in four main ways: by taxes, user charges and fees, borrowing, and inter-governmental grants. In this paper I examine how local government raises revenue from local residents, namely by local taxes and user charges.

Taxes and user charges are commonly assessed against four main criteria: administrative simplicity, equity, efficiency, and transparency / accountability. Competitive neutrality, a recently introduced criterion, can be viewed as a component of efficiency. This note focuses on the first three criteria.

Specifically the paper:

- examines whether the rating system that accounts for nearly half of all local government revenues is administratively simple, equitable and efficient and discusses briefly the impacts of rate pegging; and
- discusses whether user charges are efficient, with some examples in relation to water and sewerage services, waste management services, fees and parking charges;

A short background on the sources and nature of ordinary revenue is provided in Section 2. Section 3 defines the criteria to be adopted for the assessment. Sections 4 and 5 examine the rating system and key user charges with respect to these criteria. The final section provides some conclusions.[2]

2 Background

Table 1 shows the major sources of revenue from ordinary activities for the last two financial years for which the data are available. Rates and user charges account for nearly two-thirds of revenue. Grants account for about 16 per cent. Contributions and donations, mainly payments by the Roads and Traffic Authority and Section 94 contributions by developers, account for about 12 per cent.[3]

---

[1] Peter Abelson is a Director of Applied Economics P/L. The writer was a Councillor of Mosman Council from 1978 to 1987 and Mayor from 1983 to 1985.
[2] Given the scale and scope of the paper, the analysis is necessarily at a high level.
[3] The discussion in this section draws on Department of Local Government, *Council Rating and Revenue Raising Manual, 2005*, see www.dlg.nsw.gov.au.

Table 1 Major sources of ordinary revenue

Sources	2002/03 $m	2003/04 $m	2002/03 %	2003/04 %
Rates and annual charges	3,034	3,132	47.3	47.6
User charges and fees	1,070	1,108	16.7	16.8
Interest	216	252	3.4	3.8
Grants	1,041	1,053	16.2	16.0
Contributions and donations	815	758	12.7	11.5
Other revenues	241	279	3.8	4.2
Total ordinary revenue	6,147	6.582	100.0	100.0

Source: Department of Local Government, *Comparative Information on NSW Local Government Councils 2003/04*.

The current system of rating and charges is based on the *Local Government Act 1993* (the Act). Section 492 of the Act provides for two types of rates: ordinary and special rates. Councils are required to make and levy an ordinary rate each year on all rateable land in its area. This rate may vary for four types of land: farm, residential, mining and business land. Under the Act, a substantial amount of land is exempt from ordinary rates, including land held by the Crown (Commonwealth and State Government holdings) and land held by religious and charitable bodies. Councils also give rate discounts to certain categories of ratepayers (e.g. aged pensioners).

Councils are also empowered to raise special rates on properties that benefit from specific works or services. (Briefly explain S94 contributions) Under exceptional circumstances this may be all properties in the area.

The ordinary rate may consist of a base amount and an *ad valorem* amount. The base amount is a common absolute dollar levy on all properties within a rating category. It is intended to reflect the cost of common overhead services such as ????? and the revenue raised must not exceed 50% of the revenue from that rate category. Councils have a fair amount of discretion within this constraint.

The *ad valorem* amount of a rate is levied on the assessed land value of properties. This land value is the assessed improved land value, inclusive of capital applications. It is not the pure unimproved land value that Henry George and his followers advocated as the basis for all taxation[4]. Nor is it the property value inclusive of structure that is the basis of the property tax in most of the United States.

Chapter 15 of the Act enables the Minister for Local Government to limit a Council's general income, which means in effect the total (???) income from ordinary and special rates and annual domestic waste management charges. Each year the Minister informs councils of the maximum percentage by which they may vary this total income (is this how the rate pegging formula works? If not please briefly explain how it applies). The limit may vary for different councils. A

[4] Henry George, 1879, *Progress and Property*.

council that does not increase its annual charge to the limit permitted has two years in which it is allowed to catch up the shortfall.

The Act also enables councils to levy charges or fees for services that it provides. The Act generally encourages a flexible approach to setting charges and the use of modern pricing approaches subject to charges not exceeding reasonable costs.

3 Criteria for Taxes and User Charges

Administrative simplicity means that raising revenue should have low administration or transaction costs for the revenue raising agency. It may also be interpreted as a system that imposes low compliance costs. It may therefore be regarded as a form of cost-effective (efficiency) criterion.

The **equity criterion** means that taxes and charges should be fair to taxpayers. However, fairness has two possible and distinct interpretations. The *benefit principle* of fairness is that people should pay for services in proportion to the benefit that they receive. User charges that reflect costs are an application of this principle.

On the other hand, the *ability to pay principle* is that people should pay for services in accordance with their ability to pay. The *ad valorem* component of the ordinary rate is sometimes viewed as an application of this principle.

Which of the two principles should apply to local government, or the extent to which each principle should apply, depends on the role that local government is expected to play in the community. It is generally agreed that the Commonwealth has prime responsibility for equity in the community lies through its control over the income tax / welfare transfer system (see Abelson, 2003, Chapter 27). However, most local communities also wish to provide some equity for their local households. Thus the appropriate outcome is likely to be a balance between the benefit and the ability to pay principles.

In the public finance literature, an **efficient tax** is one that does not distort economic activity. The classic example of a distortionary tax was the seventeenth century British tax based on windows in the house. Not surprisingly households boarded up their windows. The cost of the tax was the sum of the tax paid and the loss of light. A more contemporary example would be the effect of income tax on labour supply. High taxes on housing may reduce the production and consumption of housing. Local government taxes may also distort the location of households or businesses.[5]

Other less common meanings of efficiency include autonomy and flexibility (the capacity to provide each government with sufficient income), and predictability and stability (so that councils can budget with confidence). Brief comments on these attributes of local taxes are made below.

---

[5] Note that this concept of efficiency is separate from efficient (low cost) administration of the tax system, which is dealt with under administrative simplicity.

An efficient user charge is one that encourages efficient use of resources. The principles are discussed further in Section 5.

4 Analysis of the Rating System

Administrative simplicity. The present rating system is administratively cost-efficient. The main reason for this is that the tax base (land) is not mobile and stays broadly the same in physical and usage terms from one year to the next. Changes in ownership are notified to councils. By contract the introduction of the poll tax in the United Kingdom in the late 1980s proved an administrative nightmare as councils had no reliable information base on their taxpayers.

The main exceptional administrative cost associated with the land value tax is the cost of regular valuations to a reasonable level of accuracy. Because the tax base is not related to an ongoing market transaction such as payment of a wage or a consumer purchase, there is a special transaction cost with estimating the tax base. Who pays this transaction cost – state or local govt?

Equity. As we have seen**,** equity implies an appropriate balance between benefit and ability to pay principles. This means balancing appropriately the ordinary rate base charge and *ad valorem* charge along with user charges.[6] These instruments provide councils overall with a reasonable capacity to produce fair outcomes subject to four reservations below. Moreover, because the tax base (land) is immobile and easily identified, tax cannot be evaded. Whether councils actually achieve a fair balance is a separate empirical matter that is beyond the scope of this paper.

However, there are four ways in which the rating system is not completely equitable. First, land values are correlated only weakly with income or with ability to pay. Land is only one component of wealth. Also, wealth is not necessarily correlated with income. Owner-occupied land does not produce income. Some unit owners (and not only occupants of penthouse apartments) have a high income, but pay relatively low rates even though they may use Council services more than house owners (e.g. a home with a garden may compost a lot of its waste). Property values or income are better indicators of ability to pay than are land values.

Second, many rate exemptions are inequitable. Many exempted bodies, especially state government trading enterprises, receive significant local government services and have the ability to pay for them (some pay tax equivalent payments to the Office of State Revenue, but these are not passed onto local councils). Third, valuations are sometimes inaccurate but hard to challenge, and so create unfair outcomes. Fourth, visitors generally contribute less than their fair share to the provision of local services. This can be alleviated partly by user charges, especially for parking. However, this may not compensate fully for the burden carried by ratepayers.

On the other hand, the claim sometimes made that local rates create horizontal inequality between areas should be dismissed. It is true that similar households living in similar quality houses pay higher rates (or receive poorer services) when they live in a poor area. This occurs because the rate per dollar of land value is higher in areas with low land values. However, the higher rate in the dollar is compensated by lower house prices. There is substantial evidence in the United States that differential property rates (or service levels) are capitalized in property prices including in land values (Mieszkowski and Zodrow, 1989).

[6] Ideally the overall system of charges should be fair. This does not require each component to be fair.

A final important matter relates to landlords and tenants. Although landlords pay the rates, the rates are mainly passed on to tenants in the long run. The return on property must equal that on other assets. If costs rise, either rents must rise or landlords vacate the sector in which case market rents rise in due course with falling unit supply. This places renters in a similar position to homeowners with regard to the bearing of local costs. However, as most renters occupy units, they usually pay a low share of the ordinary rate. Also tenants may not be aware of any link between their rents and council rates while their landlords may not be entitled to vote in council elections.

Efficiency. Taxation of land values is generally considered non-distortionary and therefore efficient because the supply of land is fixed. Taxation of land does not affect the total supply of land. This is true up to a point but it ignores the true economic nature of land.

First, land values include capital improvements to the land, including provision of local roads, water and sewerage services, power supply and so on. Therefore taxation of land value is in substantial part a tax on capital. However, because the demand for these components of a house is highly price inelastic, a land value tax has little (distortionary) effect on the provision of these services.

Second, land uses vary. In so far as taxes on certain land uses are higher than on others, for example higher on urban housing than on farmland, the land use may be distorted away from housing towards other uses such as farmland. This could occur if housing consumption was sensitive to the level of rates. However, rates (which average $??? Per household in NSW) areonly a small part of the user cost of housing, which includes actual and imputed interest payments. In practice a tax on land value has little effect on the amount of housing consumed or produced. It may be concluded that taxes on land value have only minor efficiency (distortionary) effects.

Other issues. Rates, which account for almost half of all ordinary income of councils, are predictable and stable and allow for a fairly high level of local financial autonomy. The homeowner land value tax base is not shared with other levels of government. Any lack of autonomy reflects a lack of income or an unwillingness of local jurisdictions to tax local household rather than an underlying weakness of the tax base.

Rate pegging. Because local councils are monopoly suppliers of various basic services, it may be argued that, like private monopolies, the price of their services (in this case local rates) should be regulated. Certainly there may be an abuse of monopoly power, which is not checked adequately by four yearly elections. Also municipalities and shires with a high tenant population may be oblivious to a councils rating policy since the link with their rents is not obvious and their landlords may not be able to exercise a vote on such policy. In such cases the true cost of services to the community may not be well understood by many voters resulting in a higher preference for services than would otherwise be the case.

On the other hand it may be questioned whether and how rate pegging in NSW affects actual rates. In the experience of the writer, rate pegging tends to legitimize and to encourage rate increases at the officially sanctioned maximum rate increase. Secondly, it may be questioned whether the criteria used by the Minister to determine the maximum rate increase and exceptions to this maximum have an adequate economic base. Since rate pegging was introduced in the mid 1970's, the Minister has often set the peg below generally accepted cost indices without giving an adequate explanation for such action. These are open questions, but there appears to have been limited research and analysis of these issues.

5 Local Government Charges

Efficient pricing of services, in the public sector as in the private, ensures efficient use of resources and an efficient output of services. Efficiency means producing the services that individuals are willing to pay for at least cost of supply. As shown in Abelson (2003, Chapter 15), efficient pricing of public services varies with market circumstances. The following are three important general principles:

- If the service is produced by a single public supplier, and output can be increased, the efficient price of the service is the short-run marginal cost, i.e. the cost of providing an extra unit of service.
- If the service is produced by a single public supplier, and output is fixed, the efficient price is the market clearing price.
- If the service is or can be supplied by more than one supplier, including by private firms, the efficient price is the long-run marginal cost, i.e. the future average cost of providing the service (past costs are ignored but all future costs are relevant).

Of course, equity considerations may suggest that government adopt other prices than these efficiency criteria suggest. They may suggest that prices be subsidized for some groups with the subsidy funded either by higher prices for other groups or from consolidated revenue.

Local councils are not especially restricted in the kinds of charges that they may make other than that the charges should reflect reasonable costs. This broad guideline (is this guideline in the legislation or is it issued by the LG???) provides some limits on the prices that councils can charge. However it does not provide clear pricing guidelines.

Three main areas in which prices or fees are charged are water and sewerage, waste management services, and development and building approval fees. Parking fees are a relatively new and potentially major source of revenue. We make some brief observations on efficiency implications of pricing in each of these areas. Of course, in each case an equity argument may be mounted for other charges, usually lower ones.

Water and sewerage services are typically supplied by a public monopoly (direct private competition is usually not viable at the local level). Where water is limited, efficiency strongly suggests setting a market clearing price to endure efficient use of the water. Often water is underpriced with the result that inefficient rationing of water has to be introduced.

Waste management services are a contestable service (is this true for all councils? Do any provide it themselves without market testing it?). Therefore long-run marginal cost prices are appropriate. However, the structure of charges is important. Efficient management of waste is encouraged by user charges that reflect the weight or volume of materials collected rather than by fixed annual charges that do not influence use of the service.

When a local council is sole supplier of development and building approvals (what is typical situation – suggest a footnote), efficient pricing suggests that they approvals be charged for at marginal cost. Charging a higher price may deter households from proceeding with minor developments or, more likely, encourage significant non-compliance. However, if the service is provided competitively, long-run marginal cost pricing is appropriate.

When there is a shortage of parking facilities, efficiency strongly suggests charging at the market clearing price. This ensures that scarce parking space is utilized most efficiently. Parking charges are also an effective way of ensuring that visitors pay for local services. Importantly, parking systems are now visually relatively neutral. However, groups who lose free parking rights naturally resent the new charges and the fines that go with overstaying parking meters A recent survey using Office of State Revenue data obtained under Freedom of Information laws found that parking fines alone generated $94.7 million in council income in 2004/05, up from $59.8 million in 2002/03.[7] (if you would like a copy of this I could fax or post it to you)

6 Conclusions

The NSW land value rating system is administratively quite simple, although there is a significant valuation load. It also has only small distortionary resource impacts. Moreover the rating system is broadly a fair one that allows both for both the beneficiary and the ability to pay principle.

However, there are some inequities at least in some jurisdictions due to a low correlation between land values and income (ability to pay), wide ranging rate exemptions, inaccurate valuations, and undercharging for visitors. Greater use of user charges can reduce some of these inequities. It would also be timely to review the whole range of rate exemptions, especially for government trading enterprises

In addition, while there is a case for rate pegging if well applied, this paper recommends that the effects of, and criteria used in, the rate pegging system be reviewed, especially the repeated failure over many NSW Government administrations to adhere to an objective cost index in setting the annual rate

Finally the paper outlines the key principles of efficient pricing of local public services. These principles are more precise that the generic instruction (from where???) to local councils that prices should reflect reasonable costs. This paper recommends that the Department of Local

[7] *Councils out of control - Fury at parking fines scandal*, Sydney Daily Telegraph, 24th October 2005.

Government refine the pricing guidelines for local councils, using perhaps the Productivity Commission's report on cost recovery by general government agencies

References

Abelson, P., 2003, *Public Economics, Principles and Practice,* Applied Economics, Sydney.

Mieszkowski, P., and G.R.Zodrow, 1989, 'Taxation and the Tiebout Model: The Differential Effects of Head taxes, Taxes on Land Rents, and Property Taxes', *Journal of Economic Literature*, XXVII, 1098-1146.

Productivity Commission, Inquiry Report, *Cost Recovery by Government Agencies (Report No.15)*, March 2002. (Peter, the Treasurer's media release on the Productivity Commission's website has a good tabular summary of this report's recommendations and the government's response to each proposal).

Salanie, B., 2003, *The Economics of Taxation*, MIT Press.