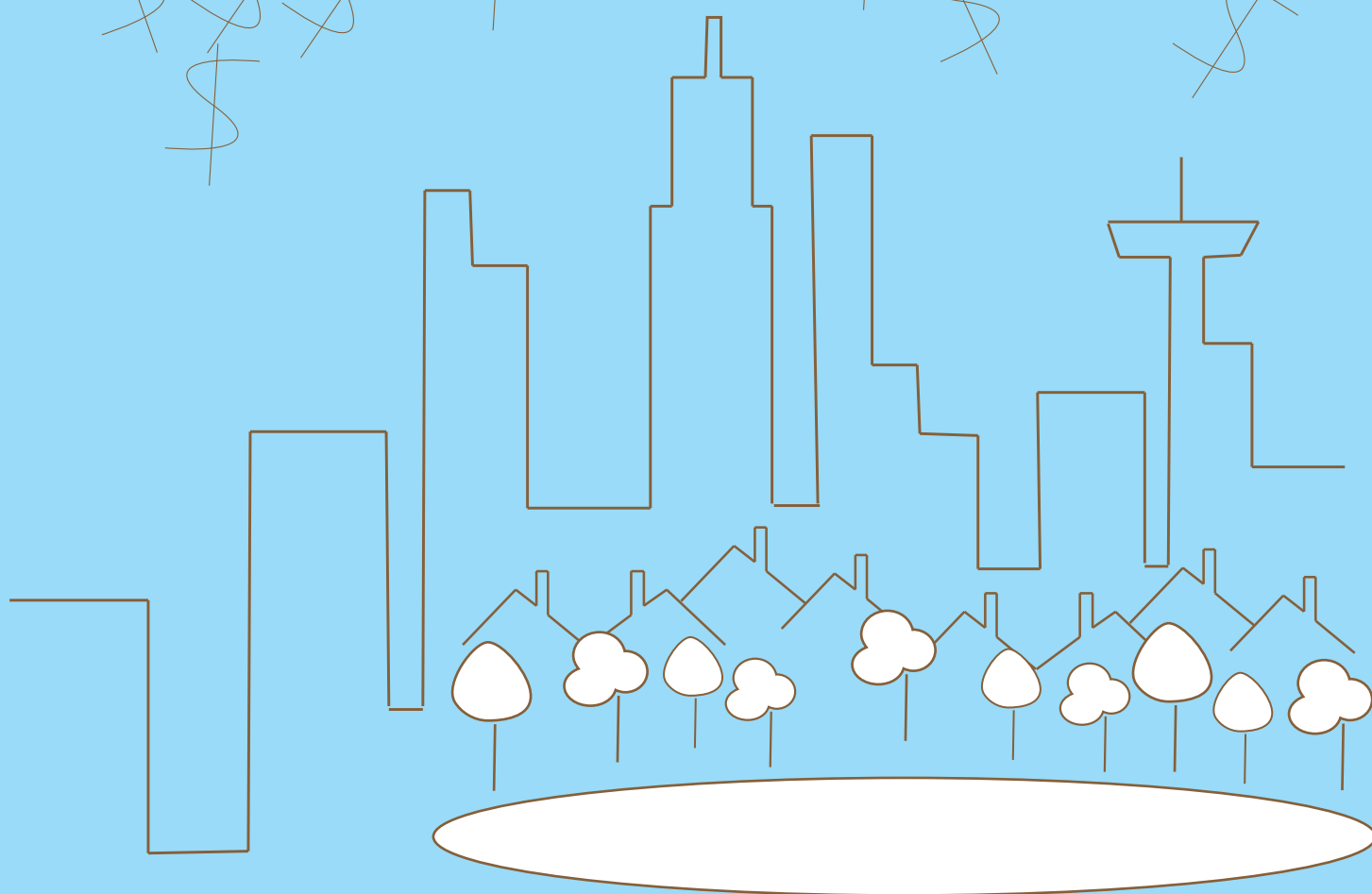


TAXING GROWTH AND DEVELOPMENT

A Critical Review of the Role of Development and Financial Contributions



LOCAL GOVERNMENT
FORUM

Property Council
New Zealand



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F O R U M

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New Zealand



The Local Government Forum comprises organisations that have a vital interest in the activities of local government. Its members include Business New Zealand, Electricity Networks Association, Federated Farmers of New Zealand, New Zealand Business Roundtable, New Zealand Chambers of Commerce and New Zealand Retailers' Association. The Forum was established in 1994 to promote greater efficiency in local government and to contribute to debate on policy issues affecting it.

Property Council New Zealand is a not for profit organisation that represents New Zealand's commercial, industrial, retail, property funds and multi-unit residential property owners, managers and investors. Property Council New Zealand represents all forms of commercial property and property investment in New Zealand.

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EXECUTIVE SUMMARY

- Most territorial local authorities impose development or financial contributions, or both, when land is subdivided or developed. Regional councils may impose financial contributions but not development contributions. This report examines whether such contributions are desirable from an economic perspective.
- Under the Local Government Act 2002, territorial local authorities may use development contributions to fund reserves, network infrastructure and community infrastructure where there is a direct causal link between the need for such capital expenditure and a development (or more than one development in combination). Such expenditure is often said to be 'caused by growth'. The claimed causal link may be problematic as *Neil Construction Limited & Ors v North Shore City Council* highlighted.¹
- Development contributions are commonly used to fund capital expenditure on potable water, wastewater and stormwater systems, transport, and parks and reserves. They are less commonly used to fund capital expenditure on recreation and parking facilities, public libraries, community halls, cemeteries, refuse and recycling facilities, public conveniences and urban design.
- Under the Resource Management Act 1991, financial contributions may be applied by councils to fund capital expenditure on similar activities to those which may be funded by development contributions where the spending is intended to mitigate the environmental effects of developments. They tend to be preferred to development contributions in funding parks and reserves.
- The Local Government Act 2002 introduced development contributions following lobbying by local government. The sector argued that financial contributions were too restrictive. They were also subject to the appeal provisions contained in the Resource Management Act. There are no comparable rights of appeal for development contributions.
- Almost all capital expenditure funded by development and financial contributions is spent upstream or downstream of the relevant subdivision or development. The landowner generally directly funds works undertaken within the subdivision or development.
- Financial and development contributions have been growing rapidly. Development contributions were expected to yield \$3.9 billion or 5.3 percent of the total revenue that all territorial authorities were projected to raise during 2006–16. They comprise up to 20 percent of the forecast revenue of certain local authorities whose population is growing rapidly.

¹ *Neil Construction Limited & Ors v North Shore City Council*, High Court, Auckland, CIV-2005-404-4690, 21 March 2007.

- Development contributions are a large impost on some developments. Contributions of around \$30,000 for each residential lot are common in certain districts. Commercial projects are also subject to development and financial contributions. Those costs can generally be expected to be passed forward to homeowners and consumers, or backward to the owners of undeveloped land and suppliers of other inputs, including employees.
- Major problems with development and financial contributions are identified. They include the following.
 - Councils may apply complicated formulas to calculate the level of development contributions. The detail and apparent precision of such formulas may belie their efficacy from an economic perspective, including the validity of the causal relationship between a development and capital expenditure on infrastructure.
 - Development and financial contributions are poor substitutes for efficient prices where such prices are feasible and appropriate. Development and financial contributions, for example, do not confront new and existing users with the marginal cost of supplying the related goods and services.
 - The level of spending on infrastructure is often determined politically or administratively, without regard to the willingness of users to pay. In those circumstances, development and financial contributions, and user charges cannot affect the level of resources committed to the supply of the relevant goods or services. From an economic perspective, they are selective taxes rather than prices charged for the goods and services supplied. Such taxes are likely to be inefficient and inequitable.
- Some broad concerns arise in examining whether development and financial contributions are desirable when user charges are feasible and appropriate.
 - The tyranny of the majority may apply. Because development and financial contributions are levied on a limited number of landowners each year who command few votes, elected representatives are encouraged to impose excessive costs on them for the benefit of the majority of residential and non-residential ratepayers.
 - The infrastructure to be funded by development and financial contributions may be 'gold' or 'green' plated. Councils may be encouraged to incur a higher level of capital expenditure initially, funded by such contributions, rather than incur further capital expenditure at a later stage when development contributions cannot be charged. They may also be induced to favour a more capital-intensive investment option with lower operating spending than otherwise because operating costs are generally funded from rates.
 - The funding of private goods and services by development and financial contributions encourages waste and impairs competition. User charges induce consumers to conserve resources and encourage alternative sources of supply to emerge where economic.

- Development and financial contributions lack transparency and weaken the accountability of elected representatives.
- Infrastructure (such as stormwater systems) that benefits the community generally rather than affected landowners is required to be vested in councils without compensation. The taking of property rights by any government without good cause and compensation encourages waste and discourages private investment. However, in computing the level of compensation, any increase in the value of the development that arises from local government services should be taken into account.
- Financial and development contributions may be inconsistent with longstanding constitutional principles.
- The mispricing of goods and services rather than the presence of external costs and benefits is the main reason why mass public passenger transport, public libraries, museums and art galleries are subsidised. If governments wish to subsidise public transport and amenities that could appropriately be funded through use-related charges, they should usually do so through general taxes (central government) and rates (local government).
- The main recommendations are summarised below.
 - Prices rather than development and financial contributions should be charged for goods and services where they are feasible and appropriate.
 - There are grounds for imposing the cost of some genuine local public goods on landowners who benefit. The cost of supplying public goods, such as neighbourhood parks, reserves, outdoor recreation facilities and stormwater systems that exclusively or predominantly service or enhance a development and are located within a development, may appropriately be imposed on relevant households and businesses by requiring the developer to pay for, or provide, the facilities. There should be a close connection between the subdivision or development on the one hand, and the relevant infrastructure and facilities on the other.
 - Developers should have the right of appeal against the requirement to fund public goods, as is presently the case for financial contributions but not for development contributions.
 - An economic test of the merits of investment in local public good activities is that the value of the development with the relevant facilities should be no less than the sum of its value without the investment in local public good facilities and the cost of their provision. Consideration should be given to making a value for money test a criterion for establishing the reasonableness of council requirements and charges. If that approach is not adopted, the maximum level of development contributions should be capped, as is generally the case in Australia, and the principle of capping financial contributions should be retained.

I OVERVIEW

[W]hether viewed as a tax or a charge or a hybrid, a development contribution involves:

A compulsory exaction of money by a public authority for public purposes, enforceable by law ... not a payment for services rendered.

Potter J.²

Landowners have traditionally been required to bear the capital cost of works that are undertaken within subdivisions and developments and are necessary to enable council-provided services to be used. Landowners have also been required to compensate local authorities for certain costs that councils incur in connecting council-provided services for land that is subdivided or developed.

Consistent with these arrangements, infrastructure constructed on private land that is directly related to the provision of services to the owner (such as water pipes connecting a house to the feeder supply in the street) is generally privately owned. Its upkeep and renewal is the responsibility of the landowner.

Territorial authorities had power to make advances to landowners for potable water, wastewater and stormwater (the 'three waters') connections.^{3 4} Advances were often made to assist landowners to connect to new reticulation systems that replaced the landowner's facilities, such as rainwater and septic tank systems.

Landowners are generally best placed to control the costs of works undertaken within developments. They enjoy the majority of the benefits arising from the investment. Aside from possible concerns about the cost of connecting to council-provided services (which may be subject to little or no competition) and the efficacy of standards applied to works connected to council networks, these longstanding arrangements are appropriate from an economic efficiency perspective and appear to be broadly accepted by landowners.

Land for neighbourhood roads and infrastructure constructed on or under such land by developers (such as water pipes) are required to be vested in councils without

² *Neil Construction Limited & Ors v North Shore City Council*, High Court, Auckland, CIV-2005-404-4690, 21 March 2007, para 47. This case is referred to below as the *Neil* case. The quotation cited by Potter J is the definition of a tax given by Latham CJ in the High Court of Australia in *Matthews v Chicory Marketing Board (Vic)* (1938), 60 CLR 263.

³ See, for example, Local Government Act 1974, ss 384 (water supply) and 463 (sewerage and stormwater). These powers were not included in the Local Government Act 2002, which repealed most of the Local Government Act 1974.

⁴ For convenience, potable water is referred to below as water.

compensation. Similarly, infrastructure constructed on private land as part of a development that extends council-provided services to the neighbourhood or beyond rather than to individual properties (such as feeder pipes for water and stormwater reticulation systems) is also generally vested in councils. Councils specify the minimum standards for work affecting their networks and are responsible for their subsequent operation, maintenance and renewal.

Councils have generally been responsible for the construction of infrastructure required up to the boundary of developments, such as water and stormwater mains, and roads. They were traditionally funded from a combination of general and special rates, debt, government grants, operating surpluses and, in the case of some water and road works, user charges. Rates might be viewed as a proxy for a recurring flat rate charge for property-related services that cannot be funded through user charges.

These provisions have typically applied to property-related services provided for residents and businesses by a council network undertaking, such as the three waters and roads (including related road markings, signs and traffic signals, channelling, stormwater disposal, berms, footpaths and street lighting). They mainly applied in cities, towns and some rural settlements because comparable infrastructure, other than state highways and local roads, was not usually provided in rural areas. Similar provisions often applied when councils supplied electricity or gas.⁵

Landowners who subdivide or develop their land have generally been required to contribute to parks and reserves in cash or in kind. This facilitated the establishment of neighbourhood parks and reserves. Although the cost is initially borne by the developer, it is ultimately shifted forward to homeowners and other property owners (who pay a higher price than otherwise for developed land) or backward to the owners of undeveloped land (who receive a lower price than otherwise) and suppliers of other inputs.⁶

A free-rider problem (the infeasibility of excluding people who will not pay voluntarily for the goods or services they enjoy) may arise in respect of public goods and services such as parks. The practice of funding some public goods by tying charges to the use of complementary or closely related private goods or services is widely recognised in the economic literature as a response to the free-rider problem.⁷ The requirement for developers to contribute land, money, or both, for parks, reserves and neighbourhood

⁵ Privately provided network services, such as fixed-line telephone and television services, are often supplied on a similar basis, with homeowners paying directly for connection costs and equipment installed on their property, and with operating expenditure and a return on capital mainly funded through a combination of use-related and flat-rate charges. Private providers usually undertake the work required whereas council providers tend to charge connection fees and require landowners to undertake any work necessary on their properties. Privately owned network assets are largely funded from cash flow from operating activities, and debt and equity capital. Private suppliers may choose to recover some, or all, of the initial capital outlays and connection costs from income earned subsequently from the supply of services.

⁶ In the long run, developers could expect to earn a normal return on development activities at the margin. Thus developers do not bear the cost. The level of development undertaken may, however, be lower than otherwise.

⁷ The classic example relates to the funding of lighthouses in eighteenth-century Britain through port charges, see section 4.2.

roads are examples. This approach becomes problematic, however, as people who do not contribute (directly or indirectly) to the cost of public goods enjoy an increasing proportion of their benefits. The use of reserve contributions levied on developments in one locality to fund neighbourhood parks in distant areas of the district or region is an example.

The scope of contemporary development and financial contributions extends well beyond the traditional arrangements outlined above. The Local Government Act 2002 (LGA 2002) introduced development contributions. It empowers territorial local authorities (but not regional councils, or council controlled or owned organisations) to levy them. Territorial authorities and regional councils may apply financial contributions as a condition of a resource consent issued under the Resource Management Act 1991 (RMA 1991). Before the RMA 1991 came into force, financial, development and reserve contributions could be imposed under the Local Government Act 1974. Present statutory provisions applicable to development contributions are complex.

Development contributions may be used to fund reserves, network infrastructure and community infrastructure where there is a direct causal link between the need for such capital expenditure and a development (or more than one development in combination). Such expenditure is said to be caused by growth. Development contributions are often used to fund capital expenditure on the three waters, transport, parks and reserves. They are less commonly used to fund capital expenditure on recreation and parking facilities, public libraries, community halls, cemeteries, refuse and recycling facilities, public conveniences and urban design.⁸

Financial contributions may be applied to fund similar capital expenditure where the spending is intended to mitigate the adverse environmental effects of a development. They tend to be preferred to development contributions in funding parks and reserves.⁹ Councils cannot apply development and financial contributions to fund the same expenditure for the same purpose, or to fund operating spending.

Councils, especially large councils and those that are growing strongly, are increasingly using development contributions to fund capital expenditure. Relatively less reliance is being placed on financial contributions. In 2007/08, 44 of the 73 territorial local authorities had an operative development contributions policy while 70 had a financial contributions policy.¹⁰ Development contributions are expected to yield \$3.9 billion or 5.3 percent of the total cumulative revenue of \$73.3 billion that the 73 territorial authorities were projected to raise during 2006–16.¹¹ However, development contributions are equal to up to 20 percent of the forecast total revenue of some local authorities, including those

⁸ SPM Consultants Limited (2008a), *Analysis of 2007/08 Development Contributions*, Report prepared for the Department of Internal Affairs, Department of Internal Affairs, Wellington, p 20.

⁹ SPM Consultants Limited (2008b), *Analysis of 2007/08 Financial Contributions*, Report prepared for the Department of Internal Affairs, Department of Internal Affairs, Wellington, p 17.

¹⁰ SPM Consultants Limited (2008a), *op cit*, p 6 and SPM Consultants Limited (2008b), *op cit*, p 5. Of the 44 territorial authorities with an operative development contributions policy, 42 had a financial contributions policy.

¹¹ SPM Consultants Limited (2008a), *op cit*, p 25.

experiencing high population growth such as Queenstown Lakes District Council and Tauranga City Council.¹²

Infrastructure is like any other form of investment from an economic perspective. Some classes of infrastructure have a long life, for instance certain bridges and wastewater and water pipes are 75 or more years old. Infrastructure is also often capital intensive.

Almost all capital expenditure funded by development and financial contributions is spent upstream or downstream of the relevant subdivision or development because the landowner generally funds works directly within the subdivision or development. The related goods and services are often supplied by councils to users free of charge or on a heavily subsidised basis. It may be infeasible to charge for goods and services that are genuine public goods, for instance some stormwater services, and it may also be inappropriate to charge for them or to charge a use-related price at a level that would fund their cost.

However, some goods and services funded by development and financial contributions are private goods and services (for example, water supply and wastewater disposal). The supply of private goods and services should be left to the private sector. There is strong evidence that, on average and over time, private ownership of businesses is more efficient than public ownership.¹³ If the government elects to provide private goods and services, it should generally fund them on a user-pays basis rather than from development or financial contributions, or general rates revenue. Capital expenditure would initially be funded mainly by borrowing, ratepayers' equity and cash flow from operations. User charges or prices may also be appropriate where the relevant goods and services are club goods. These are an intermediate category between private and public goods that can be funded by user charges.

Resources are likely to be allocated efficiently if the prices charged for goods and services reflect their opportunity cost (efficient prices), if costs are minimised and if the level of goods and services supplied is responsive to user demand (willingness to pay). This outcome is less assured if the level of output is determined through political and administrative processes and if the supply of goods and services is funded from taxes such as rates.

Development and financial contributions focus on capital spending that is perceived to be due to growth. Although the LGA 2002 does not specify how attributed units of demand are to be measured, councils generally use some measure of population or household growth to allocate capital expenditure to developments.

The growth in population or the number of households is often a poor proxy for the incremental demand for goods and services arising from a development or subdivision. There is no need to use a proxy measure of demand to allocate costs when the particular

¹² *Ibid* and SPM Consultants Limited (2008b), *op cit*.

¹³ Megginson, William L and Netter, Jeffrey M (2001), 'From State to Market: A Survey of Empirical Studies on Privatization', *Journal of Economic Literature*, vol 39, no 2, pp 321–389.

product supplied can be priced directly. Allocations based on growth in the number of households may be arbitrary and non-transparent.

New Zealand's development contributions regime was largely modelled on the equivalent Australian contribution schemes, particularly that of New South Wales. In 2007, New South Wales restricted contributions to the funding of infrastructure and land requirements necessary to support development rather than infrastructure deemed to be caused by population growth.¹⁴

Development and financial contributions are poor substitutes for efficient prices where such prices are feasible and appropriate. Development and financial contributions, for instance, do not confront new and existing users with the marginal cost of supply for the following main reasons.

- The level of capital spending taken into account in setting development and financial contributions usually reflects the outlays projected in a council's long-term council community plan (LTCCP). They are arbitrarily limited to a 10-year period, are often not discounted to reflect the time value of money and may not take account of the extent to which capital spending is brought forward by additional demand.
- The forecast aggregate level of capital spending is allocated to developments using a proxy to measure demand perceived to be caused by growth even when a direct measure (such as water consumed) could be used.
- Operating costs are omitted. The opportunity cost of water is also omitted.

The level of spending on infrastructure is often determined politically or administratively, without regard to the willingness of users to pay. In those circumstances, development and financial contributions, and user charges cannot affect the level of resources committed to the supply of the relevant goods or services. From an economic perspective, they are best viewed as selective taxes rather than prices charged for goods and services supplied. Such taxes are likely to be inefficient and inequitable. They may unduly discourage subdivisions and developments because the amount of investment is likely to be more sensitive to small changes in the level of the tax than property, especially the unimproved value of land, which is subject to general rates. Moreover, such taxes are horizontally and vertically inequitable.

Some broad concerns arise in examining whether development and financial contributions are desirable when user charges are feasible and appropriate.

- The tyranny of the majority may apply. Because development and financial contributions are levied on a limited number of landowners each year who command few votes, elected representatives are encouraged to impose excessive costs on them for the benefit of the majority of residential and non-residential ratepayers. The *Neil* case highlights this risk. Potter J observed that the purchasers of properties that are developed become future ratepayers in the district of the relevant local authority,

¹⁴ Developer contributions, which apply in some states and territories of Australia, are summarised in the appendix.

but in relation to any development contribution required, they have no say through the ballot box.¹⁵ A similar risk arises with all selective taxes that are not subject to the freely given consent of affected ratepayers before the relevant spending is committed.

- The infrastructure to be funded by development and financial contributions may be 'gold' or 'green' plated. Councils may be encouraged to incur a higher level of capital expenditure initially, funded by such contributions, rather than incur further capital expenditure at a later stage when development contributions cannot be charged. They may also be induced to favour a more capital-intensive investment option with lower operating spending than otherwise because operating costs are generally funded from rates.
- The funding of private goods and services by development and financial contributions encourages waste and impairs competition. User charges induce consumers to conserve resources and encourage alternative sources of supply to emerge where economic. If, for example, the efficient price of reticulated water is sufficiently high, homeowners may be encouraged to collect rainwater for use in their gardens.
- Development and financial contributions lack transparency and weaken the accountability of elected representatives. SPM Consultants Limited was unable to ascertain how financial contributions were determined for 30 of the 70 local authorities known to have a financial contributions policy.¹⁶
- Infrastructure (such as stormwater systems) that benefits the community generally rather than affected landowners is required to be vested in councils without compensation. The upholding of strong property rights furthers the autonomy of the individual and encourages the productive use of resources. The taking of property rights by the government without good cause and compensation encourages waste and discourages private investment. However, in computing the level of compensation, any increase in the value of the development that arises from local government services should be taken into account.

Financial and development contributions may be inconsistent with longstanding constitutional principles. Suri Ratnapala has observed the following:

The RMA's grant of virtually unconstrained discretionary power to the executive represents a calculated departure from the rule of law standard and the principle of parliamentary democracy in favour of command and control.¹⁷

¹⁵ *Neil case, op cit*, para 55. Because development contributions are intended to fund growth, Potter J appears to have assumed all property owners would be new to the district. This may not be the case.

¹⁶ SPM Consultants Limited (2008b), *op cit*, p 17.

¹⁷ Ratnapala, Suri (2009), 'Environmentalism Versus Constitutionalism: A Contest Without Winners', Research Paper No. 09-17, TC Beirne School of Law Legal Studies, The University of Queensland, Brisbane.

On this basis, financial contributions, which are inextricably linked to the RMA 1991, are inconsistent with the rule of law. Development contributions may also depart from that principle for similar reasons.

The mispricing of road use rather than the presence of external costs and benefits is the main reason why mass public passenger transport is subsidised. The funding of investment in passenger transport facilities by development and financial contributions subsidises public transport users, including bus commuters who benefit from the use of roads, and discourages the subdivision and development of land. Efficiency and recognised equity criteria (such as horizontal and vertical equity) suggest that, if the government wishes to subsidise public transport, it should generally do so through general taxes (central government) and rates (local government). The cost would then be imposed on all taxpayers and ratepayers rather than selected landowners.

Mispricing, rather than externalities, is also the main reason why public libraries, museums and art galleries are heavily subsidised by ratepayers. If they are to be subsidised, they should generally be funded from rates rather than development and financial contributions.

There are, however, grounds for imposing the cost of genuine local public goods on landowners who benefit. The cost of supplying public goods, such as neighbourhood parks, reserves, outdoor recreation facilities (for example, playgrounds) and stormwater systems that predominantly or exclusively service or enhance a development and are located within a development, may appropriately be imposed on relevant households and businesses by requiring the developer to do one or more of the following:

- undertake the necessary works;
- make a monetary contribution; or
- grant land (for example, for a park).

If a development comprises a new town or town centre as well as land for residential and business purposes, there may be grounds for funding part or all of the capital cost of a wide range of amenities, such as libraries, that are constructed within the development in the same way.

These arrangements should preferably be agreed between the council and developer before the development is committed. This approach has the virtue of obtaining a measure of consent of the payer, although such an agreement may be less than freely given because councils can withhold resource consents. The amount of the contribution should relate to the cost of the land and facilities to be provided in the particular neighbourhood.

There should be a close connection between the subdivision or development on the one hand, and relevant infrastructure and facilities on the other. Because facilities such as parks are located further away from the development, the nexus between the cost imposed on landowners within the development and the related benefit derived by them becomes problematic. The link also becomes doubtful when the facilities within a development are likely to be widely used by people who reside outside of the development.

There may also be grounds for a developer to fund at least a part of public good facilities that are constructed upstream or downstream of the development but are located close to it and are to be used predominantly by the landowners. However, a much tighter relationship between the development and the location of the facilities and their use by landowners is required than at present to contain the potential for the abuse of development and financial contributions. Public goods not closely connected to a particular development should be funded from general revenue.

Landowners should have a right of appeal against the requirement to fund public good activities through development, financial and reserve contributions. At present, they may only appeal against financial contributions because they are imposed as a condition of a resource consent.

An economic test of the merit of investment in local public good activities is whether the value of the development with the relevant facilities is at least equal to the sum of the value of the development without those facilities and the cost of their provision. Consideration should be given to making a value for money test a criterion for assessing the reasonableness of council infrastructural requirements. This would encourage councils to limit their charges to the value of public amenities that benefit landowners.

The balance of this report is presented in 6 sections. The next section (section 2) summarises statutory provisions relating to development and financial contributions. The *Neil* case is also reviewed. The size and significance of financial and development contributions are examined in section 3. The economic framework is discussed in section 4. The funding of infrastructure is analysed in section 5. The question of whether development and financial contributions are desirable general revenue taxes is addressed in section 6. The conclusions are presented in section 7.

2

STATUTORY FRAMEWORK

2.1 Introduction

The statutory authority for financial, development and reserve contributions was contained in the Local Government Act 1974 and some of its predecessor statutes.^{18 19} The statutory power to impose financial contributions, aside from certain transitional arrangements, was transferred by the RMA 1991 to that Act. The statutory provisions relating to financial contributions under the RMA 1991 were more limited than those that applied under the Local Government Act 1974 and are subject to appeal provisions that apply to district plans and decisions relating to resource consents.

Certain territorial authorities, including the North Shore City Council, subsequently lobbied the government to include an alternative funding tool to financial contributions in the LGA 2002. Development contributions were introduced in response. Local Government KnowHow commented on their adoption in the following terms:

The biggest change created by the new provisions of the Act is the emphasis placed on integrating development contributions with the other strategic planning processes which the council must undertake.²⁰

In July 2003, the Papakura District Council became the first council to apply development contributions under the LGA 2002. Other councils that implemented development contributions soon after the LGA 2002 came into force included the Waitakere, Manukau and North Shore city councils and Franklin District Council.²¹

¹⁸ Under the Land Act 1885, purchasers of Crown land had to pay one-third of the price to the local authority for roading. From 1896, those leasing Crown land had to pay one-third of their rent (or one-quarter for small grazing runs) towards roads, see Swarbrick, Nancy (undated), 'Rural Services', *Te Ara – The Encyclopaedia of New Zealand*, www.teara.govt.nz (last accessed 25 August 2009).

¹⁹ Section 335 of the Municipal Corporations Act 1920, for example, required property owners to provide for roads and reserves. Section 351 of the Municipal Corporations Act 1954 empowered a local authority to refuse to approve a subdivision plan where adequate provision had not been made for drainage or the disposal of sewage. Section 351BE of that Act, as amended in 1964, required developers to pay an amount that the local authority considered 'fair and reasonable' for, or towards, the cost of providing water, drainage or sewer connections, as well as meeting the cost of constructing such works within the development. Similar provisions were included in the Local Government Act 1974, part XX.

²⁰ Local Government KnowHow (2003), *Best Practice Guide to Development Contributions*, Local Government New Zealand, Wellington, p 47. Local Government KnowHow comprises Local Government New Zealand, the Society of Local Government Managers and the Department of Internal Affairs. It is understood the *Guide* was withdrawn in response to the decision in the *Neil* case, *op cit*.

²¹ Covex Limited (2004), *The Socio-economic Impact of Development Contributions for Waitakere City Council*, Waitakere City Council, Waitakere City, p 29.

The statutory provisions on financial and development contributions are related. The provisions common to both are examined before their separate provisions are discussed in turn.²²

2.2 Common provisions

Financial and development contributions are similar. However, only a territorial local authority can impose development contributions. The Shand Inquiry proposed that regional councils also be empowered to levy them. The Labour-led government did not adopt this recommendation, although councils in the Auckland region were invited to develop a region-specific development contribution. This is likely to be overtaken by reorganisation of local government governance in Auckland.^{23 24}

The provisions in the LGA 2002 that relate to financial and development contributions must be interpreted in the light of the purposes of the LGA 2002 and of local government.²⁵ The purpose of local government is to enable democratic local decision-making and action by, and on behalf of, communities, and to promote the social, economic, environmental and cultural well-being of communities, in the present and for the future.²⁶ The social, economic, environmental and cultural well-being of communities is often referred to as the 'four well-beings'.

Local authorities are required, at all times, to have a LTCCP. It must be adopted, and can only be amended, using the special consultative procedure.^{27 28}

A local authority must adopt certain funding and financial policies, including a revenue and financing policy, and a development or financial contributions policy, using the special consultative procedure. These policies must be included in the council's LTCCP and can only be changed as an amendment to the LTCCP.²⁹

²² The discussion that follows draws mainly on the relevant legislation and Kirkpatrick, David (1999), *Financial Contributions and the Law: An Overview*, www.qualityplanning.org.nz (last accessed 25 November 2008), DLA Phillips Fox (2008), *Review of Financial Contributions & Development Contributions*, Unpublished report for the Ministry for the Environment and Local Government New Zealand, Auckland, SPM Consultants Limited (2008a), *op cit* and SPM Consultants Limited (2008b), *op cit*.

²³ Shand, David, Horsley, Graeme and Cheyne, Christine (2007), *Funding Local Government: Report of the Local Government Rates Inquiry*, Department of Internal Affairs, Wellington, p 21. This report is referred to below as the Shand Inquiry.

²⁴ Department of Internal Affairs (2008), 'Local Government Rates Inquiry: Progress', Report to the Minister of Local Government, 16 December, Department of Internal Affairs, Wellington.

²⁵ *Neil case, op cit*.

²⁶ LGA 2002, s 10.

²⁷ LGA 2002, s 93.

²⁸ The special consultative procedure requires councils to prepare a statement of proposal, include it on the agenda of a meeting of the local authority and make it available for public inspection. A summary of the proposal must be publicised and distributed, and the opportunity must be provided for people and other interested parties to make submissions on the proposal, see LGA 2002, ss 83 to 89.

²⁹ LGA 2002, s 102. A council could resolve not to apply financial or development contributions.

According to Potter J, a development contributions policy must comply strictly with the relevant provisions of the LGA 2002.³⁰ They are the sole source of a council's power to extract development contributions. The policy on development or financial contributions must, in relation to the purposes for which development or financial contributions may be required, do the following:

- summarise and explain the capital expenditure identified in the LTCCP that the local authority expects to incur to meet the increased demand for community facilities resulting from growth;
- state the proportion of capital expenditure that will be funded by development or financial contributions and other sources of funding;
- explain, in terms of the funding criteria specified in section 101(3) of the LGA 2002, why the local authority has determined to use such funding sources to meet its forecast capital expenditure;
- identify separately each activity or group of activities for which a development or financial contribution will be required and, in relation to each activity or group of activities, specify the total amount of funding to be sought by development or financial contributions;
- comply with the statutory requirements relating to the contents of a development contributions policy and schedule thereto (sections 201 and 202) if development contributions will be required;³¹ and
- summarise the provisions that relate to financial contributions in the district or regional plan prepared under the RMA 1991 if financial contributions will be required.³²

The information contained in a LTCCP in respect of assets (asset management plans) is used in computing financial and development contributions. A LTCCP must, in relation to each group of activities of the local authority, identify the assets or groups of assets required and identify the following, in relation to those assets or groups of assets:

- how the local authority will assess and manage the asset management implications of changes to the following:
 - demand for, or consumption of, relevant services; and
 - service provision levels and standards;
- what additional asset capacity is estimated to be required in respect of changes to each of the matters described immediately above;
- how the provision of additional asset capacity will be undertaken;

³⁰ *Neil case, op cit*, para 48.

³¹ LGA 2002 ss 201 and 202 are summarised below.

³² LGA 2002, s 106(2).

- the estimated costs of the provision of additional asset capacity identified above, and the division of those costs between each of the matters in respect of which additional capacity is required;
- how the costs of the provision of additional asset capacity will be met;
- how the maintenance, renewal and replacement of assets will be undertaken; and
- how the costs of the maintenance, renewal and replacement of assets will be met.³³

The controller and auditor-general is required to audit a council's draft LTCCP. His report on the asset management plans for LTCCPs 2006–16 concluded that a significant number of local authorities did not clearly meet the disclosure requirements contained in Schedule 10 of the LGA 2002 and did not clearly explain the way they were dealing with anticipated growth in relation to asset management.³⁴

An overarching principle of financial management contained in the LGA 2002 requires a local authority to manage its revenues, expenses, assets, liabilities, investments and general financial dealings prudently and in a manner that promotes the current and future interests of the community. A local authority must make adequate and effective provision in its LTCCP and annual plan (where applicable) to meet the expenditure needs of the local authority that are identified in its LTCCP or annual plan.³⁵

The key criteria for funding council spending are contained in section 101(3) of the LGA 2002. They apply to spending that may be funded by development or financial contributions. The funding needs of a local authority must be met from the sources that the local authority determines to be appropriate, after consideration of the following:

- the matters, in relation to each activity to be funded, as listed below:
 - the community outcomes to which the activity primarily contributes;³⁶
 - the distribution of benefits “between the community as a whole, any identifiable part of the community, and individuals” (the benefit principle);
 - the period in or over which those benefits are expected to occur;
 - the extent to which the actions or inaction of particular individuals or a group contribute to the need to undertake the activity (the exacerbator pays principle);
 - the costs and benefits, including consequences for transparency and accountability, of funding the activity distinctly from other activities;³⁷ and

³³ LGA 2002, Sch 10, cl 2(1)(d).

³⁴ Brady, Kevin (2007), *Matters arising from the 2006–16 Long-Term Council Community Plans*, Office of the Controller and Auditor-General, Wellington, pp 65 and 68.

³⁵ LGA 2002, s 101(1) and (2).

³⁶ A local authority must, not less than once every six years, carry out a process to identify community outcomes for the intermediate and long-term future of its district or region. It is also required to monitor and, not less than once every three years, report on progress made by the community in achieving the community outcomes of the district or region, see LGA 2002, ss 91 and 92.

³⁷ LGA 2002, s 101(3)(a).

- the overall impact of any allocation of liability for revenue needs on the current and future social, economic, environmental and cultural well-being of the community.³⁸

An activity means a good or service provided by, or on behalf of, a council or council-controlled organisation, including the provision of facilities and amenities, the making of grants and the performance of regulatory and other governmental functions.³⁹

A local authority's revenue and financing policy must state its policies in respect of funding operating and capital expenditure from the sources listed in the LGA 2002. Those sources include general and targeted rates, lump sum contributions to a capital project, fees and charges, investment income, borrowing and the proceeds of asset sales, development and financial contributions, grants and subsidies, and any other sources. The revenue and financing policy must show how the local authority has, in relation to the sources of funding identified in the policy, complied with section 101(3).⁴⁰

2.3 Financial contributions

The main provisions of the RMA 1991 that relate to financial contributions are summarised below.

- Financial contributions are imposed as a condition of a resource consent. Section 108(1) states that, except as expressly provided by section 108 and subject to any regulations, a resource consent may be granted on any condition that the consent authority considers appropriate. A consent authority comprises a regional council, territorial local authority, unitary council whose permission is required to carry out an activity for which a resource consent is required or the minister of conservation.^{41 42}
- Subject to section 108(10), a resource consent may include a condition requiring that a financial contribution, comprising money or land, or a combination of both, be made.⁴³ For this purpose, land includes an esplanade reserve or esplanade strip (other than in relation to a subdivision consent), but generally excludes Maori land.
- According to section 108(10), a consent authority must not require a financial contribution to be made unless it is imposed in accordance with the purposes specified in a district plan or proposed plan (including the purpose of ensuring positive effects on the environment to offset any adverse effects). The level of

³⁸ LGA 2002, s 101(3)(b).

³⁹ LGA 2002, s 5(1).

⁴⁰ LGA 2002, s 103. If the ratepayer agrees, a lump sum contribution may be made to fund a capital project pursuant to Part 4A of the Local Government (Rating) Act 2002.

⁴¹ RMA 1991, ss 108(1) and 2(1).

⁴² For a brief legislative history of financial contributions see DLA Phillips Fox (2008), *op cit*.

⁴³ RMA 1991, s 108(2)(a), states, "Subject to subsection (10), a condition requiring that a financial contribution be made". Section 108(2)(b) states that a bond may be required in accordance with section 108A. Section 108(9) defines a financial contribution for the purposes of section 108 to mean a contribution of money, land (subject to some restrictions) or a combination of both.

the contribution must also be determined in the manner described in the plan or proposed plan.⁴⁴

- A financial contribution can be required at different times and different stages of a development, depending on when subdivision, building or other development work occurs and consequently when different resource consents are sought.⁴⁵
- A financial contribution may be required to be made in respect of a 'permitted activity', which does not require a resource consent, if the requirement for a financial contribution relating to that permitted activity is specified in a district plan or proposed plan.⁴⁶
- A consent authority may require a landowner to provide services or works, including works that protect, restore or enhance any natural or physical resource.⁴⁷
- A consent authority is required to refund a financial contribution if the activity for which the contribution was made does not proceed. The authority is entitled to recover its costs in relation to the activity and its discontinuance.⁴⁸
- A consent authority is required to deal with contributions of money "in reasonable accordance with the purposes for which the money was received".⁴⁹ Financial contributions may be used to fund planned capital expenditure that a local authority expects to incur as a result of a development.
- A condition of a resource consent will only be valid under the general law if it is for a resource management purpose and not for an ulterior reason, is fairly and reasonably related to the activity to which it is attached and is not so unreasonable that the courts may intervene to correct it. The threshold for proving unreasonableness is very high.⁵⁰

⁴⁴ Before 17 December 1997, a contribution could not exceed in value the maximum amount specified in, or determined in accordance with, the plan. Prior to 1 August 2003, a financial contribution could only be imposed in an operative plan and thus not in a proposed plan.

⁴⁵ Kirkpatrick (1999), *op cit*, p 12.

⁴⁶ A resource consent is not required for an activity that is described in the RMA 1991, regulations, or a plan or proposed plan as a 'permitted activity', if the activity complies with the requirements, conditions and permissions, if any, specified in the RMA 1991, regulations, the plan or proposed plan (RMA 1991, s 87A). One such requirement could be an obligation to make a financial contribution, see DLA Phillips Fox (2008), *op cit*.

⁴⁷ RMA 1991, s 108(2)(c). Before 17 December 1997, when this subsection first applied, the provisions relating to financial contributions also governed the conditions that required a consent holder to contribute works or services.

⁴⁸ RMA 1991, s 110.

⁴⁹ RMA 1991, s 111.

⁵⁰ In *Associated Provincial Picture Houses v Wednesbury Corporation* [1948] 1 KB 223, the court stated it would only intervene to correct an administrative decision on grounds of its unreasonableness if the decision was, as articulated by Lord Diplock in *Council of Civil Service Unions v Minister for the Civil Service* [1985] AC 374, 410, "So outrageous in its defiance of logic or accepted moral standards that no sensible person who had applied his mind to the question to be decided could have arrived at it".

- A consent holder may appeal to the Environment Court against the whole, or any part, of a decision of a consent authority on an application for a resource consent or a change of consent conditions, or on a review of consent conditions.⁵¹

The following broad approaches may be taken in setting the level of contributions.

- The maximum amount for financial contributions may be specified in a council's district plan. This method, which is commonly used for the contribution of land for reserves, has the advantages of being simple, transparent and predictable. However, the district plan must be changed, which could take several years to implement, if the maximum amount of financial contributions were to be altered.⁵²
- A council may specify the contribution in money that it considers reasonable, having regard to the type and scope of the proposed land use, the amount of other contributions that may be made and the likely impact on the demand for infrastructure that arises from the proposed land use.
- A council may specify a formula or procedure to be used in computing the financial contribution required.⁵³ At one time, a council was required to specify the amount of financial contributions or specify the formula to be applied in its district plan. The formula approach has been developed further in relation to development contributions.

2.4 Development contributions

The statutory provisions that relate to development contributions are contained in Part 8, subpart 5, of the LGA 2002. They are complex.^{54 55}

Development contributions may be used to fund reserves, network infrastructure or community infrastructure that arise from a development. The following definitions are important.

- Network infrastructure means the provision of roads and other transport, water, wastewater, and stormwater collection and management.

⁵¹ RMA 1991, s 120.

⁵² The Auckland City Council's district plan (isthmus section), for example, provides for a financial contribution for residential development under clause 4B.4.4. The contribution is to provide for additional areas of open space and to develop existing reserves more intensively to meet the recreational and open space needs of additional residents. A contribution is required for residential development and subdivision of either land (30m² for each new residential unit or new residential allotment created), the cash equivalent of this value, or a combination of the two. The amount specified is a maximum and may be reduced at the council's discretion. This rule is, however, considered to be replaced by a requirement to make a development contribution.

⁵³ Of the 70 councils that levy financial contributions, 35 apply a formula. The approach adopted by another 30 was described as unclear or unknown, see SPM Consultants Limited (2008b), *op cit*, p 9.

⁵⁴ For a brief legislative history of development contributions see DLA Phillips Fox (2008), *op cit*.

⁵⁵ Much of the LGA 2002 came into force on 25 December 2002 but Part 8 did not apply until 1 July 2003.

- Community infrastructure is land, or development assets on land, owned or controlled by a territorial local authority, including land the local authority will acquire, to provide public amenities.
- Development means any subdivision or other development that generates a demand for reserves, network infrastructure or community infrastructure but does not include the pipes or lines of a network utility operator.
- A network utility operator is defined broadly to mean a person who does the following:
 - undertakes or proposes to undertake the distribution or transmission by pipeline of natural or manufactured gas, petroleum, biofuel or geothermal energy;
 - operates or proposes to operate a network for the purpose of telecommunication or radio communication;
 - is an electricity operator or electricity distributor;
 - undertakes or proposes to undertake the distribution of water for supply (including irrigation);
 - undertakes or proposes to undertake a drainage or sewerage system;
 - constructs, operates or proposes to construct or operate a road or railway line;
 - is an airport authority or a provider of any ‘approach control service’; or
 - undertakes or proposes to undertake a project or work prescribed as a network utility operation for the purposes of this definition by regulations made under the RMA 1991.⁵⁶
- A service connection means a physical connection to a service provided by, or on behalf of, a territorial local authority.⁵⁷
- Community facilities mean reserves, network infrastructure or community infrastructure for which development contributions may be required in accordance with section 199 of the LGA 2002.⁵⁸

A territorial local authority may require a development contribution to be made when granting a resource consent under the RMA 1991, a building consent under the Building Act 2004 or an authorisation for a service connection. The granting of a consent is not, however, the statutory ‘trigger’ for a development contribution because other statutory provisions (sections 199, 197 and 198(2) of the LGA 2002) apply but it is the point at which

⁵⁶ LGA 2002, s 197 and RMA 1991, s 166.

⁵⁷ LGA 2002, s 197.

⁵⁸ LGA 2002, s 197.

a contribution may be payable. A development contribution is also imposed in monetary form only.⁵⁹

A territorial local authority may only impose a development contribution in accordance with the development contribution policy adopted by the authority. The policy must contain the required contents of such a policy.⁶⁰

According to section 199, development contributions may be required in relation to developments if the effect of the developments (or the cumulative effects that a development has in combination with another development) is to require capital expenditure for reserves, network infrastructure or community infrastructure. Such spending may be required for new or additional assets, or to acquire assets with an increased capacity. A territorial local authority may also require a development contribution for capital expenditure incurred in anticipation of a development. The capital expenditure required is often said to be caused by growth.⁶¹

Once it has been determined that certain capital expenditure may be funded by a development contribution under section 199, a development contribution becomes a funding source available to the council along with other sources authorised by the LGA 2002. A council must determine the appropriate sources to meet its funding needs after examining the five factors identified in section 101(3)(a). The council must then satisfy itself as to the overall impact of each funding source determination on the four well-beings, as part of its broad role and purpose in promoting those well-beings (sections 10 and 101(3)(b)).⁶²

All of the critical factors listed in section 101(3) must be weighed in respect of each activity. They are cumulative and not alternatives or options. The LGA 2002 does not permit councils to single out and adopt, say, the exacerbator pays approach at a policy level in relation to development contributions.⁶³

A territorial local authority must not require a development contribution for a reserve, network infrastructure or community infrastructure if, and to the extent that, the following apply:

- the territorial local authority has applied a financial contribution as a condition of a resource consent in relation to the same development for the same purpose;

⁵⁹ LGA 2002, s 198(1) and *Neil case, op cit*, para 116. A territorial local authority can withhold its approval of a survey plan that is required to register the plan, prevent the commencement of a resource consent, withhold a code of compliance certificate under the Building Act 2004 and withhold a service connection if a development contribution is not paid. The development contribution can also be registered as a charge on the title of the land, see LGA 2002, s 208. DLA Phillips Fox note that the power to prevent commencement of a resource consent may not be straightforward because there is no equivalent provision in the RMA 1991, see DLA Phillips Fox (2008), *op cit*.

⁶⁰ LGA 2002, ss 198(2), 102(4)(d) and 201.

⁶¹ LGA 2002, s 199. Section 199(1) refers to developments rather than a development. Its interpretation was examined in the *Neil case, op cit*, paras 108–113. Potter J observed that the reference to ‘developments’ can only apply to projects each of which meets the definition of a ‘development’ under section 197.

⁶² *Neil case, op cit*, paras 207–218.

⁶³ *Ibid*, paras 212 and 217.

- the developer will fund or otherwise provide for the same reserve, network infrastructure or community infrastructure; or
- the territorial local authority has received or will be funded for the reserve, network infrastructure or community infrastructure by a third party.⁶⁴

A territorial local authority may accept voluntary additional contributions for reserves, network infrastructures or community infrastructures.⁶⁵ Development agreements are becoming increasingly common as an alternative to applying a development contribution policy to a particular development. They enable the developer to negotiate with the council and can provide increased certainty for the developer. They may also allow the developer to provide reserves or infrastructure directly rather than contribute financially to those assets.⁶⁶

Third-party funding may also prevent the imposition of development contributions. This mainly applies where government agencies fund the relevant capital expenditure as part of their statutory responsibilities.⁶⁷

The main provisions relating to the content of a policy on development contributions are noted below.

- A development contribution means a contribution provided for in a development contribution policy included in the LTCCP of a territorial local authority and calculated in accordance with the methodology set out in Schedule 13 of the LGA 2002. The contribution must comprise money or land, or both. Land includes a reserve or esplanade reserve, other than in relation to subdivision consent, but generally excludes Maori land.^{68 69}
- If a local authority has determined to seek funding for community facilities by way of development contributions, its policy on development contributions must include, in summary form, the following:
 - an explanation of, and justification for, the way each development contribution in the schedule required by section 202 of the LGA 2002 is calculated;
 - the significant assumptions underlying the calculation of the schedule of development contributions, including an estimate of the potential effects, if there is a significant level of uncertainty as to the scope and nature of the effects;
 - the conditions and criteria (if any) that will apply in relation to the remission, postponement or refund of development contributions, or the return of land; and

⁶⁴ LGA 2002, s 200.

⁶⁵ LGA 2002, s 200(2).

⁶⁶ DLA Phillips Fox (2008), *op cit*.

⁶⁷ *Ibid*.

⁶⁸ LGA 2002, s 197.

⁶⁹ A local authority must adopt a policy on development or financial contributions as part of its funding policy and LTCCP (LGA 2002, s 102).

- the basis on which the value of additional allotments or land is assessed for the purposes of section 203(1) which relates to the maximum level of such contributions.⁷⁰
- A development contributions policy must contain a schedule prepared in accordance with section 202. The schedule must specify the following:
 - the development contributions payable in each district, calculated, in each case, in accordance with the methodology in respect of reserves, network infrastructure and community infrastructure; and
 - the event that will give rise to a requirement for a development contribution under section 198, whether upon granting of a resource consent under the RMA 1991, a building consent under the Building Act 2004 or an authorisation for a service connection.⁷¹

The above provisions apply to each part of a district if different development contributions are payable in particular geographical areas of the district. Parts of districts are commonly referred to as ‘catchments’ although this terminology is not contained in the LGA 2002. Furthermore, the information specified must be given separately in relation to each activity or group of activities for which separate development contributions are required.⁷²

Development contributions for reserves must not exceed the greater of the following:

- 7.5 percent of the value of the additional allotments created by a subdivision; or
- the value equivalent of 20 square metres of land for each additional household unit created by the development.⁷³

In response to the Shand Inquiry, the Labour-led government agreed the above cap would be removed when a suitable legislative opportunity arose.⁷⁴

Development contributions for network infrastructure or community infrastructure must not exceed the amount calculated by multiplying the cost of the relevant unit of demand (calculated under clause 1 of Schedule 13) by the number of units of demand assessed for a development or type of development as provided for in clause 2 of Schedule 13.⁷⁵ A unit of demand is not defined. Councils often use a measure of population growth, for example, household equivalent unit as a unit of demand.

Councils are required to adopt an appropriate methodology for differentiating between capital expenditure caused by growth and other causes. This is especially difficult where a new asset is required and only a portion of that need is attributable to growth. The LGA

⁷⁰ LGA 2002, s 201.

⁷¹ LGA 2002, s 202(1).

⁷² LGA 2002, s 202(2) and (3).

⁷³ LGA 2002, s 203(1). These maxima are unchanged from the LGA 1974.

⁷⁴ Department of Internal Affairs (2008), *op cit*, p 5.

⁷⁵ LGA 2002, s 203(2).

2002 does not provide any guidance on this matter (other than specifying the maximum level of contributions).

These provisions have led to the development of complicated formulas for calculating the level of development contributions.⁷⁶ The detail and apparent precision of such formulas may belie their efficacy from an economic perspective, including the validity of the causal relationship between a development and capital expenditure on infrastructure. Key assumptions affect the levels of charges that are applied, as Covec Limited noted in a working paper that described emerging best practice. They relate to factors such as the level of services, the sources of demand for additional capacity, causation versus benefits, the length of time over which expenditure is recovered and the profile of charges over time.⁷⁷

A development contribution must be used for, or towards, the capital expenditure of the reserve, network infrastructure or community infrastructure for which the contribution was required, which may also include the development of the reserve, network infrastructure or community infrastructure. However, it must not be used for the maintenance of the reserve, network infrastructure or community infrastructure.⁷⁸

These provisions relating to the use of development contributions are subject to the following further provisions in respect of reserves.

- A territorial local authority must use a development contribution received for reserve purposes for the purchase or development of reserves within its district, which may include the following:
 - the development of community or recreational facilities associated with the use of a reserve;
 - the provision or improvement of recreational facilities at a school established or about to be established under the Education Act 1989 if provision is made for the reasonable use or occupation of such facilities by members of the public;
 - the purchase of land or an interest in land that is to be held for conservation purposes under the Reserves Act 1977 and is, or will be, subject to a conservation covenant under that Act;
 - payment to the following:
 - another local authority or public body in which land in the district is vested to enlarge, enhance or develop the land for public recreation purposes;

⁷⁶ The Manukau City Council's development contribution policy is an exception. The levies comprise \$5,956 plus GST per household equivalent unit for residential, \$2,978 plus GST for each minor (less than 60 metres squared) household unit and \$17.31 plus GST for each square metre of non-residential construction. The policy is under review.

⁷⁷ Covec Limited (2009), 'How to Make Development Contributions More Fair & Reliable', Unpublished working paper, 19 June, Covec Limited, Auckland.

⁷⁸ LGA 2002, s 204.

- the administering body of a reserve held under the Reserves Act 1977 to enlarge, enhance or develop the reserve;
- the trustees or body corporate in whom is vested a Maori reservation to which section 340 of Te Ture Whenua Maori Act 1993 applies, to enhance the reservation for cultural or other purposes; or
- any person, to secure an appropriate interest in perpetuity in land for conservation purposes.⁷⁹

There is further provision for a territorial local authority to use its development contribution for reserves to add to, improve or develop land outside of its district for public recreation. With the consent of the minister of local government, a local authority may pay another local authority or public body to add to, improve or develop land for public recreation. A local authority can also develop a lake bed, harbour or foreshore over which it has control for public recreation purposes. These provisions apply where a territorial local authority has adequate reserves or where it is impractical to purchase or develop reserves in the relevant locality and where the authority considers such action would benefit the residents of the district in which the relevant development is located.⁸⁰

A local authority is required to refund or return a development contribution if the development in respect of which a contribution was paid or land was set aside does not proceed because the resource consent lapses or is surrounded, or the building for which a building consent was granted does not proceed. A refund is also required if the local authority does not provide the reserve, network infrastructure or community infrastructure for which the development contribution was required. The authority is entitled to recover its costs (or retain land to an equivalent value) in relation to the development or building and its discontinuance. These provisions are similar to those that apply to a financial contribution levied that relates to a development that does not proceed.⁸¹

A development contribution that is paid or land that is set aside for a specified reserve purpose must be refunded or returned if the development contribution or the land is not applied for the purpose specified within 10 years or another period specified in the council's development contribution policy. The council may retain part of the contribution or the land to cover the costs of repaying the contribution or returning the land.⁸²

⁷⁹ LGA 2002, s 205.

⁸⁰ LGA 2002, s 206.

⁸¹ LGA 2002, s 209.

⁸² LGA 2002, s 210.

Network growth charges

The LGA 2002 and RMA 1991 do not authorise council controlled and owned organisations to charge development and financial contributions.⁸³ Some such entities apply network growth charges, which are similar to development contributions, as a condition of supply. They are additional to the cost of connecting to related services, which is also borne by the landowner. As with development charges, the economic merit of such charges in respect of private good activities depends on whether they constitute part of an efficient pricing regime for the services supplied.

2.5 Differences between financial and development contributions

There are important differences between financial and development contributions. The main ones are listed below.

- Only territorial local authorities may apply development contributions. Regional councils and territorial authorities may apply financial contributions.
- A council must adopt a policy on development or financial contributions.
- Financial contributions can only be applied if a policy on them has been adopted as part of a territorial authority's LTCCP and if provision is made for them in its district plan. Financial contributions are imposed as a condition of a resource consent.
- A development contribution may be applied where there is a development (as defined by the LGA 2002) that, either alone or jointly with other developments, requires expenditure on certain infrastructure or reserves and is provided for in the council's development contributions policy.
- Development contributions focus on funding infrastructure that is due to growth. In contrast, financial contributions relate to the actual environmental effects (that is, on-site or localised effects) that a subdivision or development creates.
- Financial contributions may reflect past and current expenditure only whereas development contributions may take account of future spending arising from the subdivision or development.

⁸³ Councils in Auckland may have included capital spending by Watercare Services Limited in their development contributions. The local network operators (LNOs), which are council water retailers and distributors, negotiated a revision to their contract in 2005 that required Watercare to identify separately its capital spending due to growth. According to a paper examined by Waitakere City Council at its meeting on 25 June 2005, the purpose of this provision was "so that the growth cost portion can be charged to developers in conjunction with the LNO development contributions and charges". Because Watercare charges LNOs for water supplied, this arrangement could result in an element of double charging. The LGA 2002 declares Watercare not to be a council-owned organisation. However, a similar approach might have been used to enable growth-related spending of council-owned organisations to be funded through development contributions or similar charges. The Local Government Forum does not know whether any such spending by Watercare or any other council-controlled organisation has been reflected in development contributions or similar charges, see www.waitakere.govt.nz/AbtCnl/ct/council.asp#2005 (last accessed 27 August 2009).

- A development may be subject to a financial or development contribution but a territorial local authority cannot apply both to a particular subdivision or development for the same purpose.
- A council's proposal to include financial contributions in its district plan or to alter its policy on such contributions may be subject to submissions to the council and objections to the Environment Court. Furthermore, the application of the policy in granting resource consents can be appealed to the Environment Court. There are no comparable rights of appeal relating to development contributions. A council's decision to apply financial or development contributions could, however, be subject to judicial review if, for instance, the council failed to follow proper process or otherwise acted unlawfully.

2.6 The *Neil* case

The leading court decision on the interpretation and application of development contributions is the *Neil* case. It is summarised in Box 1.

Box 1: The *Neil* case

The North Shore City Council adopted a policy on development contributions in conjunction with its LTCCP for 2004–2014. Neil Construction Limited and certain other parties affected by the policy sought a judicial review of the council's decision.

The plaintiffs claimed the council had failed to apply the decision-making process and criteria prescribed by the LGA 2002 by, for instance, failing to justify sufficiently its choice of funding options and not complying with the mandatory requirement to explain its choice as set out in section 106(2)(c) of the LGA 2002. In their view, the council's development contributions policy was fundamentally flawed. As a consequence, its application was unfair, arbitrary and went beyond the parameters of the LGA 2002.

In *Neil Construction Limited & Ors v North Shore City Council*, Potter J focused on the definition of 'development' (section 197). The court held that the main trigger for the charging of a contribution was whether there was a development that caused a demand for infrastructure rather than the granting of a resource or building consent, or a service connection authorisation. There needed to be a causal link between a development and the demand for infrastructure. Potter J ended her analysis of this issue in the following terms:

I conclude the Act requires that before a development contribution may be required by the Council, there must be a "development" and a direct causal nexus between that "development" and the demand for infrastructure it, either alone or jointly with another development, generates. This necessarily requires the Council to determine as a preliminary point, on a case by case basis, whether a particular project is a "development" as defined in s 197.

The main example of the council's expenditure for which contributions were taken in the case was the northern busway project (involving the construction of bus lanes and stations

adjacent to the northern motorway). Over 90 percent of the North Shore City Council's share of the funding for that project was to come from development contributions, and the plaintiffs' complaint was that the developments levied did not place the level of demand on infrastructure necessary to warrant the busway project. The court agreed the proportion of development contribution funding for the project was out of step with the demands arising from the developments levied.

The court analysed the appropriateness of the council's decisions on who should pay for reserves and infrastructure under its development contributions policy. The main issue was the extent to which the council should have considered the benefactors to reserves and infrastructure funded by development contributions when apportioning costs between developers and general ratepayers. The plaintiffs argued that developers were effectively subsidising existing residents who would also benefit from the busway, and that developers were being asked to remedy a pre-existing demand for increased roading and public transport capacity.

The court held that it was not lawful for the council to adopt an exacerbator-pays approach to funding growth, and it needed to have regard to the distribution of benefits to the community as a whole. The court relied in particular on section 101 of the LGA 2002, which required the council to examine certain criteria in funding its activities. The council was required to consider the community outcomes to which the activity primarily contributed, the distribution of benefits between the community as a whole and any identifiable part of the community, and individuals, the period in or over which those benefits were expected to accrue, the extent to which the actions or inaction of particular individuals or groups contributed to the need to undertake the activity, and the costs and benefits of funding the activity distinctly from other activities.

Once the council applies these criteria, it must, according to the court:

... stand back and consider the overall impact of any allocation of the liability on the current and future well-being of the community, from social, economic, environmental and cultural perspectives.

The court also described the need to assess the distribution of benefits and consider all available options, as follows:

The distribution of benefits between the community as a whole and any identifiable part of the community, and individuals, is a factor the Council must consider in relation to each activity ...

[The Council] should have regard to the views of all of its communities, and in its decision-making take account of the interests of future as well as current communities ... the Council must seek to identify all reasonably practicable options for achieving the objectives and to assess those options by considering the costs and benefits of each option in terms of the four well-beings and the extent to which community outcomes would be integrated or achieved in an integrated and efficient manner.

The court outlined the steps required to decide whether a development contribution may be required.

I consider the relevant provisions of the Act inter-relate to require of councils the following stepped process and line of inquiry when considering whether a development contribution or development contributions may be required:

- Step 1 Is the subdivision or development a “development”, i.e. does it generate a demand for reserves or infrastructure? (s 197 definition)
- Step 2 Does the development (either alone or cumulatively with another development) require new or additional assets or assets of increased capacity to provide for reserves or infrastructure which will cause the council to incur capital expenditure (s 199(1)) or has already caused the council to incur capital expenditure for the development? (s 199(2))
- Step 3 Is there an alternative source of funding? (s 200)

Following the judgment, the parties involved entered into negotiations on a revised level of contributions to be paid. In May 2009, the council agreed to make more than 4,000 refunds totalling \$10 million to developers.

Sources: *Neil case, op cit*, DLA Phillips Fox 2008, *op cit* and *New Zealand Herald*, 14 May 2009.

3

THE SIGNIFICANCE OF CONTRIBUTIONS

3.1 Overview

Development contributions are becoming a relatively more important source of funding than financial contributions. The Joint Central Government/Local Authority Funding Project Team reported in 2005 that almost half of all territorial authorities (31 of the 74) had introduced development contributions or planned to do so in their next LTCCP.⁸⁴ SPM Consultants Limited reported that 44 of 73 territorial authorities had an operative development contributions policy in 2007/08.^{85 86}

In contrast, 70 of the 73 territorial local authorities had a financial contributions policy. However, it is not known whether all such policies are operative. A council may not apply its financial contributions policy when a development contribution is collected for the same purpose.⁸⁷

Forty-two territorial authorities applied both development contributions and financial contributions. Two authorities (Kaikoura and Selwyn district councils) applied development contributions but not financial contributions. Twenty-eight councils applied financial contributions alone. Wairoa District Council was the only territorial local authority that did not have an operative development or financial contributions policy in 2007/08.⁸⁸

Larger territorial authorities and those with the highest rates of growth in the number of households tend to have an operative development contributions policy.⁸⁹ Smaller councils and those with low or negative growth in the number of households are more likely to have a financial contributions policy and less likely to have an overlapping development contributions policy.⁹⁰

⁸⁴ Joint Central Government/Local Authority Funding Project Team (2005), *Local Authority Funding Issues*, Report of the Joint Central Government/Local Authority Funding Project Team, Department of Internal Affairs, Wellington.

⁸⁵ SPM Consultants Limited (2008a), *op cit*, p 6. Rodney District Council introduced development contributions in its 2009–19 LTCCP, see www.rodney.govt.nz (last accessed 25 August 2009).

⁸⁶ Income generated by financial and development contributions levied by the Auckland City Council, the country's largest local authority by population, amounted to \$28.5 million in 2007/08 and \$13.9 million in 2008/09. They were budgeted to raise \$39.3 million in 2008/09. Income from development contributions amounted to \$22.3 million in 2007/08 and \$11.5 million in 2008/09. They accounted for 83 percent and 78 percent respectively of the total of financial and development contributions raised in 2007/08 and 2008/09 respectively.

⁸⁷ SPM Consultants Limited (2008b), *op cit*, p 9. Its study did not include regional councils (p 12).

⁸⁸ SPM Consultants Limited (2008a), *op cit*, p 6.

⁸⁹ *Ibid*, p 29.

⁹⁰ SPM Consultants Limited (2008b), *op cit*, p 5.

SPM Consultants Limited examined the application of development contributions to eight classes of activities by the 44 territorial authorities that apply them. Development contributions were commonly applied to wastewater (40 territorial authorities), transport (39), water supply (38) and stormwater (30). Only 22 territorial authorities applied development contributions in respect of reserves. Financial contributions seem to be preferred to development contributions to fund reserves. Few councils apply development contributions to community services such as libraries, leisure activities or community centres (19), other community infrastructure such as local urban design, refuse and recycling, cemetery, public amenities and strategic projects (12) or parks infrastructure (11). Thirteen councils applied development contributions to six of the eight activities, 10 to three activities and eight to five activities.⁹¹

Nineteen territorial authorities with an operative development contributions policy amended their policy during 2006/07. The remaining councils with such a policy continued to apply the policy adopted in their 2006–16 LTCCP.⁹² Further modifications to contribution policies will have been made in light of the decision in the *Neil* case, which was released in March 2007.

The 73 territorial authorities were expecting to collect an aggregate of \$3.87 billion or 5.3 percent of their cumulative total revenue of \$73.3 billion during 2006–16 through development contributions.⁹³ This estimate may understate the importance of development contributions to councils because only 31 councils published forecasts of their development contributions revenue separately from other revenue. On the other hand, seven councils that do not apply development contributions currently appear to forecast such revenue (which may be financial contributions). A further 29 councils do not levy development contributions.

The Shand Inquiry reported that development contributions are expected to increase from an aggregate of \$244 million in 2006/07 to \$447 million in 2015/16, funding about 17 percent of forecast capital expenditure by 2015/16 compared with 7 percent in 2006/07. Financial contributions are forecast to be equal to about 8 percent of capital spending in 2015/16. In aggregate, these contributions were forecast to fund 25 percent of forecast capital expenditure in 2015/16.^{94 95} Development contributions represent up to 20 percent of the forecast total revenue in 2006–16 of local authorities in high-growth areas such as Papakura District Council (19.8 percent), Thames–Coromandel District Council (19 percent), Tauranga City Council (17.7 percent) and Queenstown Lakes District Council (17.6 percent).⁹⁶

⁹¹ SPM Consultants Limited (2008a), *op cit*, p 20.

⁹² *Ibid*, p 6.

⁹³ *Ibid*, p 1.

⁹⁴ Shand, Horsley and Cheyne (2007), *op cit*, p 72.

⁹⁵ These forecasts are likely to prove excessively optimistic. The levels of operating and capital spending forecast would require many councils to impose large increases in rates in each year of their plans. Councils appear to recognise that this would be unrealistic and many are seeking to reduce the rate of growth in their forecast operating and capital spending.

⁹⁶ SPM Consultants Limited (2008a), *op cit*, p 25.

The aggregate level of assets vested in councils each year is unknown.⁹⁷ In 2007/08, vested assets for the above high-growth territorial authorities amounted to \$13 million (24 percent of total group revenue) for the Papakura District Council, \$11 million (14 percent) for Thames–Coromandel District Council, \$21 million (13 percent) for Tauranga City Council and \$24 million (22 percent) for Queenstown Lakes District Council.

Assets vested in the Auckland City Council from Stonefields and other developments amounted to \$114 million in 2007/08, comprising \$99 million of roading and road reserves (land), and \$15 million of stormwater, wastewater and water supply assets. As with other councils, vested assets are dominated by roading.⁹⁸

The levels of vested assets in Auckland City Council and Papakura, Thames–Coromandel and Queenstown Lakes district councils were unusually large in 2007/08. In the previous year they amounted to just \$4 million, \$2 million, \$3 million and \$7 million respectively, and accounted for between 0.5 (Auckland City Council) and 8 percent (Queenstown Lakes District Council) of total revenue. In contrast, vested assets amounted to \$24 million (12 percent of a much higher total revenue) in Tauranga City Council in 2006/07.⁹⁹

3.2 Selected examples

The overall level of development and financial contributions does not adequately convey their impact on particular projects. A systematic analysis of such impact is beyond the scope of this report. The following data illustrate, however, that development contributions can be a significant cost of subdivision and developments. Moreover, they are shown to have risen rapidly from comparable levies that preceded them.

LECG Limited (LECG) undertook a detailed economic analysis of the impact on prices of the contributions policy for Christchurch City Council. LECG suggested the development contributions policy adopted by the council in its LTCCP 2006–16 could lead to a 2 to 3 percent increase in the price of vacant residential sections, if the contributions were passed on in full. Development contributions were estimated to be equal to between 7 and 12.6 percent of the value of developed land in a sample of suburbs examined. House prices in the suburbs examined were estimated to increase by between 2.5 and 5.5 percent. The impact on residential house prices of development contributions was reported to be small relative to other influences such as employment or population effects.¹⁰⁰

The LECG report noted that development contributions for inner city apartments were high relative to those for greenfield residential development in the suburbs. They were up to \$31,000 (before possible offsets) for a unit, which could be a studio or one-bedroom

⁹⁷ Vested assets are generally reported as other revenue in council statements of financial performance and stated at ‘fair value’ in council assets.

⁹⁸ Stonefields is a major urban development on a 110 hectare site in East Auckland. It is intended to include 2,900 dwellings, parks, a primary school and town centre.

⁹⁹ Vested assets in Auckland City in 2008/09 amounted to \$49 million.

¹⁰⁰ Barnes, Sally, Moore, David, Murray, Kieran (2006), *Economic Impact of Christchurch City Council 2006–2016 Development Contributions Policy*, Unpublished report to the Development Contributions Working Party of the Christchurch City Council, LECG Limited, Wellington, pp 33–70.

dwelling unit. Development contributions could be equal to up to 7 percent of the selling price of the unit. LECG observed that the development of apartments in Christchurch could consequently be less attractive than in certain other centres.

The impact on non-residential development of development contributions was expected to be modest but LECG's analysis of that sector was more limited than in the case of the residential sector. LECG reported that development in the city centre might be delayed, thereby reducing supply and placing upward pressure on commercial rents. In the long run, prices paid for undeveloped commercial property might fall (that is, the development contribution would tend to be passed backward and reflected in the price of undeveloped land).

Covec Limited's 2008 report for Waitakere City Council estimated that development contributions had yielded \$17 million, or under 1 percent of its cumulative rates requirement, since their introduction in July 2004. Average development levies (financial contributions plus development contributions) in Waitakere City Council increased by \$3,992 to \$19,765 a unit (an increase of 25 percent) when development contributions were introduced. The level of the increase in neighbouring councils was found to be similar, except for North Shore City Council where average development levies increased by 76 percent. Average development levies per unit were reported to be \$26,601 in Manukau City Council, \$31,505 in Rodney District Council, \$33,227 in North Shore City Council and \$35,981 in Auckland City Council. They were estimated to be equal to 6.7 percent of the median house price in Waitakere City Council and between 7.7 and 8.1 percent of the median house price in neighbouring cities and districts.¹⁰¹

Covec Limited undertook an econometric analysis that suggested Waitakere City Council's development contributions have had no discernible effects on housing supply and affordability, both in terms of house prices and rental values, business investment and employment growth, even in the construction industry. It did, however, find weak evidence of a small reduction in the level of residential building consents. On the assumption that all other factors were held constant, the introduction of development contributions was reported to be associated with a 3 percent reduction in quarterly residential consents. The level of building consents was reported to be much more sensitive to changes in interest rates.¹⁰²

Bob Robertson of the Infinity Investment Group, a property developer active in the Queenstown Lakes District, examined the level of development contributions payable in respect of new sections in Wanaka. In July 2008 they amounted to \$19,203 (before GST) on a per dwelling equivalent basis. Development contributions comprised charges for the three waters, reserves, roads and community facilities. A further \$13,400 was estimated to be incurred for the council's new 'affordable housing' initiative (\$10,000) and to connect utilities (electricity and telephone services, \$3,400), making a total cost of \$32,603 per dwelling. In July 2002, charges for the three waters and utilities were

¹⁰¹ Covec Limited (2008), *Development Contributions: An Empirical Study of Effects*, Unpublished report prepared for Waitakere City Council, Waitakere City.

¹⁰² *Ibid*, pp 1–2.

\$3,875 and \$1,661 respectively, or a total of \$5,536. There were no direct charges for the other categories in 2002.¹⁰³

According to Robertson's analysis, development contributions have increased relative to comparable charges in 2002 by almost four times or at an average rate of almost 30 percent a year for six years. The total costs examined per dwelling (which includes affordable housing and utility services) have increased at a somewhat higher rate during the same period. They increased by almost five times or at an annual average rate of over 34 percent. Total costs examined were estimated to be equal to 11 percent of the value of the land in 2002. By July 2008 they had increased to 16 percent of the value of the land, a real increase of almost 50 percent.¹⁰⁴ Robertson's estimates are consistent with the relatively high reliance that the Queenstown Lakes District Council places on development contributions to fund forecast capital expenditure, as noted in section 3.1.

The level of financial contributions was unable to be estimated from the information available to SPM Consultants Limited. Financial contributions are sometimes levied up to the maximum level computed according to a formula prescribed in the council's financial contributions policy. This applies especially in relation to reserves. The level of financial contributions is often negotiated or modified as part of the consent process.¹⁰⁵

¹⁰³ Robertson, Bob (undated), 'Wanaka Development Contributions (per Dwelling Equivalent) Case Study', Unpublished memorandum, Infinity Investment Group Holdings Limited, Wanaka. Section prices were assumed to be \$50,000 in July 2002 and \$200,000 in July 2008. The Queenstown Lakes District Council announced its decision on plan change 24, community and affordable housing, in January 2009. The Local Government Forum has been advised by Robertson that the decision is unlikely to significantly affect the estimated cost of affordable housing and further changes are possible before the plan change is finalised.

¹⁰⁴ *Ibid.*

¹⁰⁵ SPM Consultants Limited (2008b), *op cit*, pp 5 and 8.

4

ECONOMIC FRAMEWORK

4.1 Introduction

The central question is whether financial and development contributions are desirable on broad public policy grounds and, if so, when should they be applied and under what general conditions. This issue centres on the most efficient and equitable way of funding certain services supplied by local government. Should the relevant services generally be funded by use-related charges, or by rates levied on all ratepayers or a particular subset of ratepayers? This in turn depends on whether the affected services constitute public goods, quasi-public goods or private goods, and whether any net external effects that arise warrant government action. These concepts are discussed below, drawing extensively on the Local Government Forum's report, *Local Government and the Provision of Public Goods*.¹⁰⁶ They are discussed and applied in the following two sections.

4.2 Public goods

Private firms may not supply public goods, except under contract, or they may under-supply them because they cannot recover their full costs by charging in the normal way. Pure public goods have the following distinctive characteristics.

- Once a public good is provided, it is infeasible to exclude non-payers from enjoying the benefits provided because there is a 'free rider' problem. This characteristic is known as non-excludable consumption.
- When a public good is provided, one person's use of it does not limit its availability for use by others. This feature is known as non-rival consumption.

Given these characteristics, a firm may be unable to recover the costs of providing public goods because too many people would try to benefit without paying and too few would be willing to pay a price that would cover the cost of their production. In that event, the affected goods or services may not be provided at all or they may be under-provided unless government funds private suppliers or directly provides them, recovering its costs by taxing the community that benefits.

A rough practical test to determine whether goods or services are public goods is to ask whether it is cost effective to charge users directly for them. If it is, the goods or services are not public goods. However, where it is infeasible to charge directly for goods or services (for example, free-to-air broadcasting) they may be able to be indirectly funded (for example, through advertising or by tying the charge to complementary private

¹⁰⁶ Local Government Forum (2008), *Local Government and the Provision of Public Goods*, Local Government Forum, Christchurch.

goods or services). The latter illustrates that changes to the definition and enforcement of property rights may sometimes overcome the problem caused by public goods.¹⁰⁷

National defence and street lighting are examples of genuine public goods.¹⁰⁸ Both provide an indivisible collective benefit to their respective communities, and the number of people who benefit does not directly affect their availability. Moreover, it would be too costly to exclude people from receiving the benefit once the product or service is provided. For such public goods, private supply (other than by government contract) may be infeasible and they may need to be funded by taxes levied on the people who benefit.

‘Public goods’ is a technical term that has a narrower meaning than ‘public interest’ and can be distinguished from services available to people generally and those provided by government agencies. Confusion arises because government goods and services are often described as public goods, a widespread pattern of community benefits is alleged or the goods or services are deemed to be good for the public in some sense when a careful analysis would reveal they do not exhibit the characteristics of public goods.¹⁰⁹

The expression ‘public transport’ is one such example. People who are not prepared to pay are not allowed on a bus or train and once a seat is taken, it is not available for another potential passenger. The term public goods used loosely becomes no more than an assertion that the government should support a particular activity.

Potter J did not discuss the argument that the bus services to be provided following completion of the northern busway project are private good activities that should generally be funded by bus users.¹¹⁰

4.3 Quasi-public goods

There are certain goods and services that fall between pure public goods and private goods because they are excludable or rivalrous. They are termed non-pure or quasi-public goods. Some quasi-public goods are referred to as club goods. They are public goods that become crowded at some level of use, and consumption then becomes rival. Further increases in their use impose additional costs, either through increased congestion among users or the need to provide additional capacity. Public road networks are an example.

¹⁰⁷ The classic example of tying in the economic literature relates to the funding of British lighthouses through port charges in the eighteenth century. Lighthouses are public goods because the service provided is not excludable (all ships that pass benefit) and non-rival (the use of the light by one ship does not diminish that available to another). Another feature of some early British lighthouses is that shipowners petitioned to have lighthouses constructed and agreed in advance to pay the toll required to fund them, see Coase, Ronald H (1974), ‘The Lighthouse in Economics’, *Journal of Law and Economics*, vol 17 (October), pp 357–376.

¹⁰⁸ There are exceptions in the case of street lighting such as that provided by shopping centres or as part of a development or subdivision (in respect of initial construction only).

¹⁰⁹ Local Government Forum (2007), *Democracy and Performance: A Manifesto for Local Government*, Local Government Forum, Christchurch.

¹¹⁰ *Neil case, op cit.*

A club is a voluntary association of members who derive mutual benefit from sharing a collectively consumed good or service.¹¹¹ At its simplest, it can be a group of like-minded individuals who share their knowledge, skills and equipment in pursuit of a common interest (for example, a tramping club). Where activities require more elaborate facilities that are beyond the reach of most individuals (for example, tennis courts or golf courses), they can be provided through the members combining resources in a more formal organisation.

Club facilities are often excludable at reasonable cost. Although the collective of the members jointly provides them, their use need not be free of charge. Two-part charges may be levied. For instance, sports clubs commonly recover the fixed costs of facilities through annual membership subscriptions and recover variable costs (for instance, maintenance and electricity) through use-related charges.

The technical feasibility and cost of identifying and charging individuals determine whether it is efficient to apply two-part (or multi-part) charges. Where the transaction costs of doing so are high, it may be more efficient not to charge every time the facilities are used, for example by providing a season ticket that entitles the member to unlimited use of the club's facilities.

The excludability of collective services is largely determined by technology. The list of pure and quasi-public goods will change over time as new charging mechanisms become feasible. For instance, most roads are provided as if they were public goods, but in some locations, technology and the level of use make it feasible to apply direct charges for the use of road space (for example, urban congestion charges in London, Singapore and some Scandinavian cities, and toll roads in New Zealand).¹¹²

4.4 Private goods

Most goods and services consumed or enjoyed by the community are private goods. These can be supplied and charged for directly by firms. Competitive markets for private goods, which are supported by the general legal framework and supplemented by industry-specific regulation where appropriate, encourage producers to minimise their costs and allocate economic resources to the production of goods and services that consumers value most.

Local government in New Zealand engages in a large array of private good activities. These include ports and airports, farming and forestry, public transport, water supply, refuse collection and disposal, and off-street parking facilities. The first best policy would

¹¹¹ Cornes, Richard and Sandler, Todd (1986), *The Theory of Externalities, Public Goods and Club Goods*, Cambridge University Press, Cambridge.

¹¹² Tolls were collected to help fund early road construction (for example, the Panmure bridge) and road maintenance (for example, a toll on a bridge over the Otahuhu creek was introduced in 1866 to fund maintenance of the main Auckland to Otahuhu road), see Haslip, Lesley (undated), 'The Royal New Zealand Fencibles', <http://lesleysfamilytree.co.nz/royalnzfencibles.html> (last accessed 29 July 2009) and Swarbrick, *op cit*. Tolls were applied to the Auckland and Tauranga harbour bridges and, recently, to selected motorways or expressways in Auckland and Tauranga.

be for local government to exit from such activities. If they do not do so, user charges should generally be applied to fund such goods and services as discussed below.

4.5 Externalities

The essence of an externality is an unpriced third-party effect, which causes the costs or benefits of a decision from the overall perspective of society to deviate from the costs or benefits to the decision maker. Some costs may be borne by third parties who are not compensated. Similarly, some benefits may accrue to people who are not involved in the transaction and do not pay for the benefits they obtain. The decision maker does not take such externalities or 'spillover' costs and benefits into account in making decisions. Thus there may be a difference between the costs and benefits of a proposal from the perspectives of society and the decision maker.

Some environmental effects may not be satisfactorily reflected in the prices that decision makers face. For instance, pollution such as smoke discharges from multiple factories may be illegal, but it may be impossible to stop by common law processes because of the problem of proving which chimney caused which illness or what property damage. In these cases, the products of such factories may be over-supplied, from a community-wide perspective, in the absence of further government action. The economically efficient solution depends on whether living with the adverse effects, reducing the discharges by installing filters or taking other remedial measures would impose a lower overall cost on the community.

Certain externalities can be resolved by private negotiation or legal proceedings. Even if it were less costly to reduce the smoke discharge through private negotiation, that approach may fail. Many people who would benefit may be unwilling to contribute to the negotiation and may prefer to free ride on the efforts of others, or negotiations may entail excessive transaction costs. In such circumstances, intervention by a public agency may be efficient because it could overcome free riding and extract contributions from all who benefit.

A contemporary economic approach acknowledges that externalities are ubiquitous, and many do not warrant a government response.¹¹³ Because the risks of government failure are at least as large as those of market failure, greater reliance should be placed on private solutions to externality problems today than was the case during much of the last century.¹¹⁴

¹¹³ For example, The Tax Review 2001 concluded that estimates of generalised environmental noise and air quality externalities assembled by the Ministry of Transport's 1996 *Land Transport Pricing Study* were too speculative to provide a firm basis for the general revenue excise levied on petrol, see McLeod, Robert, Chatterjee, Srikanta, Jones, Shirley *et al* (2001), *Issues Paper*, The Tax Review 2001, The Treasury, Wellington, pp 60–61 and 206–208.

¹¹⁴ Friedman, David (2004), *Private and Political Markets Both Fail: A Cautionary Tale About Government Intervention*, New Zealand Business Roundtable, Wellington.

4.6 Mispricing of resources

The mispricing of a resource should not be confused with an externality problem. Mispricing occurs when the buyer obtains goods or services from the supplier at a price that does not reflect the supplier's costs. In this case, there is no third-party effect. The seller's costs may be identical to social costs. However, the mispricing of resources and externalities may lead to a misallocation of resources.

Successive governments have provided hospital services free of charge to residents for equity reasons. Those services are predominantly private goods and services.¹¹⁵ The policy leads to the mispricing of hospital services. The patient benefits directly. There is no externality. The application of the exacerbator pays principle, which is sometimes applied to address externality problems by imposing costs on those deemed to cause the problem, is inappropriate. Governments could charge users directly for the services that they consume. However, if they elect to subsidise hospital services, such services must generally be funded from taxation.

The mispricing of services arises in relation to certain infrastructure supplied by local government, such as water, wastewater and public transport. It often appears to be inappropriately viewed as a policy-relevant externality in discussions of financial and development contributions. This leads to doubtful funding decisions and inconsistent policies when the better solution from an economic perspective would be to apply efficient prices.

¹¹⁵ The main exception relates to communicable diseases.

5

FUNDING INFRASTRUCTURE

5.1 Introduction

This section examines the question of whether development contributions constitute an efficient user charge or price for certain goods and services supplied by local authorities. A user charge is first distinguished from a tax. Development contributions are then examined to determine whether they might constitute an efficient price for goods and services supplied or whether it would be better to apply appropriate user charges for at least some of the activities that development contributions are intended to help fund.

Financial contributions are intended to address adverse environmental effects and are mainly a response to externalities rather than a user charge. The issue of whether such externalities warrant the imposition of financial contributions is examined.

5.2 User charge or tax?

The quotation from the *Neil* case, cited at the start of section 1, reflects the conflicting expert evidence on the nature of development contributions that was before the High Court. The judge concluded that the case could be decided by interpreting the statute without the need to resolve the contrasting views of expert witnesses.¹¹⁶

Potter J was not prepared to rule unequivocally whether development contributions were a tax, a user charge or a hybrid comprising features of both. Somewhat inconsistently, Potter J observed that development contributions fell within the definition of a tax adopted by Latham CJ in *Matthews v Chicory Marketing Board*.¹¹⁷ His definition recognised that a tax is mandatory and does not constitute a payment for services.¹¹⁸

From an economic perspective, a tax has two key characteristics that are consistent with the definition advanced by Latham CJ. First, a tax is compulsory. Secondly, a tax is unrequited in the sense that the benefit provided by the government to the taxpayer is not intended to be in proportion to his or her payments.¹¹⁹ When these conditions hold, the payment does not represent a payment for particular goods or services supplied.

¹¹⁶ *Neil* case, *op cit*, para 206.

¹¹⁷ *Matthews v Chicory Marketing Board* (Vic) (1938) 60 CLR 263 at 276.

¹¹⁸ *Neil* case, *op cit*, para 47.

¹¹⁹ The Organisation for Economic Co-operation and Development, International Monetary Fund and United Nations have adopted definitions that focus on these characteristics for the purposes of collecting revenue statistics, see, for example, <http://stats.oecd.org/glossary/detail.asp?ID=2657> (last accessed 18 March 2009).

The difference between a tax and user charge can be illustrated by the way Tauranga and Auckland city councils fund refuse collection. Refuse collection is a private good activity. Householders in Tauranga City are required to attach a pre-paid sticker, which costs \$1.20, to each paper bag of refuse to be collected.¹²⁰ This scheme is voluntary and the level of payment is related to the use made of the service. The fee per bag is a payment for a service – a user charge or price – rather than a tax. It directly affects the allocation of resources. The charge encourages residents to economise on refuse disposal. The more bags that residents are willing to pay to have collected, the more resources will be devoted to their collection. Competing services might develop if private providers believe they would be profitable. The threat of such competition can be expected to influence the level of the council's charge.

In contrast, Auckland City Council generally applies a targeted rate for refuse collection of \$183 for each rateable residential property.¹²¹ The targeted rate is a tax. It is payable even if no rubbish is collected. Thus it is not a payment for a service. Residents are not encouraged to economise on waste by the rate. Decisions about the level of resources allocated to refuse collection are not directly related to the willingness of citizens to pay for the service and are made politically or administratively. The targeted rate therefore has no direct effect on the efficiency with which resources are used to provide the service. It simply raises the rates revenue used to fund rubbish collection.^{122 123}

Development contributions are compulsory. However, if the level of development contributions is directly related to the particular classes of goods and services provided to the landowner and the quantity of services supplied, they might still be viewed mainly as a user charge. If this is not the case, development contributions are unambiguously a tax, as Potter J concluded. In that event, the question is whether development contributions constitute a more efficient and equitable source of revenue than other feasible taxes such as general rates. This issue is examined in section 6.

Covec Limited appears to view a development contribution as a user charge.¹²⁴ In one report, it states that, although they are compulsory, development contributions are not a "tax *per se*".¹²⁵ Covec Limited's advice on setting the level of development contributions appears to be based on the principle of marginal cost pricing (see below). However, Covec

¹²⁰ See www.tauranga.govt.nz/rubbish/home.aspx (last accessed 2 December 2009). Residents may also buy pre-paid rubbish bags from supermarkets. The principle is the same.

¹²¹ See www.aucklandcity.govt.nz/Council/services/rates/assessed.asp#waste (last accessed 2 December 2009).

¹²² The rate, however, adversely affects efficiency.

¹²³ The funding of refuse collection by a targeted or general rate may be more efficient than a user charge if the transaction cost of applying a user charge were excessive. This would require, for example, the deadweight cost arising from the rate to be weighed against the economic costs that would be incurred by residents and the council if a user charge were applied.

¹²⁴ Covec Limited (2004), *op cit*, Covec Limited (2005), *Development Contributions: Policy Design Issues*, Unpublished report prepared for the 8th Annual Local Government Finance Forum, Auckland, Covec Limited (2007), *Non-Rates Funding Options Available to Local Authorities*, Unpublished report prepared for the Local Government Rates Inquiry, Auckland, Covec Limited (2008), *op cit*. In contrast, Covec Limited's most recent report makes no reference to pricing principles, see Covec Limited (2009) *op cit*.

¹²⁵ Covec Limited (2004), *op cit*, p 2.

Limited does not appear to have examined adequately whether development contributions are a payment for a service and the related question of whether the level of investment in infrastructure is affected by them (that is, whether development contributions, like prices, directly affect the efficiency with which resources are used).

Some of Local Government KnowHow's observations on economic principles relating to development contributions are similar to those of Covtec Limited. However, those principles are not applied.¹²⁶ The "costs of growth" are reported to "ultimately fall either on the environment (by reduced standards) or the community (through rates and reduced standards) where development contributions are insufficient to cover those costs".¹²⁷ All costs are ultimately borne by individuals.

5.3 Efficient prices

Resources are likely to be allocated efficiently if the prices charged for goods and services reflect their opportunity cost, if costs are minimised and if the level of goods and services supplied is responsive to user demand (willingness to pay). These conditions are most likely to apply where transactions are undertaken on a voluntary basis and markets are contestable.

An inefficient allocation of resources, in a sense, entails waste because the resources could be used more productively. The level of output obtained could be increased without requiring additional resources, for example, or the same level of output could be obtained using fewer resources.

Efficiency is generally consistent with the promotion of the economic and social well-being of communities. The material well-being of society depends on the level and quality of goods and services consumed. An efficient allocation of resources expands the consumption opportunities available to society. Efficiency may also be desirable on environmental grounds, for example where charging for water discourages its waste.

Efficiency and equity may also be compatible. Efficient prices of private goods and services may be viewed as equitable prices because consumers face the social cost of the resources they use. There are other aspects of equity that suggest, for instance, that people who would otherwise face hardship should be assisted.

Efficient prices are forward-looking, based on cost, and subjective. The price charged to new and existing customers should generally reflect the cost of supplying an additional unit of the relevant product or service, that is its marginal cost.¹²⁸ The marginal cost of supplying water (which is used to illustrate efficient pricing) should include the opportunity cost of the water and operating costs such as electricity and maintenance,

¹²⁶ Because incremental costs are difficult to identify, an alternative approach, which focuses on the proportionate allocation of costs to the causes of works and projects (renewals, catch up, service level improvement, environmental improvement and growth), is proposed, see Local Government KnowHow (2003), *op cit*, p 18.

¹²⁷ Local Government KnowHow (2003), *op cit*, p 18.

¹²⁸ Existing customers may be supplied under contracts that limit the extent to which prices can be adjusted.

and take account of capital expenditure brought forward by the additional demand and opportunity cost of capital.¹²⁹

Where there are several dimensions to the supply of goods or services, the price charged for each aspect should be computed on a marginal cost basis. A schedule of efficient water prices may, for instance, include the marginal cost of connecting an additional consumer to the network, the cost of supplying an additional unit of water and the cost of adding extra capacity to meet peak demand.

The initial cost of connecting customers to the network (including installation of water meters) should reflect the marginal cost of doing so. This approach is broadly applied in relation to reticulated gas, which is supplied on a voluntary basis and subject to competition from electricity. The connection of satellite television services is another example. Connection costs for water, wastewater and stormwater services are generally charged to landowners on a lump sum basis under current arrangements.¹³⁰ This is appropriate.

The continuing fixed costs of water supply should generally be charged to consumers on a regular basis, for instance monthly. Such costs may differ among consumer groups reflecting variables such as the size of the connection. The extent to which continuing fixed costs are averaged across consumer groups depends on the cost and benefit of separate pricing arrangements for different classes of customers and different locations.

Use-related charges include the direct costs of providing the goods or services. They also include the indirect cost of any capital spending brought forward by the demand (that is, the present cost of all incremental or avoidable costs incurred today or in the future that are attributable to present demand).

As a general rule, there are no economic grounds for distinguishing between the price charged to new and existing customers when the same facilities are used to produce the product or service. Both categories of customers should be charged the marginal cost of supplying the product or service. If increased demand means that the capacity of the supply system must be increased, both classes of customers should be required to contribute to the cost involved. The last unit of consumption supplied to an established customer is as much responsible for bringing forward new capacity as the first unit supplied to a new customer.¹³¹

Common costs arise in network industries, such as the three waters and roading, because each customer uses only a part of the productive capacity of the network. Common costs also arise when the same inputs are used to produce more than one product. Water reticulation systems, for example, provide water for drinking and street cleaning. The

¹²⁹ The discussion draws on CS First Boston NZ Limited (1996), *Reform of the Water Industry*, New Zealand Business Roundtable, Wellington, especially section 4.

¹³⁰ Councils have sometimes scheduled payments over time when establishing new reticulation schemes.

¹³¹ Marginal costs should be reflected in the prices charged under term contracts. With the elapse of time, agreed prices may differ from contemporary estimates of marginal costs. The sanctity of contracts requires that agreed prices be applied until they are due for review.

marginal cost of each product may, however, be able to be determined.¹³² Moreover, the marginal cost of a joint product cannot exceed the marginal cost of supplying the product on a stand-alone basis.

If common costs cannot be attributed to the marginal cost of a particular product or service, marginal cost pricing will not permit total costs to be funded from related revenue. A similar problem arises where there are economies of scale. Such economies can, however, be overstated. For example, increasing costs may arise with water storage and treatment facilities, the costs of expanding distribution systems in established urban areas (such as central business districts) and the environmental cost of water wastage.

The economic literature suggests two broad approaches where marginal cost pricing would not generate sufficient revenue to fund total costs. First, 'Ramsey pricing' might be applied. The price charged to consumers would be higher where the level of demand is relatively insensitive to small changes in prices.¹³³ Secondly, a multi-part tariff might be set that allows the price of the marginal unit of output to be set closer to marginal costs than otherwise. A two-part tariff, comprising a fixed charge per consumer, say for a month, and a use-related charge, is an example. In both approaches prices on average must exceed marginal costs to allow total costs to be funded.

The practical application of marginal cost pricing is not straightforward because of the difficulty of identifying and measuring relevant costs. Marginal costs take account of changes in future costs and the costs of unmet demand. They are difficult to compute with precision. It is not generally efficient for firms to attempt to price exactly at marginal cost because information costs are likely to outweigh related benefits. The principle of marginal cost pricing should, however, inform pricing decisions where charging is appropriate and feasible.

The difficulty of establishing marginal costs highlights the important role of contestable markets in facilitating the discovery of prices. Markets cannot perform this role when the supply of goods and services is subject to a statutory monopoly, which is often the case where the government is the provider.

5.4 Are development contributions efficient prices?

The broad approach to marginal cost pricing outlined above contrasts starkly with the way development and financial contributions are computed. They are an economically inferior form of funding where marginal cost pricing is appropriate and feasible, for the reasons outlined below.

- Development and financial contributions aim to charge capital expenditure that is perceived to be due to growth to landowners who subdivide or undertake

¹³² For example, the marginal opportunity cost of producing one product in common with another includes the marginal opportunity cost of forgone production of the second product.

¹³³ Ramsey pricing is difficult to apply because reliable and detailed information is required, for example, on the relationship between small changes in the price of a product and the demand for it and other products. The absence of such information is a key reason why the principle was not applied in designing the goods and services tax. GST is instead applied at a uniform rate.

developments rather than to all users of the relevant facilities. Existing and new customers in otherwise comparable circumstances would face different charges for investment and hence different incentives to consume the relevant product or service. New customers alone would face a lump sum charge for certain continuing fixed costs associated with incremental investment that is deemed to be due to growth.

- The lump sum for capital expenditure deemed to be due to growth is unlikely to reflect the marginal cost of installing new or expanded capacity to service the subdivision or development because of the contrasting way in which development and financial contributions on the one hand and marginal costs on the other are calculated. With contributions, aggregate capital expenditure that is forecast in the LTCCP and deemed to be due to growth is commonly allocated among attributed units of demand. The expenditure is often not discounted to take account of the time value of money. Similarly, benefits derived from investment that extend beyond the period of the LTCCP may not be taken into account. This is particularly important for investment with a long life like water and wastewater pipes, and reservoirs. The present cost of incremental capital spending incurred today and in the future to meet today's demand is taken into account in computing marginal costs. This calculation is not arbitrarily limited by the 10-year timeframe of a LTCCP. Future costs are discounted. Bringing capital expenditure forward without changing the aggregate (undiscounted) amount of such spending would affect the level of marginal costs but may have no effect on the level of development and financial contributions.
- Capital spending that is attributed to growth must be identified. Although the LGA 2002 does not specify how attributed units of demand are to be measured, councils generally use some measure of population or household growth to allocate capital expenditure to developments. There is no need to use a proxy measure of demand to allocate costs when the particular product supplied can be priced directly.

The growth in the population or number of households is often a poor proxy for incremental demand for goods and services arising from a development or subdivision. This may be a larger problem when business developments such as the construction of warehouses and factories are expressed on a household equivalent basis. Allocations based on growth in the number of households may be arbitrary and non-transparent. New Zealand's development contributions regime was modelled on Australian contributions policies, particularly that of New South Wales. In 2007, the government of New South Wales restricted contributions to infrastructure and land requirements necessary to support land developments rather than infrastructure investment deemed to be caused by population growth.¹³⁴

- Operating costs are omitted in computing development and financial contributions. The opportunity cost of water is also omitted.¹³⁵

¹³⁴ LECCG's comment on Christchurch City Council's development contributions policy indicates the difficulty in identifying the cost of infrastructure said to be caused by growth, see Barnes, Moore and Murray (2003), *op cit*, pp 2–4.

¹³⁵ The precise rules applied by councils differ. Thus all the shortcomings of development and financial contributions as an element of a pricing regime noted above may not apply to every council's policy.

It is sometimes suggested that it is efficient to charge developers for infrastructure such as public transport and community amenities when the level of investment is determined according to a council's policies and in drawing up its LTCCP or annual plan. In those circumstances, user charges can have no direct impact on the level of resources committed to the relevant activity and can have no direct effect on the efficiency of resource use. Such user charges often constitute a selective tax rather than a payment for a service. The issue then is one of taxing rather than pricing goods and services, namely, whether development and financial contributions are more efficient than general rates. This issue appears to have been overlooked in discussions of financial and development contributions that were reviewed.

Local Government KnowHow wrote that development contributions affect the location of developments.¹³⁶ They may, at the margin, encourage developments to be located in districts with low or no development contributions. However, where a territorial local authority applies a uniform level of development contributions, they can have no effect on the location of developments within the relevant district.¹³⁷ In addition, "actual costs" that developers are said to be "most able to influence" may be determined to a considerable extent by the relevant local authority because of the factors listed below.¹³⁸

- Regional and territorial councils influence or determine the location of subdivisions or developments through their district plans and consent processes.
- Development contributions fund capital expenditure that is predominantly, if not entirely, external to the subdivision or development (for example, the capital cost of expanding the capacity of trunk water pipes) and is undertaken by councils. Such spending may be unrelated to demand associated with the subdivision or development, for instance where supply to other parts of the district is expanded and a single 'catchment' applies.
- Development contributions may have no direct impact on the level of spending on the activities they fund because the relevant decisions are made politically or administratively. Councils may, for example, have a policy that specifies the level of open space to be provided on average for each citizen. In such cases, the level of spending on open spaces is affected by changes in the total population in the relevant area, given the policy, rather than a subdivision or development. The extent to which such policy standards are achieved is decided politically. Covec Limited reported that one council charged development contributions for parks when the existing provision of open spaces was well in excess of the level specified in the council's policy.¹³⁹

Arthur Grimes and his colleagues reported that private stakeholders surveyed for a study of housing supply in Auckland were concerned their efforts to mitigate the

¹³⁶ Local Government KnowHow (2003), *op cit*, p 18.

¹³⁷ For instance, where a territorial local authority has a single catchment for its district. An exception might be where the development comprises a major project (such as oil or natural gas processing facilities) which is deemed to constitute a separate 'catchment'.

¹³⁸ Local Government KnowHow (2003), *op cit*, p 18.

¹³⁹ Covec Limited (2009), *op cit*, p 2.

need for infrastructure (for example, through innovative stormwater management) may not result in lower development contributions. This also illustrates that the level of development contributions is often unrelated to the services actually provided to affected landowners by councils.¹⁴⁰

- Councils set the specifications for capital works that relate to their networks.

Some broad concerns arise in viewing development and financial contributions as user charges.

- The infrastructure to be funded by development and financial contributions may be 'gold' or 'green' plated. Council-supplied goods and services are often subject to little competition. Competition encourages producers to minimise their costs.
 - Councils have little incentive to phase capital expenditure over time, where economic, when such expenditure can be largely or wholly funded from compulsory development and financial contributions because they can only be applied when there is a development or a resource consent is issued or a service connection. A property developer may, for instance, undertake a development in stages. Councils are understood to have undertaken related work upfront on occasions, thereby increasing the cost in present cost terms.
 - Councils are required to fund subsequent maintenance and renewals other than by development or financial contributions. This can be expected to bias investment decisions toward options that entail higher initial capital outlays and lower operating costs than might be appropriate from the overall perspective of society.
- The tyranny of the majority may apply. Because development and financial contributions are levied on a limited number of ratepayers each year who command few votes, elected representatives are encouraged to impose excessive costs on them for the benefit of the majority of residential and other ratepayers. The *Neil* case highlights this risk. Potter J observed that the purchasers of properties will become future ratepayers in the district of the relevant local authority, but in relation to any development contribution required, they have no say through the ballot box.¹⁴¹ A similar risk arises with all selective taxes that are not subject to the freely given consent of affected ratepayers before the spending is committed. This risk is accentuated by unfavourable public perceptions of developers that make them an easy target for elected representatives seeking public approval. Developers are mistakenly said to bear contributions whereas their ultimate incidence is likely to fall mainly on owners of undeveloped land and homes, and consumers of goods and services.

¹⁴⁰ Grimes, Arthur, Aitken, Andrew, Mitchell, Ian and Smith, Vicky (2007), *Housing Supply in the Auckland Region 2000–2005*, A report prepared for the Centre for Housing Research Aotearoa New Zealand, the Department of Building and Housing and Housing New Zealand Corporation, Motu Economic and Public Policy Research, Wellington, p vi.

¹⁴¹ *Neil* case, *op cit*, para 55. Potter J appears to have assumed all purchasers of newly developed property would be new to the district because development contributions may only be applied to fund capital spending due to growth. This is not necessarily the case.

- Development and financial contributions lack transparency and weaken the accountability of elected representatives.
 - SPM Consultants Limited was unable to ascertain how financial contributions were determined for 30 of the 70 local authorities that were known to have a financial contributions policy.¹⁴²
 - The programme and costs of infrastructure projects to be funded by development and financial contributions may vary from year to year and may be altered to reflect council priorities despite the payment of related contributions by developers.¹⁴³
 - The level of contributions payable may depend on agreements reached with elected representatives on a case-by-case basis. While such agreements have the advantage of including the consent of the taxpayer, the taxpayer is over a regulatory barrel because failure to agree is likely to lead to the withholding of consents. Compromises made in reaching such agreements are often difficult to establish or are unknown by members of the public. The risk is that lower development or financial contributions than otherwise may apply in respect of projects that elected representatives favour for political reasons.
- Financial and development contributions discourage the corporatisation of council businesses because council owned and controlled organisations cannot levy financial and development contributions. Income tax also impedes the corporatisation of council activities.
- Development and financial contributions may lead to some double charging of affected ratepayers. Landowners bear the cost of constructing neighbourhood roads that require little maintenance in the initial years and yet pay petrol tax, road user charges and general rates in the same way as other road users and ratepayers. Generally, landowners bear the perceived cost of growth but also often contribute to the ongoing cost of providing services to other residents and firms. Some councils provide credits to mitigate this concern.
- Infrastructural assets (such as drainage systems) that benefit the community generally, rather than affected landowners, are vested in councils without compensation. This constitutes a taking of property rights. The upholding of property rights furthers the autonomy of the individual and encourages the owners of resources to make the best use of them.

Development and financial contributions are arguably inconsistent with the rule of law. According to Ratnapala, the RMA 1991 establishes an arbitrary system of environmental management that entails command and control, and ad hoc intervention. He says there

¹⁴² SPM Consultants Limited (2008b), *op cit*. SPM Consultants Limited may have examined LTCCPs but may not have examined district plans.

¹⁴³ Some councils are understood to include interest charges in their estimate of capital spending. The lawfulness of this practice is expected to be the subject of a legal challenge.

is an inevitable tension between such methods and governance according to the rule of law.

As Locke observed, government under law is government ‘by established standing laws promulgated and known to the people and not [government] by extemporary decrees’. Qualities such as generality, constancy and publicity that Fuller identified with the inner morality of law are not necessary attributes of good management but they are essential for the rule of law. The RMA’s grant of virtually unconstrained discretionary power to the executive represents a calculated departure from the rule of law standard and the principle of parliamentary democracy in favour of command and control. The problem is that the care of the environment is not like the prosecution of a military campaign. The challenge of identifying and responding to environmental problems requires much more knowledge than is available to a ministerial commander in chief, even one aided by committees and local councils. The requisite knowledge is harnessed more effectively by allowing individuals to go about their lives within a framework of clear and fair rules.¹⁴⁴

These criticisms apply to financial contributions that are inextricably linked to the RMA 1991. Similarly, the development contributions regime reflects rules that do not reflect the qualities that apply to the rule of law noted by Ratnapala.

Some councils subsidise activities such as major sporting and other events, tourism and the production of films because they are said to boost economic activity. Their analyses often assume implausibly large multipliers, implying that initial outlays yield large spillover benefits for the wider community. In contrast, their financial and development contributions discourage investment in new stadia, hotels, shops, offices, warehouses, factories, milking sheds, houses and earthworks because growth is deemed to impose costs on the community. The apparent conflict seems to have gone unnoticed.

Inefficient pricing regimes for private goods and services would not survive if such goods and services were subject to competition. Statutory monopolies (for instance, trade waste and disposal) and artificially low or zero prices applied by organisations that do not face commercial incentives (for example, for library services) inhibit competition. The high cost of replicating reticulation systems may limit competition in network industries. Over the longer term, technological change may increase competition in network industries. Mobile telephone systems, for example, compete with fixed-line services, and facsimiles and electronic mail compete with postal services.

5.5 How should infrastructure be funded?

Development contributions are often applied to fund capital spending in situations where councils could charge for the supply of the related goods and services on a marginal cost basis but do not do so. Most councils, for example, do not meter water supplied to

¹⁴⁴ Ratnapala (2009), *op cit*, p 56.

households while others charge for water use but their prices do not approximate the marginal cost of supply.^{145 146}

Only two councils charge households and businesses for wastewater collection, treatment and disposal. Although it may not be economic to measure and charge for wastewater services directly, especially for households, it may be more efficient to link wastewater charges to water consumption (as Auckland City Council and Papakura District Council do) rather than fund them from rates and development contributions.¹⁴⁷ Most water supplied to households and businesses ends up as wastewater.¹⁴⁸ This is an example of tying the price of one good or service to a closely related good or service. Households and firms could also be charged for stormwater disposal according to the level of their impervious surfaces if it were economic to do so. The test from an economic perspective is not whether such pricing arrangements are 'ideal' but whether they are more efficient and equitable than other feasible funding options.

Mass passenger transport is often subsidised well beyond the level that could plausibly be justified on externality grounds. If government action is warranted to address valid externalities, the government should seek to internalise such costs and benefits by applying appropriate taxes and subsidies. If it is not feasible to impose the tax on the individuals or firms that impose external costs on others, the related subsidy should be funded from general taxation.

It is often argued that public transport should be subsidised to reduce the demand for roads. Many choices that people make affect their use of roads. The government does not subsidise people who choose to work at home or reside close to their work rather than drive to work, people who walk their children to school rather than take them by car, people who walk to the local dairy to shop rather than drive to a supermarket or people who watch television at home rather than drive to a movie theatre. Moreover, government subsidies for public transport often support services that do not reduce peak use of roads, for instance services during the middle of the day and on weekends and those along suburban roads that are far from congested at any time of the day. The Auckland Regional Council does not subsidise certain 'commercial services', which are often provided for people travelling to and from work at peak hours, because they are profitable.

¹⁴⁵ Auckland, Manukau, Nelson, North Shore, Tauranga and Waitakere city councils, and Franklin, Papakura, Rodney, Tasman and Whangarei district councils charge for water consumed by households on a use-related basis. Eight other councils, such as Wellington City Council, meter residential use of water in some urban areas of their territories or where households elect to pay on a use-related basis. In total, 54 of the 73 territorial authorities do not charge any households in their districts for water on a use-related basis. The introduction of water charges has reduced demand. Volumetric charging in Nelson City Council reduced peak water demand over summer by at least 37 percent. Water supplied to businesses is commonly charged on a use-related basis. For information on the metering of residential use of water, see www.sustainability.govt.nz/water/water-meters (last accessed 18 August 2009).

¹⁴⁶ Christchurch City Council installed water meters at considerable expense but does not generally charge residents for water on a use-related basis. Residents with three or more units are charged if water consumed between meter readings exceeds a calculated level. Commercial users in Christchurch are charged on a use-related basis.

¹⁴⁷ Manukau City Council charges businesses for wastewater disposal.

¹⁴⁸ Exceptions include water contained in manufactured products (for example, beer) and water discharged to pervious surfaces.

The mispricing of road use, rather than externalities, is the main reason why public transport is subsidised. The use of roads may be mispriced because of the cost of implementing more efficient pricing arrangements than fuel taxes, road user charges, licence fees, rates and other general taxes. The absence of the political commitment necessary to apply more efficient road pricing is another reason. The best solution to these problems is to better price road use where economic. Technological advances are increasing the attractiveness of this option. In the meantime, road projects upstream or downstream of developments should generally be funded by petrol taxes, road user charges and rates.

The funding of investment in mass passenger transport by development contributions subsidises public transport users, including bus commuters who benefit from the use of roads, and discourages subdivision and development. If governments wish to subsidise public transport, they should, for efficiency and equity reasons, do so through general taxes (central government) and rates (local government). The cost would then be imposed on all taxpayers and ratepayers rather than selected landowners.

The mispricing of services rather than externalities is also the main reason why public libraries, museums and art galleries are so heavily subsidised by ratepayers. These amenities are predominantly associated with private good activities. The main benefits of reading a book, for example, accrue to the reader rather than the community at large. A book taken home on loan is not available to another borrower. People who do not agree to pay a membership or borrowing fee could be denied borrowing rights just as people who live outside of the relevant district are typically denied borrowing privileges at council libraries. If public libraries, museums and art galleries are to be subsidised, they should generally be funded from rates rather than development or financial contributions.

The cost of supplying genuine public goods such as neighbourhood parks, reserves, outdoor recreation facilities, and stormwater systems that exclusively or predominantly service or enhance a development and are located within a development may appropriately be imposed on relevant households and businesses by requiring the developer to do one or more of the following:

- undertake the necessary works;
- make a monetary contribution; or
- grant land (for example, for a park).

If a development includes a new town centre, there may be a case for funding part or all of the capital cost of a wide range of amenities, such as libraries, that are constructed within the development in the same way if user charges are not applied as suggested.

These arrangements should preferably be agreed between the council and developer before the development is committed. This approach has the virtue of obtaining a measure of consent of the payer although such an agreement may be less than freely given because councils may withhold consents. The amount of the contribution should relate to the cost of the land and facilities to be provided in the particular neighbourhood.

There must be a close connection between the subdivision or development on the one hand and the relevant infrastructure and facilities on the other. Because facilities such as parks are located further away from the development, the nexus between the cost imposed on landowners within the development and the related benefit derived by them becomes more problematic. This nexus also becomes problematic when the facilities within a development are likely to be used by residents generally.

There may be grounds for requiring a developer to fund part of public good facilities that are constructed upstream or downstream of the development but are nonetheless close to the development, and are to be used primarily by the landowners. However, a much tighter linkage between the development and location of the facilities and their use by landowners is required than at present to contain the potential for the abuse of development and financial contributions. Public goods and quasi-public goods that are not closely connected to a particular development should be funded from general revenue.

Developers should have the right to appeal against the requirement to fund public good activities as is the case with financial contributions. The economic test of the merits of investment in community infrastructure is that the value of the development with the relevant facilities and services should be no less than the sum of the value of the development without the facilities and the cost of providing them. Consideration should be given to making this value for money test a criterion in establishing the reasonableness of council requirements. If that approach is not adopted, the maximum level of development contributions should be capped, as is generally the case in Australia, and the principle of capping financial contributions should be retained.

It is sometimes suggested that councils should not be permitted to fund capital expenditure by imposing a lump sum cost on developers or ratepayers. They should instead fund the initial capital outlay through ratepayers' equity and debt finance, and then recover the cost over the life of the related facilities. Given certain restrictive assumptions, the two options are identical from an economic perspective. The assumptions include certainty and the absence of transaction costs. In those circumstances, the same interest rate applies to borrowers and investors, and firms can borrow in anticipation of future revenue.

Given uncertainty and positive transaction costs, lump sum charges might discourage development and affect the pattern of developments. Development contributions levied on the subdivision of land, for example, are payable upfront. Firms may therefore face increased difficulties in financing subdivisions. Development contributions would tend to encourage smaller projects than otherwise, and some firms may be unable to finance worthwhile developments. This problem is best addressed by limiting the scope and level of charges imposed on developers as proposed above. If that approach is not adopted, there may be grounds to restrict the ability of councils to impose lump sum charges on landowners for capital expenditure on upstream and downstream infrastructure.

6

TAX ISSUES

6.1 Introduction

If financial and development contributions are a tax rather than a payment for services, are they generally an efficient and equitable source of general revenue? This issue is examined briefly because the arguments against their use as a tax are compelling.

6.2 Efficiency

Financial and development contributions are generally inefficient sources of general revenue for the following main reasons.

- Selective taxes on subdivisions and developments are likely to be inefficient relative to general rates on the land value, capital value or annual value of property. The level of incremental investment in new subdivisions and developments is likely to be more sensitive to small changes in prices than existing rateable property.
 - Land is an immobile factor of production and thus rates on the “unimproved” value of all land impose a wealth loss on landowners but do not directly affect efficiency and so have no direct effect on investment or growth. The unimproved value of land for this purpose excludes any value added by investment or work undertaken by the past or present owners of the land.
 - Rates on the capital or annual value of property would discourage investment in improvements, such as structures, but a part of such rates would also fall on the unimproved value of land and on sunk investment in buildings and other improvements.
 - In contrast, financial and development contributions are imposed on certain new investments.
- The tyranny of the majority may apply as noted above. Because development and financial contributions apply to a limited number of ratepayers each year who command few votes, elected representatives are encouraged to impose excessive costs on them for the benefit of the majority of residential and other ratepayers. A similar risk arises with all selective taxes that are not subject to the free consent of affected ratepayers before spending is committed.
- Financial and development contributions are relatively opaque taxes, as noted above.
- Incremental administration and compliance costs of development contributions are likely to be relatively high. They are additional to the main rating system that councils use. Detailed rules are required to apply development contributions.

6.3 Equity

Local Government KnowHow emphasised the role of development contributions as an alternative funding tool to rates. It stressed equity issues. These perspectives are also consistent with the view that development contributions are often in the nature of a tax rather than user charge.

Local Government KnowHow states:

If the costs of infrastructure needed to service growth are funded by rates, then existing residents will bear some of the burden for paying for that infrastructure even though they have no need for any additional services. That is an unfair burden on existing taxpayers.¹⁴⁹

Therefore it is appropriate for territorial authorities to have a tool for collecting revenue from those who cause the need for additional infrastructure as a result of growth. In that sense, development contributions are a fiscal tool to identify and allocate, fairly and equitably, the cost of growth ...

A development contribution shifts the burden for providing land or funds for certain infrastructure from the territorial authority (and its ratepayers) to the person who causes the need for that infrastructure. It is an issue of fairness and equity, to ensure that growth does not create a burden on existing ratepayers who have not themselves created the need for infrastructure.¹⁵⁰

The report also states that “developers who gain by the increase in land value that the infrastructure to service their development provides” appropriately pay development contributions.¹⁵¹ This ignores the question of whether the increase in value of the development due to public investment in infrastructure is at least equal to the cost of financial and development contributions. It also focuses on who pays the tax rather than its ultimate incidence.

Development and financial contributions are inequitable taxes. They fail two of the most widely applied tests of equity, namely horizontal and vertical equity. The level of tax imposed on landowners in similar situations differs. Those who undertake developments pay a higher level of tax than other landowners. This is horizontally inequitable. Further, people on a given income or level of wealth may pay less tax than a landowner on a lower income or with less wealth who is subject to development or financial contributions. Thus such contributions are also vertically inequitable.

6.4 Concluding comment

The following advice of Richard Epstein should be adopted for efficiency and equity reasons:

¹⁴⁹ Potter J rejected a similar argument in relation to the northern busway project.

¹⁵⁰ Local Government KnowHow (2003), *op cit*, p 9.

¹⁵¹ *Ibid*, p 18.

Avoid the special taxes when there are no special benefits. It is much more likely that general revenue taxes will prove less mischievous.¹⁵²

Where there are special benefits, the consent of those who are expected to benefit should be obtained before the spending is committed and the tax is levied. A majority larger than 50 percent should be required because individuals in the minority are compelled to contribute.

¹⁵² Epstein, Richard (2009), 'The Supreme Court's Chance To Limit Special Taxes', www.forbes.com/2009/02/16/supreme-court-empres-opinions-columnists_0217_richard_epstein.html (last accessed 20 August 2009).

7

CONCLUSION

The main conclusions are summarised below.

- Under the Local Government Act 2002, territorial local authorities may use development contributions to fund reserves, network infrastructure and community infrastructure where there is a direct causal link between the need for such capital expenditure and a development (or more than one development in combination). Such expenditure is often said to be ‘caused by growth’.
- Development contributions are commonly used to fund capital expenditure on potable water, wastewater and stormwater systems, transport, and parks and reserves. They are less commonly used to fund capital expenditure on recreation and parking facilities, public libraries, community halls, cemeteries, refuse and recycling facilities, public conveniences and urban design.
- Under the Resource Management Act 1991, financial contributions may be applied by regional and territorial local authorities to fund capital expenditure on similar activities where the spending is intended to mitigate the environmental effects of developments. They tend to be preferred to development contributions in funding parks and reserves.
- Councils may apply complicated formulas to calculate the level of development contributions. The detail and apparent precision of such formulas may belie their efficacy from an economic perspective, including the validity of the causal relationship between a development and capital expenditure on infrastructure.
- Development and financial contributions are poor substitutes for efficient prices where such prices are feasible and appropriate. Development and financial contributions, for example, do not confront new and existing users with the marginal cost of supplying the related goods and services.
- The level of spending on infrastructure is often determined politically or administratively, without regard to the willingness of users to pay. In those circumstances, user charges, and development and financial contributions, cannot affect the level of resources committed to the supply of the relevant goods or services. From an economic perspective, they are selective taxes rather than prices charged for the goods and services supplied. Such taxes are likely to be inefficient and inequitable.
- Development and financial contributions lack transparency and weaken the accountability of elected representatives.

- The mispricing of goods and services rather than the presence of external costs and benefits is the main reason why mass public passenger transport, public libraries, museums and art galleries are subsidised. If governments wish to subsidise public transport and amenities that could be funded through use-related charges, they should usually do so through general taxes (central government) and rates (local government).
- The main recommendations are summarised below.
 - Prices rather than development and financial contributions should be charged for goods and services where they are feasible and appropriate.
 - There are grounds for imposing the cost of some genuine local public goods on landowners who benefit. The cost of supplying public goods, such as neighbourhood parks, reserves, outdoor recreation facilities and stormwater systems that exclusively or predominantly service or enhance a development and are located within a development, may appropriately be imposed on relevant households and businesses by requiring the developer to pay for, or provide, the facilities. There should be a close connection between the subdivision or development on the one hand, and the relevant infrastructure and facilities on the other.
 - Developers should have the right of appeal against the requirement to fund public goods, as is presently the case for financial contributions but not for development contributions.
 - Consideration should be given to making a value for money test a criterion for establishing the reasonableness of council requirements and charges. If that approach is not adopted, the maximum level of development contributions should be capped, as is generally the case in Australia, and the principle of capping financial contributions should be retained.

APPENDIX: AUSTRALIAN DEVELOPER CONTRIBUTIONS AND CHARGES

There are two main types of infrastructure – economic and social – for which Australian councils may impose charges on developers. Basic infrastructure (such as roads, water, sewerage, gas and electricity works, which enables new lots to use related services) is generally constructed by the developer and handed over to the relevant authority (often a local council) as a contributed asset. In other cases, developers may be charged for the costs incurred by local government in providing new infrastructure.¹⁵³

Legislative restrictions on the ability of local government to impose developer contributions and charges vary across states and territories. Planning legislation in New South Wales and Victoria generally allows local government to impose charges to fund the capital costs of certain infrastructure. Comparable provisions in Queensland, Western Australia, South Australia, Tasmania and the Northern Territory are generally more restrictive in scope than that of other states.

The Australian Capital Territory cannot impose developer contributions but it imposes ‘change of use’ charges for any variation of a Crown lease that increases the value of the lease, and developers may be required to provide infrastructure as a condition of the initial release of land under a Crown lease. These provisions are somewhat similar to developer contributions but the funds raised may be spent on any government activity.

Developer contributions cannot generally be levied for maintenance or operating costs. Local governments may not be permitted to require greater developer contributions than those permitted under a development plan. Development contribution systems are open to legal challenge.

The New South Wales, Victorian and Queensland systems are similar to those in the United States and United Kingdom in that development contributions must satisfy explicit criteria. Although the language varies in the legislation, each system requires formal development plans that meet standards of reasonableness and accountability.

The principle of reasonableness reflects notions of fairness, equity, sound judgment and moderation. An aspect of reasonableness requires councils to establish a nexus between the development and the demand for public infrastructure. The nexus might be causal (where the development creates a need for, or increases demand for, public infrastructure), spatial (where the infrastructure funded by the contributions is likely to serve the needs of the development making the contribution) or temporal (where the public infrastructure is provided within a timeframe that will benefit those who contributed towards its cost).

Councils are also required to take into account the reasonableness of the amount and timing of contributions on the one hand and recovery of anticipated future costs on the

¹⁵³ This appendix is based on a report by Australia’s Productivity Commission, see Productivity Commission (2008), *Assessing Local Government Revenue Raising Capacity*, Research Report, Canberra.

other. The principle of apportionment encapsulates the proposition that the share of new infrastructure costs recovered through contributions should be proportional to the impact on infrastructure of the new development. These reasonableness criteria are linked with the economic concept of user charges where the contribution reflects the private benefit that the owners of individual developments obtain from the infrastructure provided.

In New South Wales, councils can grant consent for developments conditional upon a developer contributing land free of cost or making a monetary contribution, or both, under section 94 of the Environmental Planning and Assessment Act 1979 (New South Wales). Developer contributions may be levied for economic and social infrastructure (for example, trunk roads within the development and land for parks and education) and are imposed in accordance with a development contribution plan.

Alternatively, local governments may require a levy on all new development set at the maximum percentage of the cost of the proposed development prescribed by the state government. Generally, the maximum percentage prescribed is 1 percent of the cost of development, although in regional cities the limit may be as high as 3 percent. Moreover, local governments and developers may agree to an alternative contribution amount as part of a voluntary planning agreement in addition to, or in substitution for, contributions determined under other provisions of the Act.

The New South Wales government administers a special contributions areas fund from which payments can be made to public authorities for the provision of infrastructure. It may levy, or direct consent authorities to levy, special infrastructure contributions in areas deemed to be 'special contributions areas'.

Development contributions were made more consistent, certain and transparent in 2007. Contributions were explicitly restricted to infrastructure and land requirements to support land developments rather than infrastructure requirements driven by population growth.

In Victoria, municipal councils may impose a development infrastructure levy or a community infrastructure levy in accordance with a developer contributions plan under the Planning and Environment Act 1987 (Victoria) as amended by the Planning and Environment (Development Contributions) Act 1995 and the Planning and Environment (Development Contributions) Act 2004. Some specified land and types of development might be exempt from paying contribution levies under the plan. Differential rates or levies may be payable in respect of different types of land development or different parts of the area. A maximum amount of community infrastructure levies is prescribed. Local governments also have the authority to specify conditions on planning permits and voluntary agreements may be made between councils and developers.

In Queensland, local governments may impose a charge for the supply of trunk infrastructure and require development contributions for 'development' infrastructure under the Integrated Planning Act 1997 (Queensland) as amended by the Integrated Planning and Other Legislation Amendment Act 2003. The basis for infrastructure charges is a priority infrastructure plan that contains an infrastructure charges schedule of eligible developer contributions. The Act provides for regulation of the charge and

the development for which the charge may be levied. Infrastructure charges levied by a council are taken to be a rate, unless specified as a debt owed by the developer in a written agreement between the council and developer.

The Town Planning and Development Act 1928 (Western Australia) allows local governments in Western Australia to require contributions for on-site physical infrastructure and the ceding of land for primary schools and open space. The scope of contributions is guided by Western Australian Planning Commission policies.

Development contributions in South Australia are dictated by the Development Act 1993 (South Australia) and Local Government Act 1999 (South Australia). The former allows councils to require developers to provide basic subdivision infrastructure (access roads and drainage connections) and land for open spaces. The Local Government Act 1999 allows the levying of separate rates, service rates and service charges that can be used as indirect development charges.

Tasmanian planning authorities, including local councils, are permitted to negotiate agreements with developers that specify development contributions for infrastructure as a condition of a permit, a planning scheme provision or a special planning order in accordance with the Land Use Planning and Approvals Act 1993 (Tasmania). The Act defines infrastructure as the “services, facilities, works and other uses and developments which provide the basis for meeting economic, social and environmental needs”.

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