RATING POWERS ACT

ISSUES PAPER

This paper was prepared in June 1997 by Brendon Whiteman, Senior Consultant with MDL for the Local Government Forum to contribute to the current review of the rating powers of local authorities in New Zealand.

Executive Summary

This paper has been produced for the Local Government Forum. The Forum consists of major corporates and industry groups which are major funders and consumers of local authority services.

Forum members have a strong interest in a legislative framework that allows councils to operate as efficiently and accountably as possible. Since debate about the financial management provisions in part VIIa Local Government Act 1974 (LGA) began it was clear that the 'toolbox' available in the Rating Powers Act 1988 (RPA) would not be able to provide the full flexible range of mechanisms needed to implement the cost allocation decisions under part VIIa.

The government has signalled that it is to review the RPA and this paper is an early contribution to the debate about that review.

Analytical Framework

Rating legislation should recognise that policy decisions about the allocation of costs should occur under part VIIa LGA. The new RPA should provide a full range of flexible tools, not further tests or economic principles.

The rating and valuation systems should generally provide for as few distortions to economic activity as possible. The tax base should be as wide and clearly defined as possible. There should be few exceptions and exemptions.

Mechanisms should be as simple and efficient as possible. They should be simply drafted by reference to their purpose and complex definitions should be avoided.

Tools should clearly be available for use as taxes for public good functions. Tools should also be available which can provide proxies for actual use of services.

Problems

The current legislation does not meet the tests set up in the analytical framework. The legislation is often highly specific so that anything not very specifically authorised may not be lawful.

Various parts of the Act have been added over time but fail to cohere. Different parts of the Act contain different kinds of tests which tie decisions about funding tools to patterns of benefits. These are largely redundant now that part VIIa LGA is in place.

A number of concerns expressed about rating involve issues about funding policy and rating tools. Common problems are, high commercial differentials, large portions of budgets funded from general rates, and valuation driven changes to rates assessments.

These can be fully addressed only through changes to council policy. A smarter set of tools can however give councils more flexibility and options which can allow them to avoid repeating those policies.

Other problems can be directly solved by funding tools. These include the complaint that current tools leave councils and ratepayers uncertain about what is lawful and the fact that desirable funding tools are simply not available.

New Powers

Councils now make rates through a two track process under both the LGA and the RPA. The RPA track does not add any real accountability and ideally there should be only one single process for making rates through the annual plan. More detail needs to be added to the annual plan process however, so that in addition to the policy issues which are already illuminated ratepayers can determine what proposed rates will mean for them.

The legislation for local authority rating and charging should draw together all local authority pricing and charging powers. Pricing and charging powers exist under the RPA, the LGA, the Resource Management Act and a raft of other legislation which governs council activity. Some of these powers are outdated and provide for very low dollar limits. Very few of them make it clear exactly what kind of costs are intended to be recovered. They should be restated according to a template which makes clear, in economic terms, the costs councils can include in calculating charges.

Councils can set charges on proxies for the use of some services. An example is the 'pan tax' which allows for sewerage charges based on the number of toilets in a property. Councils should have a full range of proxies available so that (using sewerage as an example) they could charge per pan, per connection, according to the volume of water supplied to the property, or on other measures such as the number of rooms in a hotel.

Rather than try to specify all proxy charges in advance the legislation should allow councils to design their own. A basic set of requirements could be established requiring that the units be identifiable and countable, that the proxy bears a reasonable relationship to the service (as tested under part VIIa LGA). The test should also ensure that the proxy charge is capable of being levied on separately rateable properties and that the costs of the mechanism are reasonable.

Valuations fix property prices at a point in time and can release them suddenly into rating systems. These shocks frequently cause councils to adjust the relationship between property value and rates to minimise impacts. This process is inefficient and would be less common if valuations were annual and were produced at a point in local authority planning cycles where the council has an opportunity to appropriately assess the effects.

Local authorities should be able (within appropriate limits) to make trade-offs between the quality, quantity and cost of valuation data. For instance they should be able to choose the level of resolution of the valuation information (eg $1,000 or $20,000 tranches), whether the data includes land value or capital value entries and what other information is to be included. Ideally (and subject to appropriate standards) they should be able to choose the agency that provides it.

Special rateable values create a regime which creates artificially low valuations for out of zone properties (ie properties used for purposes which are now of lower value than uses made of similar land in the area). This practice is inefficient, distorts against higher value uses of land, and increases the rates burden on the rest of the community. Special rateable values, except perhaps for a transition regime or for farmland should be abolished.

Capital value has some theoretical advantages over land value as a tax base. The debate about land and capital value assumes the choice is more important than it really is. Under part VIIa LGA land and capital value are simply aspects of the design of funding tools, and choices about them should follow from the allocations of cost which have been set by councils in the light of the benefit of services. Both land value and capital value could be useful tools and it is not appropriate for the RPA to discriminate between them (or annual value).

There should be a simple exception regime for rates which sees councils forming policies which show; the reason for their policies, a threshold for the application of powers, the criteria for assessing applications, the distributional effects, the effective rate of interest of any deferral, and the administrative costs.

Such a single policy could replace the complex set of powers about rates relief, remission and postponement now found in the RPA. It would provide a very valuable tool to deal with truly exceptional cases. If it was available councils main policies could be more robust.

As a basic proposition all land (including Crown land) should be rateable. The current exception regime is highly flawed. It is based on a set of assumptions and distinctions about the activities that are carried out by public and private entities, land status, and land use which are outdated. It is also, in part, built around legal relationships which can be used to avoid liability.

More fundamentally the provisions have their origins in the idea that publicly owned land is devoted to a public purpose and should not be subjected to further taxation for another public purpose. This approach is inconsistent with modern understandings of the role of government and in the need for a tax neutral regime to encourage the most efficient possible choices between public and private provision and the use of land and other resources.

If councils feel that some uses of land should receive support this issue can most appropriately be addressed transparently (and with an explicit price tag) through a generic exceptions regime or through councils' powers to give grants and other kinds of support.

Regional council's rating powers are more limited than those of territorial authorities. Regional councils also have a set of rating powers inherited from bodies such as catchment and river control boards which can contain some quite complex benefit based tests which are redundant the enactment of part VIIa LGA. The allocation of regional council costs can also be distorted through the way rates are collected for them by territorial authorities.

Regional councils should have the same rating powers as territorial authorities and they should issue rates demands and have rates collected in a way that does not distort the allocation of costs they have chosen.

The legislation should address intergenerational issues. It should provide a mechanism to allow rates to be made before the work being funded is actually started. This may be appropriate only in rare cases but its appropriateness will be tested by the intergenerational principle in s122F(1)(a) LGA.

The legislation should also allow councils to form policies which permit ratepayers who have unusual income patterns to shift their payments forward or back in time. So long as the policies maintain the net present value of rates as struck such practices would not have any net intergenerational effects.

Such policies would be effected by ensuring that appropriate discount or interest rates were incorporated. This policy would allow councils to deal with unusual cases such as the elderly low income earner in a high valued home and industries like forestry whose earning cycles do not correspond with annual rating.

There are suggestions that the rating and valuation system could be modified to recognise the restrictions on sale and cultural values inherent in Maori land and to deal with issues about its development. If a resolution of those issues is attempted it should incorporate provisions which recognise the overall distributional effects of policies and involve consultation with other ratepayers.

Rates are subject to GST and they should remain so, so that the consumption tax base remains as wide as possible and distortions do not occur to councils' choices of funding mechanisms or ratepayers' choice of services from their local authorities. The GST and tax treatment of rates should not lead to different treatment for business when rates are set.

The major powers under the Rating Powers Act are difficult and complex provisions. The main rating powers (including the sections on differentials) could be replaced by a single generic tool which allowed councils to impose rates by:

- specifying any of the permitted measures of property value (land, capital, annual).
- delimiting the area(s) over which the rates will apply.
- specifying any modification to the application of the rates to different types of property.

Uniform annual charges and separate uniform annual charges could be subsumed under the general power to define appropriate rating units and proxy charges.

A schematic outline of these proposals is contained in appendix 1. Appendix 2 shows how they would deal with the issues now dealt with in the RPA.

1. Purpose of Paper

Background

The Local Government Forum exists to encourage principled debate about the role of local government and efficient performance by local authorities.

The Local Government Forum consists of:

- The Electricity Corporation of New Zealand Limited
- The New Zealand Manufacturers Federation
- Federated Farmers of New Zealand Inc
- The New Zealand Business Roundtable
- The New Zealand Chambers of Commerce
- Fletcher Challenge Limited
- The New Zealand Forest Owners Association
- The Building Owners and Managers Association

Its members are major consumers and funders of local authority services. They are significantly affected by the way local authorities work.

Forum members have for some time been concerned that councils can allocate the costs of their activities inefficiently, often by having businesses pay for a large share of council costs.

The Forum generally takes the view that (because an efficient council benefits the whole local economy) it is best to have local authorities operate in a framework which promotes principled decision making.

This approach is to be preferred to one which seeks to restrict particular outcomes in advance, or focuses solely on the impacts of council decisions on business.

The Forum took essentially this view in the process that resulted in the financial management provisions in part VIIa LGA. From the beginning of that process it was clear that the current ‘toolbox’ in the RPA would not be adequate.

A review of the RPA is now proposed and the Forum believes a thorough reassessment of councils’ charging tools proceeding from first principles is needed.

This paper is an early contribution to that debate and is intended to:

- Set out some principles that could be applied to the review.
- Demonstrate how those principles can be translated into workable powers.
- Show how these approaches could fix some of the problems experienced with the legislation.

2. Analytical Framework

Relationship With Part VIIa Local Government Act

The significant decisions about how to allocate costs should be make under part VIIa LGA which is specifically designed to address this issue. The legislation on funding tools should not itself deal with the policy decisions on how costs should be allocated but provide tools to achieve the allocations which councils have decided are desirable.

The tools should be as flexible and adaptable as possible. If they are, tools will generally be available to match any allocation of costs reached under part VIIa LGA.

General Analytical Approach

Generally, the valuation and rating system should provide as few distortions as possible to economic activity. The obvious exception is tools intended to serve policies which promote or discourage particular kinds of activity.

The tax base for rating should be wide and clearly defined. A tax levied on a wide tax base causes less distortion than one spread more thickly over a smaller tax base. There should be few (and simply defined) exceptions, because they narrow a tax base and create opportunities for avoidance.

Mechanisms should be as simple and efficient as possible, and as far as possible be defined by reference to their purpose. Complex definitions should be avoided since they create uncertainty.

The tools (and processes for using them) should allow people to be as clear as possible about the way rates will impact on them, so that they can build clear expectations into their plans for the future and into their transactions with other parties.

Scope

It is not possible to separate issues about rating, from those about how the valuation base is defined and constructed.

Since valuation issues are not directly addressed in the proposed RPA review this paper deals with them only so far as is necessary to underpin the analysis of rating issues.

Charging tools are scattered through the RPA, Resource Management Act, LGA, and the raft of other legislation which defines local authority functions. The same principles can be applied to local authority pricing and charging across the range of council activity. A standard principle-based template for pricing and charging should be legislated for. It could then be applied across the range of local authority functions.

Taxes and Charges for Services

Much debate centres around whether local authority rating is a form of taxation or a way of charging for services. This paper takes the view that the debate can become clear only when it is realised that rating tools can be used either:

- as taxes to fund public good functions, or
- as proxies for payment for use.

Quite different principles apply to each of these purposes. When funding the provision of public goods it is appropriate to levy a tax on wealth. This is so because:

- Public good functions are non-rival, and therefore a fixed amount which supplies everyone must be produced.
- Information from prices paid for the amount of services individuals want is, by definition not available.
- It is not practical to measure individuals' willingness to pay by asking them (in any case they are unlikely to tell the truth if it would mean a higher tax bill).
- In the absence of information about prices or actual willingness to pay some assumption must be made about how the benefits of these functions are distributed.
- The best proxy of individuals' true valuation of public goods to themselves is their wealth. An assumption is made that rich people (if they told the truth) would (on average) value the same benefits more highly.
- Another way of viewing the same issue is to realise that a dollar is worth less to a rich person than a poor one. Rich people will (it is assumed) on average be willing to pay more for the same level of some public service.

Generally though it should be recognised that Councils lack the information needed to make the judgements involved in redistributing income. This function is appropriately left to central government with the implication that Councils should minimise their use of general rates as opposed to user charges or other mechanisms which are a reasonable proxy for them

Non public good services should be approached differently:

- Where the costs of doing so allow it, it will be most efficient to charge prices for each unit consumed.
- Where it is not practical to measure and price actual usage,

some proxy for use should be identified and used.

- This approach will be efficient because people will be faced with the full costs of their choices to consume. Better signals will be sent for decisions about the investment and the allocation of resources.

3. Problems: Legislative Architecture

Rating started as a simple mechanism to levy the cost of basic local authority services on the value of land.

Several processes contributed to the creation of the complex, contradictory and gap-filled legislation now contained in the RPA.

One process, common to much local government legislation, involves a succession of minor amendments. Minor changes are made to ensure that some very narrow and specific practice is authorised. As many amendments accrete over time they produce a pattern which renders anything that is not very specifically authorised, unlawful. This process creates an ongoing appetite for yet more changes.

Rating powers have steadily become more complex. Whole new elements have been added to the rating system en bloc. Examples are uniform annual charges, lump sum contributions, differentials, instalment rating, and rates remission for commercial development and voluntarily protected land.

Many of these new elements have been (at least by the standards of their time) well constructed pieces of legislation. The parts however do not cohere and terms are not used consistently between them. There is no framework that unites the parts of the Act either in terms of process, or in their substantive effects on total rating systems.

Fashions have changed in the way the statutory discretions are specified:

- Older powers were limited by a rate-in-the-dollar cap
- More recent powers are loosely tied to the areas which benefit from functions (special rates under s16 RPA and regional council powers are examples)
- The differential rating powers set down procedural requirements but few substantive limitations.
- Some recent additions (eg the powers on rates remission for developments and voluntary protected land added in the 1990s) require councils to consider economic effects, and contain significant consultation requirements.

All these kinds of powers exist together in the RPA and there is no consistent approach across them. In any case all these techniques can be seen as redundant now that issues about matching costs to benefits are addressed coherently in the LGA.

4. Problems: Generic

The RPA is regularly criticised by local authorities and ratepayers. This section isolates some of the major kinds of problem and sketches how some of them may be addressed by creating better funding tools.

Many of the concerns focus on the impact of rates, but when considered in depth relate back both to rating tools (the subject of the RPA review) and to the way councils form funding policy (which is governed by the LGA) and therefore outside the scope of the review. Problems of the second kind include:

- The extent of commercial differentials which load costs onto businesses.
- The amount of council activity which is funded from general rates rather than more targeted mechanisms (this practice can create very high rates bills for commercial buildings and farms which have high property values).
- The fact that the valuation cycle fixes values at a particular time and releases them suddenly into rating systems, causing councils to alter their rating systems to compensate.

For the purposes of this paper it is necessary to go past the fact that these issues have elements which are concerned with policy formation and extract those elements of the problems that can be addressed by creating better funding tools.

For instance if they had more flexible tools to target different users and beneficiaries, councils might not resort so quickly to lumping costs onto general rates or commercial differentials.

More frequent valuations, timed to fit the annual planning cycle would smooth the fluctuations in the rating base and allow councils time to deal properly with the distributional issues raised.

A more general criticism is that in practice (though not explicitly) councils can form funding policy by ‘backsolving’. This involves working from their existing rating policy and attempting to find an economic justification for it.

The current rating tools can encourage this process because the funding mechanisms clump together (as ‘the general rate’ or ‘the commercial differential’) funding decisions which should be thought of discretely on a function by function basis. The careful consideration of funding tools for each function that should occur can be blunted because these general categories of funding tool from the RPA come to dominate debate.

A freer, more flexible ‘mix and match’ set of tools as proposed in this paper would allow councils to focus more clearly on funding mechanisms that were appropriate to each of their activities. This would occur because more flexible tools would be available to match the allocation of costs councils wish to achieve for each function.

Other kinds of criticism are more directly related to funding tools.

Councils regularly point out difficulties and anomalies with the current legislation. Mechanisms can be used in some circumstances but not in others where they might be equally appropriate. Frequently the tools to achieve sensible cost allocations are simply absent. For instance councils cannot generally charge for sewerage according to the proxy of the volume of water supplied to a property. Councils have also had real difficulty in finding an efficient and fair way of charging schools for sewerage. A general power to define appropriate units of charging could solve many of these problems.

Another set of problems involve rating activities which have unusual patterns of costs and benefits.

Councils can often be unwilling to modify their systems (especially through differentials) to accommodate small numbers of cases. In other instances councils and ratepayers may agree on an appropriate approach but find that the tools to implement it do not exist. Both these issues underlie some of the complaints made by forest owners about rating. Access to a full set of tools which can more closely cost recovery to use or benefit would reduce both problems.

Another criticism is that council powers under the RPA are uncertain. A large council recently wrestled for some time with the issue of whether (and over what period) it could rate to build up a reserve for a new sewerage treatment plant. This problem could be addressed by funding tools that dealt clearly and transparently with the issue of shifting costs and payments forward and back in time.

Another set of problems have to do with charging. Many users of local authority services complain that their charges are too high. Often this perception will have to do with their policies and cost structures or with the fact that the use of taxing rather than charging mechanisms denies ratepayers the opportunity of looking to possible alternative providers or opting out of using the service at all. Problems with particular tools can also play a role. For instance:

- charging powers often do not make it clear what kind of cost allocation is intended.
- the fact that councils can sometimes charge only for some very specific services may encourage them to load costs from closely related areas where they have no charging power.

5. Process Issues

Local authorities must now make rates through a two track process:

- The processes for forming funding policy and making annual plans under part VIIa and XIIa LGA.
- Processes under the RPA centred around the use of the special order procedure.

It can be difficult for councils to co-ordinate processes along both tracks. Minor procedural errors in the RPA processes can lead to rates being invalid.

The RPA track does not add any real accountability. The special order procedure does not provide for any specific consideration of submissions and it allows submissions to be made so late that they cannot be dealt with effectively.

The RPA procedure also isolates issues about funding tools from the issues about benefit and cost allocation that are considered through the LGA process.

There should be one single process for making rates embedded in the annual planning process. Most local authorities in fact decide on their rating to a reasonably fine level of detail between the draft and final versions of their annual plan.

The annual plan process as it is currently configured, however, does not generate enough information about how rates will actually impact. It should be amended so that good information is given about intended rates so that ratepayers can see clearly how the proposals will affect them.

The annual plan process currently contains too little information because its minimum requirements are:

- That it contain the funding policy (but this only needs to be produced every third year).
- A summary of the funding policy in other years.

More detailed information should be required in each annual plan. The basic elements of such a requirement already exist in various provisions including s122O LGA, s110 RPA, and s84(1) RPA. These could be reordered and rationalised into a single provision requiring a statement of the tools that will be used as a result of the council's funding policy. The main elements of such a requirement could include:

- A brief summary of the reasons and rationales for the use of the tools taken from the funding policy.
- The rates and uniform annual general charges that will be used.
- Any modifications that will be used for different kinds of properties (and how any categories are defined)
- Charges based on proxies for use (and how they will be defined).
- Fees and charges.
- Penalties.

In addition an explicit test could be built into the legislation requiring that the information is specific enough to allow a ratepayer to calculate with reasonable accuracy the impact of the proposed tools on their own property.

While rates assessments should give ratepayers clear information about the rates they have to pay. They also provide an opportunity to explain why the rates are being paid. The annual planning process is regularly criticised on the grounds that it is not understood by or accessible to many people.

Rates assessments however, by definition reach every ratepayer. It would be possible to add a brief statement of rating policy to the assessment which would convey a very clear and basic picture of how the rates contribute to the funding of council functions. Such a statement could require:

- A list of council functions (from the categories used in the funding policy) and the total costs of each.
- A statement of how much of the funding for each function comes from rates, charges on other units, and user fees.

The statement would be issued with assessments at a time when rating policy for the year had already been set so it could not improve the quality of input into the setting of rates for that year. It could, though, over time significantly contribute over time to public understanding of how councils fund themselves.

6. Pricing Powers

There are many dozens of pricing and charging powers scattered through the RPA, those sections of the LGA which specify council functions, the Resource Management Act and in the raft of other detailed functional legislation under which councils operate. Local authorities also have a generic power to set fees and charges under s690A LGA.

Some of the specific powers contain dollar limits which are wholly inadequate (for instance it can cost $1 and $2 for amusement device permits which need to be issued by qualified inspectors). Most recently drafted powers usually provide for "a reasonable charge" but do not specify any purpose or criteria for their use.

Sometimes charges are specified for some elements of a local authority function but not others. In many of these cases the generic power in s690a LGA will not be available to fill the gaps. When faced with this situation councils may overcharge for some elements of a function to subsidise those for which they cannot charge effectively.

Many of the charging powers were drafted to meet the needs of a less complex reality when the ability to measure and allocate costs was less, and the potential for efficiency gains from more accurate charging regimes was not fully appreciated. It can be very difficult to extract answers to modern day issues about charging from the statutory language.

It is often a struggle to get any useful guidance from the relevant decisions on the kinds of costs that can be recovered through various charging powers.

A partial solution would be to identify the existing charging and pricing powers and clearly focus on their purpose. They could then be restated in terms which allowed councils to make a reasonable charge and also set out the intended effect of the charge. Possible categories could include:

- Charges set at less than marginal cost to promote some purpose (eg copies of material to assist participation in decision making).
- Charges at marginal cost, (eg the supply of other information).
- Charges intended to recover the average costs of an activity (eg inspection and processing functions).
- Charges at above average costs to provide a disincentive to an activity.

This template is not intended to be definitive but to illustrate how charging could be ordered much more clearly in economic terms.

The powers under the Resource Management Act to charge financial contributions from subdividers for council services should be included in this framework. Charges based on external environmental effects are appropriately dealt with under the RMA regime but other financial contributions (such as those towards water and sewerage) are charges for council services and should be dealt with under the same regime as other charging mechanisms. Some recognition of this fact already exists in the provisions which require some financial contributions under RMA to be dealt with in accordance with part VIIa LGA.

It is understood that the Department of Internal Affairs are identifying existing council charging powers. It might or might not be practical to slot them all into such a framework at one time. Even if this exercise was not done immediately the framework could be used as a template for new powers and for the restatement of powers in existing legislation when it is reviewed.

Local authorities can enforce a range of charges (eg overdue charges for library books and fees for using parking buildings) through bylaws. Some charges are also enforceable as rates and can bind future owners of land. Rates used as taxes for public good functions should be enforceable at low cost. Other prices and charges, however, exist for services which could also (at least in part) be provided by private entities. Local authorities' enhanced ability to enforce these charges distorts in favour of council rather than private provision, since private providers must rely on contracting and the general law.

Councils should have no greater ability to enforce prices and charges (other than rates) than do private entities.

7. Specification of Major Rating Powers

Councils' core rating powers are set out in very complex ways in s12-16 RPA which involve ward accounts, community rates, separate rates and general rates. The essential feature of these powers is the ability to impose a rate or rates on property value in parts or the whole of the district. There is no reason why these complex powers could not be reduced to these essentials:

- A power to impose rates on any of the permitted measures of property value (land value, capital value, annual value).
- A power to delimit the area(s) over which they will apply.
- A power to modify the application of rates to different types of

properties.

Taking this approach the distinction between general and separate rates disappears and the generic tool can be applied to any council function.

There appears to be no case for retaining the legal maximum in s12 (3) and (4) RPA. Modern accountability mechanisms should provide a more effective check than the maximum. In any case the existing restriction can be avoided by labelling rates as separate rather than general rates.

The power to modify the application of rates to different kinds of properties might logically be applied at the time they are made. there is no strong logic to the way the differential rating powers are currently constructed. The current system sees differential systems having a semi-independent life partly outside the annual rates making and funding policy processes.

Some rating powers are currently specified to be for some purpose (eg s16 RPA provides that special rates are "for the purpose of undertaking any specified function or work, or for providing any specified service ..."). Other rating powers (eg the main general rating power in s12 RPA) do not require any particular linkage to particular council activities.

Funding tools need only specify the tool itself. Issues about linking the tools to council activities will be dealt with by the financial management provisions of part VIIa LGA. The process of forming funding policy will determine and make clear what tools were being used for what purpose.

Similarly it would also be unnecessary to preserve any distinction between uniform annual general charges and separate uniform annual charges. New provisions should allow flat charges per property to be imposed for whatever functions (and whatever areas) they are appropriate. Flat per property charges could, as suggested in the chapter on new charging units, be considered as a subset of a much more general power for councils to define their own units of charging.

8. Other Charging Units

Local authorities currently have a number of charging powers which are based around proxies for the use of services.

A proxy can be the most efficient way of charging for services where it is not practical to identify and measure actual use and charge prices accordingly. Examples of charging by proxy in the current legislation include:

- Separate uniform annual charges for services (where a flat charge per property is thought to be a proxy for use).
- The "pan tax" (which allows charges for sewerage to be calculated on the number of toilets in a property).

- Charges for water and sewerage under s24 Rating Powers Act (where separate tenancies are thought to be a proxy for use of water and rubbish collection).

Rates themselves can also be a proxy for use rather than a tax. For instance land value or area rates can be used as a proxy for the use of land drainage services. In this case it is impractical to measure the demands made on the system by each property but area and land value systems are capable of approximating it.

The use of rates as proxies for use in such cases needs to be clearly distinguished from the use of rates as taxes for true public good functions.

There are only a few proxies for use available under the current legislation. Given that efficiency concerns are now dealt with through part VIIa Local Government Act a full range of proxy charging mechanisms should be available.

Taking sewerage as an example, councils could have available:

- Charges per pan
- Charges per connection
- Charges according to the volume of water supplied (which can be a proxy for sewage discharged)
- Other measures such as the number of rooms in hotels.

Rather than specifying specific proxies in advance the legislation should permit councils to design their own. The legislation should specify standards which the proxy charges must meet.

The standards should not provide any restrictions additional to those in part VIIa Local Government Act but provide the maximum discretion in the design of tools to achieve the allocations reached in the processes under that legislation.

Design standards for proxy charges in the legislation could require:

- That units are identifiable and countable.
- That the proxy bears a reasonable relationship to the service being funded (as tested by part VIIa LGA).
- The proxy is capable of being levied on separately rateable properties.
- That the costs of the mechanism are reasonable (as tested by part VIIa LGA, in particular s122H).

9. Valuation Issues

It is not possible to consider rating (which is a power to impose taxes on land) separately from the design of the tax base involved. The review of the RPA does not, however, extend directly to the valuation system so this section addresses valuation issues only at a very high level. The only valuation questions covered are those necessary to make the proposals elsewhere in this paper work effectively.

Valuation Cycles

Valuations fix property prices at a point in time and release them suddenly into rating systems. Local authorities can react to these shocks by altering their rating systems to avoid sudden changes to the bills faced by individual ratepayers. They do this by adjusting the relationship between property value and rates, usually by altering differentials.

This practice is inefficient since rates for public good functions should be proportional to value. Frequent adjustments set up expectations of further adjustments in the future making it politically difficult to maintain a clear proportional relationship between property values and rates for public good functions.

More frequent variations could reduce this behaviour. It is significant that Valuation New Zealand has agreed to use its discretion under the Valuation of Land Act to provide annual valuations to Wellington City. Wellington is a local authority whose rating policy has been strongly influenced by the valuation driven cycle described.

The valuations should ideally be generated at a point in local authorities' annual planning cycles where they have an opportunity to model the effects of their funding policy decisions on the new values.

Valuation Data

Issues about annual valuations are a subset of a larger set of questions about the nature of the tax base for rating. The Local Government Act requires local authorities to consider the characteristics of available funding tools and to choose those which most efficiently and effectively achieve the allocation of costs on which the local authority has decided.

This process involves making trade-offs between issues such as the precision and the cost of different funding tools.

The valuation system as it currently exists, however, fixes in place many of the quality characteristics of the valuation data which is supplied. Local authorities should be able to choose (within limits appropriate to the definition of a tax base) the cost and quality of the valuation information they need. These choices should include:

- The level of resolution of the value information (eg $1,000 or $20,000 tranches).
- Whether the data includes land value or capital value entries (some estimates put the cost of a capital value entry at four times that of a land value entry).
- Any other information that is to be included (for instance information relevant to the use of proxies for use such as the

number of tenancies or hotel rooms).
- Ideally (and subject to appropriate standards) the agency to provide the valuations.

Special Rateable Values

Part VI RPA and ss25B-25F VLA together create a regime which creates artificially low valuations for particular kinds of property (often called "out of zone" properties). These are properties used for a range of purposes which are of lower value than the uses made of similar properties in the area. The kinds of properties involved are:

- Farmland in urban areas.
- Commercial or industrial properties in residential or rural areas.
- Residential properties in commercial or industrial areas.
- Single or double unit houses where values are influenced by the demand for multi unit housing.
- Properties with existing use rights under the RMA.
- Properties subject to specific preservation conditions.

Such properties receive an artificially low valuation based on their actual rather than potential uses. This practice is inefficient since rates for public good functions should be levied on value and value will by definition be influenced by potential use.

It also distorts against higher value uses of the land affected and increases the rates burden on the rest of the community.

The practice blunts accountability. Local authorities should be accountable for the way the costs of their activities are allocated. Automatic discounting through the valuation system creates effects for which councils cannot be held responsible.

The special rateable value provisions may be driven by a concern with the potential impact of rates on some landowners. This issue is, however, best addressed through explicit provisions which make it clear the kinds of impacts that are subject to relief and the costs to the community involved in providing it.

Land Value/Capital Value

Rating on the capital value of land has several advantages over land value when considered as a tool for funding public good functions:

- The capital value land base is larger and therefore a larger subset of total wealth.
- Because it has a larger tax base, considered in total the impact of rates levied on it will be less distortionary than on the smaller land value tax base.
- There is more raw data about capital value than land value.

Proponents of land value make the observation that capital value (since it taxes improvements) may be a disincentive to development. In some cases at the margin this must be so, however for most kinds of projects it is commonly argued that rates are likely to form such a small part of the costs that they will have no effect on development decisions. It should be borne in mind that the critical issues are not the quantum as such, but the impact at the margin on project viability and the net present value of the expected rate burden, not the single year effect. Clear information about the dead-weight losses involved in each system is not available.

Land value rating may require a less costly tax base. Some estimates put the cost of a land value entry at $7 while the capital value entry may cost $28.

Land value and capital value are often spoken of as "rating bases" or "rating systems" (and are so called in the RPA). The choice between them is usually regarded as a fundamental one. This clearly would have been the case when most or all council activities were funded as a single rate in the dollar.

Councils now, however, have a much wider set of tools and the regime in part VIIa Local Government Act requires councils to choose those which achieve allocations decided on following the application of economic principles. This structure ought to reduce decisions about land and capital value to technical ones based on the efficiency and effectiveness of potential tools.

The major decisions affecting costs on ratepayers should have been made at earlier stages of the process where councils determine the balance between rates, charges for uses, and prices.

It is not appropriate that the rating legislation make any finding for or against land, capital or annual value. Rather it should allow councils to make choices between them in accordance with the Local Government Act provisions as one element in the selection of funding tools.

10. Exceptions From Rates

The legislation contains a number of provisions which allow councils to grant relief from the impact of rates:

- s177 RPA (on the grounds of financial hardship)
- s178 RPA (on the grounds of extreme financial hardship)
- s180 RPA (on land affected by natural calamity)
- s189 RPA (on multiply-owned Maori land)

several kinds of relief are available under various of the provisions. They include postponing rates (with or without interest), reducing the rates payable on a property, deferring liability until some event (such as sale or death of the owner) and relief from the obligation to pay altogether.

There is no coherent pattern to the provisions. Their application to some circumstances is unclear. It is apparent how some of them apply to corporate entities rather than natural persons.

Councils do not have to make explicit the total cost of their rates relief policies. The effects on the efficiency of their funding systems do not have to be explained.

A transparent and workable remissions power is potentially a very valuable tool. It could be used to deal with truly exceptional cases so that councils do not need to modify their main rating systems in order to deal with political concerns about ratepayers in unusual situations. An example is the commonly cited case of the elderly person on a fixed, low income who occupies a valuable property. Such people could be dealt with under an exceptions regime.

An exceptions power should require councils to take account of the distributional effects (both across the community and across time) of their decisions. Such policies would make explicit the costs of deferring payment by reference to an appropriate interest rate.

Such a provision could be constructed by allowing councils to form policies on rates relief through the special consultative process according to criteria like these:

- The threshold for application of the powers would have to be clearly defined.
- The criteria for assessing whether the threshold was met would need to be set out.
- The distributional effects would need to be considered in accordance with part VIIa Local Government Act.
- The effective interest rate of any deferral of rates should be made explicit.
- The administrative costs should be made explicit and considered in accordance with part VIIa Local Government Act.

A rough template for this kind of provision (although it predates part VIIa LGA) already exists in part XIIa and part XIIb RPA which deal with rates relief for developments and voluntarily protected land.

Rateability - Exceptions

The current legislation provides for a range of exemptions from rating including a substantial exemption for much land owned by the Crown.

Other exemptions are constructed around a range of tests which can be an ineffective means of determining rateability. They include:

- Land status (which can often be costly and difficult to determine and update).
- Distinctions between public and private use which are no longer relevant.
- Definitions built around legal relationships (such as tenancies for less than a year) which can be used to avoid liability.

The provisions seem to have their origins in English Poor Law rating which dealt with publicly owned land on the basis that land already devoted to a public purpose should not be subject to further taxation for public purposes.

This approach is inconsistent with a modern understanding the role of government which sees that many activities once considered appropriate for government can in fact be unbundled into ownership, purchase, and provision roles and that some or all of these roles may more efficiently be carried out by private entities.

The right mix between public and private provision, the use of land and other resources, one activity over another, and one location over another will only be achieved if rates and taxation treatment is neutral.

Some distinctions which are currently dealt with as exceptions (such as the distinction between land and machinery) can more appropriately be dealt with in terms of the definition of the basic unit for rating.

The basic position should be that all land is rateable and that exceptions from rateability should be granted by councils only if they demonstrably serve some policy goal.

Such a power could be constructed from elements such as, the policy objective, the effectiveness of exemption as a tool, cost and distributional effects.

Any exemptions should be based on actual use of land rather than arbitrary concepts such as land status or legal relationships which are subject to avoidance tactics.

Such criteria come very close to those suggested for rates exemptions generally. There may be no case for treating exemptions based on land use as a separate category. It may be that they can most effectively be dealt with as part of a generic exceptions power which can be applied both to land used for particular purposes and to the circumstances of individual ratepayers.

Hospitals and Schools

Hospitals and Schools are substantial beneficiaries of rating exceptions. These exceptions are inconsistent with the efficiency requirement that activities should bear their full costs. The exceptions represent subsidy from ratepayers to users of the health and education systems which are more properly funded by central government taxation. Government itself should endorse the removal of the exception as it is inconsistent with its own policy settings.

The impact on hospitals and schools, of this change, will be lessened by the other changes proposed in this paper, as generally hospitals and schools should be rated only to the extent that they benefit from rate funded expenditure.

Rates Rebate Act

The Rates Rebate Act contains a regime which provides for central government support for ratepayers with low income. The legislation allows thresholds to be set in relation to the kind of assistance and the threshold for it. A ratepayer who meets the criteria can apply to the council for a rates rebate. The council then seeks reimbursement from the Crown through the Department of Internal Affairs for the rebates granted.

The thresholds are currently set so low that the scheme forms a relatively small part of the way councils are funded (it involves less than $1m per year). In its current form it may not make a significant contribution to the issue of unpaid rates or the situation of low income ratepayers. Some individual councils total unpaid rates bills are higher than the total dealt with under the Act.

The Act confuses accountability because local government appears to be administering something that is in fact funded by central government and makes local government appear to be involved in income distribution.

Lack of income to pay rates is an income issue and should be considered as part of income redistribution and social welfare policy by central government not in a context which specifically deals with rating.

There is no reason why the Act should cut across these accountabilities. The issues it seeks to address can be more effectively met through councils' policies on exceptions to rating and central government social welfare policies. The Act should be repealed.

11. Regional Council Rating

Regional councils have extensive powers to impose fees for many of their key RMA functions but their powers to rate are much more limited than those of territorial local authorities. For instance they cannot apply differentials to their main rates and cannot use the flat uniform annual charges available to territorial authorities.

Without these powers regional councils are unable to adapt their funding systems to recognise the situations of ratepayers. When ECNZ was in dispute with a regional council over rates on one of its dams the council was willing to reconsider rating levels, but the limited powers meant that there was no readily available tool to use to achieve the desired outcome.

Regional councils like territorial authorities must allocate the costs of their activities according to the process in part VIIa LGA (and also in accordance with other functional legislation which deals with cost allocation, eg the Biosecurity Act 1993, s97). All but one regional council uses the RPA provisions (and agreements made under s127

RPA) to have territorial authorities collect rates on its behalf.

Regional councils make their own allocation of costs when they set their own rates. These allocations can however be distorted through the collection mechanisms used by the territorial authorities that actually collect the rates.

- The provisions dealing with land value and capital value rating system s(ss96, 98 RPA) can distort incidence.
- The incidence of rates can be modified through TAs own differential systems (though there is no clear statutory basis for doing so and the practice may be becoming less common).

Accountability of regional councils for their cost allocations is further weakened by the way rates assessments are presented. Frequently regional council rates appear as a few lines on a territorial authority rates demand.

Regional council rates should be levied so that the council's allocation of costs is maintained. Rates assessments should clearly show the regional council rates (with the same level of detail which applies to territorial authorities).

If these proposals were applied the processing of regional council rates could be done by territorial authorities, regional councils themselves, or other agencies, whichever was most efficient.

Regional councils also have a grab-bag of powers inherited from the abolished ad hoc bodies whose functions they inherited in the 1989 reforms. They include pest destruction boards, catchment boards and land drainage and river boards. These frequently contain powers to impose differential rates. They have their origins in a time when a need was seen to link cost recovery to benefits to a balanced generic mechanism such as part VIIa LGA. As a result many of those powers contain their own tests requiring the rates to be (in some way) linked to the benefit received.

These powers could all be replaced by general access for regional councils to the same tools recommended in this paper for territorial authorities.

12. Intergenerational Issues

Local authority funding will be more efficient if the costs of functions are borne at the same time as their benefits accrue. If this is done each generation of citizens will pay the costs its demands impose and no generation subsidises another. This idea is embodied in the 'intergenerational equity principle' in s122F(1)(a) LGA.

Shifting Costs Across Time

Councils have however an incomplete range of tools to shift the incidence of costs in time. They can shift costs forward by using debt financing which requires payment of capital sums in the future. Debt financing powers lie outside the scope of this paper.

Local authorities have far fewer powers to shift costs backward by funding future works from current ratepayers. The lump sum provisions in part IV RPA are the only major example of such a power. Backward shifting of costs is also limited by the annual funding principle which limits the accumulation of funds for future works. This Common Law principle was recently applied by the High Court in Begley & Ors v Bay of Plenty Regional Council. Councils have been unsure how far it is possible to rate to build up reserves to fund future works.

The limited powers to shift costs backwards is perhaps no surprise. It is very hard to imagine council functions which produce benefits before costs are incurred. An example perhaps is a large infrastructure project which in part is rendered necessary by the failure of past and current generations to maintain infrastructure. Such a project might be appropriately funded through its planning stages by current ratepayers, ahead of the time it actually produces benefits.

The intergenerational equity principle itself (imbedded as it is in part VIIa LGA) already tests whether costs should be moved forwards or backwards in time and would identify any such rare cases where payment should be made before benefits accrue. Further restrictions such as the annual funding principle are redundant.

Shifting Payment Across Time

It is also possible to imagine different policies which shift the obligation to pay (as opposed to the net incidence of costs) across time. The payment of rates can be moved across time without changing the net intergenerational effects. This can be done by making sure that the net present value of any future payments equals the rates forgone. This involves an appropriate discount for early payment and an interest rate on late payment.

Such a power could address issues such as:

- Those who wish to pay a lump sum early to relieve themselves or later owners of ongoing rates burdens.
- Those who wish to pay later when capital will be available (eg the elderly low income earner in a high valued home who will pay on death or sale).
- Industries whose demands on services and income streams have very marked peaks (like forestry at the end of its 30 year cycle).

In some cases the wishes of such ratepayers could be accommodated by councils. If appropriate interest rates and discount rates were incorporated in their policies the net intergenerational effects would be neutral.

The council would in effect be acting as banker to its own ratepayers. It may be that issues such as security, monitoring, and enforcement, dissuade private sector providers. Councils should have to consider the same costs and risks and the ability of markets to deal with these issues in forming their own policies and make these explicit. Desirably such powers should only be exercised when there were good transaction cost reasons for believing that the market was unlikely to provide an acceptable solution and on the basis that the ratepayers concerned gained no benefits in net present value terms.

The powers could be valuable to deal with people who have unusual relationships between income and property value. Their availability to deal with ratepayers in unusual situations, could assist in preserving the robustness of councils' main systems by reducing pressure for charge because of the impact on a few atypical cases.

Council powers to shift payments would need to take into account:

- The ability to judge costs over time (particularly relevant to the forestry example).
- What kinds of ratepayers a council wants to grant the option to (should there be a hardship test?).
- The other costs and risks associated with the activity.

Finally, this suggestion is qualified by noting that there may be difficulties in practice with its implementation. Empowering Councils to act as bankers to their own ratepayers may involve unacceptable problems of weak incentives and lack of knowledge. The proposal is put forward primarily to ensure completeness in the consideration of intergenerational issues.

13. Rating Units

Rates are a tax on land. A fundamental issue is the definition of the unit of land holding that will attract a liability to pay. The unit under the RPA/Valuation of Land Act regime is the separately rateable property (SRP).

These units get defined through a complex series of processes under the RPA and Valuation of Land Act. Roughly stated there will be a separately rateable property where there is an occupation for a term of one year or more of property that is rateable. There is an extensive body of case law on the key components of this process. There is, however, no uniting purpose behind these definitions. The process does not focus on the efficiency and incentive effects of how the basic unit of rating is defined.

However, substantially the same definitions have been in place since early this century and some level of certainty about the definition of the basic unit of rating has emerged. Any substantial re-definition would create considerable doubt as new rules were litigated.

A number of existing rating mechanisms calculate charges on units of occupation other than separately rateable properties. They include:

- Uniform annual charges (which are calculated on SRPs with some modifications), and

- Separate uniform annual charges under s24 RPA for water supply and rubbish collection (which can be calculated on the number of individual tenancies).

They are used only in calculating the amount of liability. Once calculated these charges are levied on SRPs.

In fact these other units of occupation are but a small subset of a potential range of proxies for the use of council services which could be used for charging.

This paper suggests that a wide range of such proxies should be available to be used in the calculation of charges but that they continue attach to SRPs as currently defined. It is unlikely that the creation of new separate units of liability would add anything to the efficiency of the rating and valuation systems since each new unit would create new set of obligations to pay and enforcement mechanisms.

14. Maori Land Rating

The rating and valuation of Maori land raises significant legal and constitutional issues.

Maori freehold land is rateable and (subject to a subset of special rules) it is valued and rated according to the general VLA/RPA procedures.

The special rules include exemptions for some particular kinds of Maori land (eg Marae, reserves set aside under the Maori Affairs Act). There is (in s189) an extensive and widely drawn power to remit and postpone rates on Maori land. The normal enforcement mechanisms are highly modified so that Maori land cannot be sold in a rating sale (although local authorities, through a court order, can access income streams from the land).

Some local authorities complain that restrictions on rating and enforcement mean that the owners of multiply-owned Maori land do not pay their fair share of rates.

Many Maori believe that the valuation and rating system is deeply flawed in the way it treats Maori land. Key criticisms include:

- The failure of the valuation system to recognise the restrictions on sale inherent in the tenure of multiply-owned Maori land.
- That the systems fail to recognise the cultural values which attach to land (which is not generally seen as a tradable commodity).
- That the rates on Maori land can operate as a disincentive to its development.

A Waitangi Tribunal claim has been lodged alleging that the valuation and rating systems breach Treaty obligations. A high court decision, Mangatu Incorporation v Valuer General, has held that the restrictions on sale and dealing contained in Te Ture Whenua Maori Act 1993 should be recognised in valuing multiply owned Maori land. This decision is subject to appeal.

It is likely that in the future some resolution of these issues will be achieved, perhaps through:

- Some recognition (to the extent the valuation system is suited to measuring it) of the restrictions and values which attach to Maori land in the valuation process.
- A power for local authorities to recognise cultural values and development issues when forming policies in key areas. This could occur through some translation of Treaty principles to local government.

If such charges do occur it is important that they operate in a context which recognises the overall distributional effects of policies in this area. Any favourable treatment of Maori land will have distributional effects on other ratepayers. For some local authorities with high proportions of multiply-owned Maori land in their rating base these effects could be significant. Any policies in this area should have to make the distributional effects plain and involve consultation with the whole community.

15. Local and Central Government Taxes

Two major issues are frequently raised by the interface between central and local government taxes:

- Should local authority taxes themselves be subject to the central government consumption tax, GST.
- Should liability for central government taxes be relevant to setting local taxes.

GST on Rates

Rates are under the current GST legislation subject to GST in the same way as payments for other final goods and services. This paper suggests that this is the correct position because:

- The consumption tax base should be as wide as possible to prevent distortions (a GST exemption would favour council provision over provision by other parties).
- If rates were not subject to GST councils would favour rates over prices which did attract the tax.

Even where rates fund purely public good functions such as local democracy and district plan preparation citizens still have choices to make about how much of those functions they want. The tax inputs into the costs of those services should not distort choices between their consumption and the consumption of other council functions.

Charging GST on rates does create a flow of income generated by the activities of local government directly to central government. This does not, though blur any accountabilities anymore than it does across the large range of government owned and semi-autonomous bodies whose activities attract GST.

Tax Treatment of Rates - Rates Setting

Rates paid by businesses can generally be deducted in the calculation of pre tax income. This fact has led some councils to suppose that rates have less impact on businesses than non-business ratepayers. This difference in impact is said to justify rating policies which increase the impact on businesses by an equivalent amount.

This view is misconceived. Businesses can deduct rates because their income is taxed on a net rather than a gross basis. Residential ratepayers can also receive a deduction if their gross income including rent is taxed, as when they earn rents from properties. Most residential ratepayers however are not taxed at all on the implicit rents they enjoy through their investment in housing, and because they are not taxed on this income they cannot deduct expenses from it. This does not mean that residential ratepayers are disadvantaged, rather their tax status is generally an advantage to them.

GST is paid on final goods and services. This is achieved by allowing businesses to deduct the GST on the inputs into their productive processes. Business can deduct the GST on inputs so that each business in the productive chain only produces a GST liability proportionate to the value it adds to the product.

The GST on rates can be deducted like the GST on any other input, and businesses should be free to make their own trade-offs between rates and other inputs into their business on a level playing field without rates levels themselves being affected by the GST process.

When a final good or service is produced, GST is added to the purchase price and the purchaser appears to pay it. However businesses' ability to pass on the burden of paying GST (or any other cost) will be governed by the markets in which they operate. Where markets are highly competitive they will not be able to pass GST on fully to purchasers and the cost will be borne by owners or those providing labour. Rating policies which second guess this process by making assumptions about the economic incidence of GST liability will discriminate against businesses.

In addition the task of identifying and distinguishing between 'business' and 'non business' ratepayers is a hugely difficult one. Any available proxy for 'business' status (such as commercial zoning) could miss a large number of intended targets.

Legal and Economic Incidence of Rates

More importantly the particular case of GST and tax deductibility is just a subset of a larger issues about the legal and economic incidence of rates. Councils are tempted to set policy on the assumption that the person named on the rate demand is the person on whom the burden of paying rates actually falls. Having made that assumption it is then tempting to make a further assumption about what impact means for that person.

In fact the economic impact of rates is spread through the complex set of relationships between landlords, lessees, employers, employees and owners and other players in the economy. The exact pattern will depend on the economic relationships between the different players and cannot be second guessed when councils set funding.

Councils should not use their substitute guesses about the impact of rates unless they are demonstrably better than the option of leaving incidence to work itself out through the economy.

The issues about GST and tax deductibility are treated more technically and in more detail in this extract from a submission in a local authority's annual plan.

Tax Treatment of Rates

GST

GST is intended to be a tax on final consumption spending; it belongs to the consumption tax family. In national income (GDP) terms, the GST tax base can be derived as follows:

1	GDP = C+I+(X-M)	where C is consumption, I is investment, X is exports and M is imports.
2	C = GDP-I-(X-M)	
3	GDP = O-P	where O is outputs and P is inputs. O-P is value added in production. In includes profits and wages.
4	C = O-P-I-X+M	
5	GST = Ct	where t is the rate of GST.
6	GST = Ot-Pt-It-Xt+Mt	

Equation 6 is broadly the way GST is calculated and collected. Outputs (sales) are taxed but a credit is given for GST paid on inputs and investment. Exports are zero rated which is equivalent to Ot-Xt. Imports are normally taxed by Customs when they cross the international border. (If not, a credit is not allowed when they are used in production or trade. This has the same effect as taxing them.)

Consumption could be taxed directly (equation 5) with the same effect as equation 6 but that is inferior on administrative grounds. A retail sales tax would be the closest practicable option. If GST were collected directly, the question of any tax advantage for firms from claiming a credit on input tax would not arise. This factor alone indicates that the analysis in the staff memorandum is invalid.

Because GST is intended to apply to consumption spending only, the net effect of tax on outputs and credit arrangements should be to leave income unchanged. This assumes that GST is fully passed on to consumers and ignores any macroeconomic effects. Consumption taxes do not alter before - and after - tax rates of return.

We can therefore pose the question: Does a credit for GST on rates (or any other input) alter the profitability of the ratepaying firm relative to its before-GST position? To sustain the view in the memorandum, a credit for GST should increase the firm's taxable income, ie confer a net advantage that did not previously exist. Any advantage should, according to this view, be taxed away by higher rates than otherwise. (The question of whether this is the proper function of the Wellington City Council is not addressed.)

Consider the simple example shown in Table 1 in which GST-exclusive rates remain unchanged on the introduction of GST (ie rates are increased by GST only). The accounts are shown on both a GST-exclusive and GST-inclusive basis. The rate of GST is assumed to be 12.5 percent.

The example clearly shows that the present treatment is neutral. Both before - and after - tax profit are unaffected by the introduction of GST.

It is obvious from the example that if the GST-exclusive amount of rates is increased, because the firm is said to gain an advantage, its profit will fall relative to the before-GST position.

Table 1
Effect on Profitability of GST

	Before GST	With GST	
		GST-Exclusive Accounts	GST-Inclusive Accounts
	$	$	$
Output (O)	40.0	40.0	45.0
Inputs (Rates) (P)	20.0	20.0	22.5
GST Payable			2.5
Profit Before Tax	20.0	20.0	20.0
Tax	6.6	6.6	6.6
Profit After Tax	13.4	13.4	13.4
Memorandum			

Item:			
GST Payable	Nil	2.5	2.5

Note: GST payable is not reflected on the income statement when accounts are kept on a GST-exclusive basis.

The final price to the consumer includes $5.00 of GST, $2.50 of which is collected through the firm shown above and a further $2.50 of which is collected at an earlier stage in production and distribution (ie inputs are another firm's outputs). The consumer bears the full amount of GST.

The tax-inclusive cost of rates to the final consumer (owner-occupier) is increased by GST because this is the very effect which GST was intended to have. There is no hidden or unintended advantage for producers. To suggest that the incidence of GST should be shifted from consumers to producers, which is the apparent effect of the argument in the memorandum, is to seek to modify Parliament's decision to implement a GST.

It could be argued that owner-occupation should be a taxable activity for GST purposes. If this were the case, GST on rates and other inputs would be deductible but imputed consumption (rents) would be subject to GST. In this case home owners would be taxed on the net value added from their owner-occupier business.

Income Tax

Now consider the treatment of rates for income tax purposes. In the base model income is taxable and related expenditure, including rates, is deductible (Table 2). The vast majority of investment is taxed on this basis. Income tax drives a wedge between before-tax and after-tax returns exactly equal to before-tax income multiplied by the rate of tax (33 percent in the example). The tax wedge distinguishes an income tax from a consumption tax.

Income tax discourages investment relative to the no tax case (exempt income with no deduction) because marginal projects that are attractive from a national perspective (measured by the before-tax return) are not attractive to private investors who focus on the lower after-tax return. This is, however, an unavoidable feature of the feasible income tax.

Table 2

Effect on Profitability of a Deduction for Rates

	Taxable With Deduction	**Tax Exempt No Deduction**
	Business	Residence
	$	$
Sales/Imputed Rents	40.0	40.0
Rates	20.0	20.0
Profit Before-Tax	20.0	20.0
Tax	6.6	0.0

Profit After-Tax	13.4	20.0

For present purposes, the important point to note is that a deduction for rates in a situation where income is taxable does not alter the normal relationship between income before- and after-tax. Rates are treated on the same basis as all other business expenditure.

Consider the base where income in not taxable and related expenditure is not deductible. There is no income tax wedge and the before-tax rate of return is the same as the after-tax return. Income from the owner-occupied housing (imputed rents less expenses) is treated on this basis.

A comparison of the exempt case with the taxed case illustrates the effect of introducing an income tax. In contrast to the view in the memorandum, an income tax reduces after-tax income to investors and places them at a disadvantage relative to holders of exempt assets. This would result in a fall in the value of taxable assets relative to that of other assets.

While exemption leads to greater efficiency than the base model, it raises no revenue for the government. It is therefore an inappropriate benchmark, given the imposition of an income tax. This is the reason why 100 percent first year depreciation allowances, which are equivalent to exemption from tax, were abolished.

As the norm is the case where income is taxable and expenditure is deductible, the transfer of a dollar of rates from residents to businesses would, other things being equal, reduce community welfare. It would lower after-tax income earned on an investment that is taxed and therefore discouraged, and increase income earned on tax exempt activities. Efficiency is generally enhanced by equalising the ratio of after-tax to before-tax rates of return on investment (not income) for each class of investment. This requires a move in the opposite direction, ie to encourage taxed investment by increasing its after-tax income relative to that on exempt investment.

There is no tax advantage which business ratepayers receive over residents. On the contrary, it can be argued that businesses are penalised by the requirement to pay tax on their net income whereas home owners are not taxed on their implicit income from home ownership.

The above discussion suggests that businesses are not advantaged by either the ability to claim a credit for GST paid on rates or an income deduction in respect of rates.

The tax treatment of rates is not a factor that should enter into decisions on rate differentials, which should be based on the benefit principle.

Appendix 1: Schematic Outline of New Rates Legislation

New Rating Legislation	LGA

1. Statement of what is rateable and basic rating unit 2. Generic rating power • measure of value • area • modified impact 3. Other units power define other units if: • identifiable ** • relate to basic rating unit • reasonable proxy • reasonably efficient 4. Pricing powers • less than marginal cost • marginal cost • average cost • price as disincentive 5. Intergenerational modifications • shifting costs • shifting payment (with no net intergenerational effects) 6. Generic exceptions regime: • purpose • distributional effects • costs • efficiency	7. • process set out in provisions or annual planning • rates actually made as part of annual planning process