LOCAL GOVERNMENT FORUM

Submission on *Your Region Your Future: The Auckland Regional Council's Draft Long-term Council Community Plan 2004-14*

May 2004

1. Introduction

1.1 This submission on *Your Region Your Future: The Auckland Regional Council's Draft Long-term Council Community Plan 2004-14* (the plan) is made by the Local Government Forum. The Forum comprises business organisations that have a vital interest in local government (see the Appendix). The members of those organisations are among the largest ratepayers in the Auckland region.

1.2 Our submission focuses on the Council's proposed spending and revenue, and its rating policy, particularly the issue of the business differential.

1.3 In summary, we consider that the Council's forecast spending through to 2013/14 is excessive. Much spending on mass passenger transport is unlikely to be economic. The Council needs to demonstrate that the large investment in rail projects is a good use of resources from an overall community perspective.

1.4 Users rather than ratepayers should be required to bear the costs of most mass passenger transport services. The grounds for subsidising such services are weak, especially in the medium term when more efficient pricing of roads should apply.

1.5 Members of the Forum endorsed the Council's decision to apply a uniform general rate in 2003/04. There are no compelling grounds to deviate from that policy in 2004/05.

1.6 Most councils do not apply a business differential and some of those that do, such as Auckland and Wellington cities, have accepted that their existing differentials cannot be justified and should be reduced or removed.

1.7 The balance of this submission is presented in 3 sections. The next section (section 2) discusses forecast spending and revenue. Section 3 focuses on rates. Our conclusions are presented in section 4.

2. Forecast spending and revenue

2.1 The Auckland Regional Council faced strong ratepayer resistance to its rate rise of 34 percent in 2003/04. Although much of the public debate focused on the distribution of the rate burden between residential and business ratepayers, a key underlying problem was excessive levels of forecast spending, particularly on mass passenger transport.

2.2 The projected increase in rates revenue from 2003/04 to 2010/11 has been reduced by 7 percent compared with the projection included in last year's plan but total operating spending for the same period is projected to increase by 27 percent (almost $450 million). Even with the reduced increase in rates revenue, such revenue is projected to increase by an average of 5.9 percent a year through to 2013/14. In contrast, total spending is projected to increase by an average of 7.3 percent a year over the forecast period. These trends indicate excessive growth in spending and rates.

2.3 There is little evidence of the 'belt tightening' claimed in the plan (at page 6). An alternative source of revenue, notably government funding announced in *Investing for Growth*, is by far the most important reason for a lower increase in rates than that projected last year, despite much higher spending.

2.4 From an economic perspective, the most important issue is not whether funding is by way of rates or grants funded by taxes levied by central government, but whether the proposed spending represents a good use of resources. If resources are used in low yielding activities, economic efficiency and growth, and the overall welfare of the community, are impaired.

2.5 Around 55 percent of the Council's operating spending relates to transport. Provision is also made for $270 million of capital spending on transport between 2004/05 and 2008/09, with no provision thereafter.

2.6 By far the largest element of transport spending is mass passenger transport. The draft business plan for passenger rail prepared for the Auckland Regional Council, Infrastructure Auckland and Auckland Regional Transport Network Limited by the Boston Consulting Group in May 2003 showed that the rail plan is grossly uneconomic. It is being driven by the desire to achieve passenger patronage targets that were set without regard to the cost of achieving them. While not necessarily endorsing the analysis contained in the Boston report, we believe the Council should have raised serious questions about the overall merits of the rail plan. Instead, it quickly endorsed its thrust. The costs of the Britomart project, which the Council also supported, far exceeded the expected benefits. We suspect that other mass passenger transport projects, particularly rail projects, that are being implemented or planned are poorly conceived. Major low return projects of this sort, like the Think Big projects of the 1980s, make New Zealanders poorer. The capital and other resources absorbed by them could be used in more productive, wealth-creating ways.

2.7 The economic merits of operating and capital spending on mass passenger transport should be subject to more rigorous scrutiny from an overall community perspective. The choice between buses and trains should also be examined. Projects that do not yield a worthwhile return should be dropped. The analysis of projects should be released for public scrutiny.

2.8 There is an urgent need to implement more efficient pricing of road use, including charges for congestion. In that context the proposed road pricing investigation (page 19) is endorsed, provided that it is of high quality. There is growing support within local and central government for more efficient road pricing. The focus needs to shift to the development of feasible proposals and engagement with the wider community.

2.9 The grounds for subsidising mass passenger transport are generally weak, especially for off-peak services such as the proposed new rail services from 8.15 pm to 11 pm on weekdays. Passenger transport services are essentially private good activities that should be provided privately (which is largely the case) and funded in the normal way through prices paid by users.

2.10 Citizens who work from home, live in a central city apartment or shop at nearby businesses are not subsidised for not using congested roads. In any event, the case for subsidies for passenger transport is dubious with efficient road pricing. Given the probable implementation of more efficient road pricing over the medium term, long-lived projects should only proceed if they can stand on their own feet.

3. Rates

3.1 The key features of the Council's proposed rating policy, which is broadly the same as last year's policy, include the following:

- A general rate computed at a uniform rate per dollar of capital value of rating units (ie there will be no differentials). The general rate will largely fund public good activities such as parks, regulatory and democratic activities. Some transport activities are also to be funded from the general rate. The general rate is intended to raise $59.4 million (including GST) or 48 percent of the forecast total rate revenue for 2004/05.

- A targeted passenger transport network rate computed at a uniform rate per dollar of capital value of rating units within the passenger transport rateable area (ie those units deemed to benefit from passenger transport services). This rate is intended to fund 90 percent of the cost of activities that support the development of a public transport network (such as information and publicity, and fare concessions) and are funded from rates. The balance of such costs is to be funded from the general rate. The targeted passenger transport network rate is expected to raise $26.2 million (including GST).

- A targeted passenger transport service rate computed at differential rates on the capital value of rating units within the passenger transport rateable area. The rate per dollar of rateable property will differ depending on the city or district within which the rating unit is located. The passenger transport service rate is to fund 90 percent of the cost of contracts with public transport operators that is funded through rates. The balance of such costs is to be funded from general rates. This rate is to raise $33.5 million (including GST).

- A targeted rate computed at a uniform rate per dollar of land value to fund biosecurity activities. This rate is expected to raise $4.2 million (including GST).

3.2 The Council has also put forward the following variations for consultation:

- Variation 1 entails the introduction of a differential general rate. Business ratepayers would pay 1.5 times as much per dollar of rateable property as residential ratepayers. Rates payable by business ratepayers in each city or district of the region would increase by between 46.5 percent and 48.5 percent whereas residential rates would fall by between 3 percent and 7.1 percent.

- Variation 2 comprises an alternative model for allocating transport costs. The proportion of transport costs funded through the general rate would be increased to 20 percent and the balance would be allocated by differential rates where the rate per dollar depends on the relevant area. There would be four areas (one of which would be exempt from the transport rate).

- Variation 3 combines the differential general rate in variation 1 with the alternative transport model in variation 2.

3.3 The Council is also consulting on a suggestion that an additional uniform annual charge of $10 per rating unit be levied to build up a reserve fund to buy new regional parkland.

Principles relating to user charges and rates

3.4 A principled approach to rating and charging is vital to the efficiency of local government. The efficiency of a user charge depends on whether it is the best way of encouraging the production of a socially optimal amount of the underlying good (or service). As defined, a user fee is a price that might either aim to recover the user-induced marginal cost of supply or correct a market failure. A user charge may improve efficiency where:

- the commodity being sold is a private good;
- the good is purchased voluntarily;
- competition creates pressures to supply the good at minimum cost;
- the price reflects the marginal benefit of the good to the purchaser and to society; and
- the price reflects the opportunity cost of supplying the good – eg social marginal cost.

3.5 User charges have a useful role to play where the Council provides private goods. However, as a matter of best practice, private goods should be supplied privately and competitively. Thus where user charges are appropriate, the related activity should be privatised.

3.6 A public good is the polar opposite of a private good.[1] Virtually by definition, the funding of a publicly provided public good is a taxing rather than a pricing issue. Taxes are associated with compulsion and the inability to relate the size of the impost to the magnitude of the benefit received by the taxpayer or ratepayer. Conversely, user

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[1] A 'pure' public good has both of the following characteristics:
- Non-rivalry in consumption. A good is 'non-rival' when an individual can consume a unit of it without detracting from the consumption opportunities available to other people. Examples of non-rival goods are atmospheric quality and disease eradication programmes.
- Non-excludability of benefits. Goods or services generate non-excludable benefits if it is too costly to prevent access to their benefits by people who do not pay. Examples are defence, flood control and cleaner air arising from pollution control devices.

fees are related to the value derived by the payer, or the cost of supply, where the payer is the beneficiary and can choose whether to 'buy' and so incur the charge. (Part charges apply where only part of the benefit accrues to the payers.)

3.7 Most benefits from certain local public goods may accrue to a particular subset of a local authority's ratepayers. Flood control or farm-related pest control may be examples. It is desirable to confront people who want a local authority to supply such goods with the costs of supply by requiring them to pay according to the benefit received. This has to be balanced, however, by the risk that differential and targeted rates may be applied to benefit politically influential groups while the lack of transparency concerning the distribution of benefits and rates is used to deny that this is the case.

3.8 Club goods are an intermediate case between public and private goods. Unlike in the case of a public good, with a club good people who do not pay for access to the club's facilities can be excluded. The use of public roads by motorists is a case in point. However, as long as there is excess capacity, a club good may share the public good characteristic that the use of its facilities by any one member does not detract from the ability of any other member simultaneously to enjoy those facilities. Uncongested golf courses and bowling greens are further examples of club goods.

3.9 The public provision of a club good permits, again by definition, the possibility of charging people who wish to benefit from the service. Clubs do not use coercion to fund their activities. Membership is voluntary. The case for charging members of any group or club the opportunity cost of the facilities provided is stronger the greater their ability to determine the level of service and the amount of the charge.

3.10 The discussion to this point has distinguished starkly between private, public and club goods. It has pointed to the firm conclusion that a case for coercive funding only arises in the case of public goods where private provision is inefficient. However, some commodities have a mixture of these characteristics. For example, pollution may generate negative spill-overs.

3.11 Spill-over effects in a private good context arise from what economists call externalities. Economists recognise different types of externalities and have determined that many do not justify government action. Where government action is warranted, it might take the form of regulation, corrective taxes or subsidies.

3.12 On the supply side, the relationship between user fees and marginal cost may be especially problematic when the supplier is a statutory monopoly. Charges could be too low where users exercise undue political influence over the fee-setting process. Conversely, charges could be too high, for instance where a statutory monopoly or regulated industry operates in a cost-plus manner and sets fees on the basis of excessive costs.

3.13 The foregoing comments relate to the funding of local government-provided goods and services by the users of those services through a combination of user charges and taxation. Local authorities may also need to fund expenditure that arises from nuisances such as an overflow of the stormwater system caused by the discharge of industrial waste into it. The clean-up will often benefit ratepayers that are harmed rather than the firm that caused the nuisance.

3.14 The policing of local authority rules and other options to enforce property rights are crucial obligations of good government. All residents benefit from well-enforced property rights and none can be excluded from these benefits. The incentive to comply with local authority rules arises from appropriate fines and the risk of detection of offences. The costs of policing nuisances should therefore be funded from fines with any balance funded from a uniform general rate.

3.15 The discussion can be summarised as follows:

- There are grave risks that local authorities will impose inefficient rates and misprice services. Monopoly prices are one source of such inefficiency.

- Where user charges are appropriate in terms of the principles outlined in paragraph 3.4, the relevant activity is a private good that should be privatised.

- Local public goods should be funded by efficient taxes. Sound principles, including the principle of no taxation without representation or consent, should apply.

- The voluntary consent of members should drive charging structures and levels for club goods. In the case of roads, for example, there could be some element of general tax funding to cover the public good element (footpaths in the central business district and, more generally, facilities for pedestrians and perhaps cyclists). The balance should be funded by some combination of an access fee and a use-related charge.

Application to the Council's proposals

3.16 As noted above, a key principle designed to constrain government from unduly impinging on the freedom of the individual is that there should be no taxation without representation or consent. That principle is offended by differential taxes that are not consented to by those who are required to pay the differential. In the context of the Council's policy, it means that overwhelming support of residential ratepayers is not sufficient to justify a discriminatory rate on the business sector.

3.17 The principle of economic efficiency also points to a uniform general rate to fund public goods that benefit all citizens. Local government does not have the information required to impose differential rates such that revenue is raised with the minimum distortion to output (that is, by taxing activities that are sensitive to small changes in the level of rates more lightly than those that are not). In those circumstances, low uniform rates applied to broad bases are broadly consistent with the promotion of efficiency. This is the same approach as that adopted in respect of GST.

3.18 The scope for the majority to acquire services that they demand while imposing the cost on a minority that is disproportionately represented at the ballot box is constrained by uniform taxes and rates. The motivation for the campaign for a business differential is to shift a higher share of total rates from the residential sector to the business sector. The business sector is disproportionately under-represented at the ballot box.

3.19 Business makes a larger contribution to the total rate take with a uniform general rate computed on a capital value basis than if the land value basis were adopted because the average value of improvements in the business sector is higher than in the residential sector. Thus the adoption of the capital value basis is a further reason for not applying a differential general rate.

3.20 The following arguments have been advanced by the proponents of a business differential:

- Businesses are said to benefit from the ability to claim an income tax deduction for rates and a credit for GST paid on rates.

- Businesses are claimed to have a greater ability to pay than residential ratepayers.

- Businesses are claimed to derive a greater benefit from services than residential ratepayers.

These arguments do not withstand scrutiny.

3.21 The often-repeated claim that businesses derive a tax benefit is factually wrong:

- Businesses can claim a tax deduction for rates because the related gross income is taxable. Homeowners are not taxed on their imputed rental income (the economic income that they derive from living in their own home) and therefore are not permitted to claim a tax deduction for their expenses, including rates. On the other hand, where houses are rented the rental income is taxable and rates and other expenses are deductible for tax purposes. Taxability and deductibility go together and both must be taken into account in assessing whether businesses are advantaged.

- No one seriously argues that it is an advantage to be subject to income tax. That is why many homeowners objected to the initial suggestion of the Tax Review 2001 that owner-occupied houses be brought within the income tax system.

- Most businesses are required to pay GST on their outputs. They deduct GST paid on their inputs and they pay the net amount to the government. No tax advantage arises. Local authorities are in the same position as businesses in relation to GST.

- The provision of a credit for GST paid on inputs, including rates, enables GST to be collected at each stage of production and distribution with the final consumer paying the appropriate amount of GST. It stops GST from cascading (that is, it prevents GST being applied on top of GST) as goods and services are traded among businesses.

3.22 If the claim that firms receive tax advantages were valid, it would not apply to firms that are in a tax loss position. Nor would it apply to firms that supply GST-exempt goods and services, such as financial services, because such firms are unable to claim a credit for GST paid on their inputs. Thus if the Council were to be persuaded by the tax argument, it would need to apply the differential according to the tax status of businesses. This would be impracticable.

3.23 The argument that businesses are advantaged by claiming a tax deduction for rates and a GST credit has been extensively examined over recent years by a number of experts, including Audit New Zealand, and shown to be faulty.

3.24 The claim that businesses have greater ability to pay and should therefore pay a disproportionate level of rates does not withstand scrutiny for the following reasons:

- It is predicated on the assumption that councils should engage in explicit income redistribution. To the extent that income redistribution is a legitimate role of government, it should be undertaken by central government. The core role of local government is to ensure the provision of local services of a public good nature.

- The claim that businesses have greater ability to pay than residential ratepayers is based on mere assertion. Councils have no information on the relative wealth or income of business and residential ratepayers. They only have information on the rateable value of property. Two people may own property with the same capital value but they may be in entirely different financial circumstances. For instance, one property may be wholly or partly funded by debt and the other wholly by the owner's equity. Moreover, one property owner may be a retiree dependant on New Zealand Superannuation and another may be on a high income.

- A proper analysis of income distribution would look through business structures and examine the position of the investors or owners behind them. The owners of most businesses are not disproportionately well off. Most businesses can be expected to earn no more than a normal return on their investment just as an individual can expect to earn no more than the market wage for his or her labour input. Some businesses incur losses. The Employers and Manufacturers Association (Northern) reported in 2003 that 77 percent of its member companies pay no tax at all, perhaps because they distribute their income as wages to the owners. Many owners of small businesses earn an income that is no higher than that of comparable salary and wage earners.

Many people on average incomes own shares in public companies either directly or through managed funds.

- Businesses that engage in export and import competing activities cannot increase their prices to recover the cost of higher rates. While businesses in the non-traded sector may be able to shift the incidence of rates to their customers or their employees, in both cases rates are ultimately borne by individuals.

- The ability to pay is a deficient criterion for social choice. 'From each according to his ability, to each according to his need' is a discredited doctrine. It says nothing about how much A, who is deemed to have a greater ability to pay than B, should pay relative to B – there is no logical stopping point. The criterion is tied up with 'progressive' tax ideas that led to a maximum marginal rate of income tax in Britain of 97.5 percent (19 shillings and six pence in the pound) and a top rate of 66 percent in New Zealand. Contemporary notions of equitable treatment point to flat or uniform rates of taxation. Elected bodies should protect minorities from predatory behaviour by political majorities by applying such rules and/or seeking the consent of those asked to pay.

3.25 The argument that businesses benefit from a disproportionate share of the Council's services is also flawed for the following reasons:

- As discussed above, prices should be charged for private goods and services. However, it is not feasible to charge for public goods and services and they must be funded from taxes. By definition, there is no close relationship between the benefit derived by individual ratepayers and the rate paid. The burden of proof that one group benefits disproportionately from public goods and services rests on those making the claim.

- The general rate largely funds public goods that are intended to benefit all citizens. We are unaware of any valid analysis that shows that such services disproportionately benefit the business sector. Moreover, we doubt that such an analysis could be produced. Leaving aside most transport services, the activities of regional councils are more clearly focused on public good (including regulatory) activities than those of territorial councils.

- The Forum is generally opposed to targeted rates because of the risk that a majority will demand services and impose the cost on a minority. We make an exception where the services in question unambiguously benefit an identified group of ratepayers and where the relevant group endorses the proposed expenditure and agrees to meet the cost involved. As noted above, flood prevention may be an example. The exemption of residents and businesses in the Hauraki Gulf islands from paying for services that they do not receive is another example.

3.26 The Forum supports a continuation of the existing rating policy. Members endorsed the Council's decision not to apply a general differential rate in 2003/04. Most councils do not apply a business differential and many of those that do, such as Auckland and Wellington cities, have accepted that their existing differentials cannot be justified and should be reduced. Wellington City, in particular, was concerned that its differential might be the subject of litigation.

3.27 The following additional points on the rating policy are noted:

- Most transport services are private goods and services that should be funded by users in the normal way. The level of the publicly funded subsidy relative to revenue from users seems to be well beyond any that could be justified on congestion or environmental grounds. A reduction in the level of ratepayer subsidy and a more rigorous approach to transport spending proposals are far more important issues than the relative merits of the alternative model suggested in variation 2.

- There are no compelling grounds to introduce a uniform annual general charge to build up a fund to buy parkland. The acquisition of additional parkland should, if justified, be funded from debt and the general rate. The argument (at page 43) that "Over time, the cost of purchasing new parks [funded by the uniform annual general charge] is significantly (50%) less than loan funded purchase" is flawed. It appears to omit the cost to ratepayers of funding parkland from rates whereas interest is taken into account when parkland is debt financed.

4. Conclusion

4.1 The Forum's key conclusions are listed below:

- The Council's proposed spending programme over the medium term is substantially increased from that forecast last year and is excessive.

- A much more rigorous approach to operating and capital spending is required to ensure that resources are used where they will yield an appropriate return from an overall community perspective.

- The grounds for substantial subsidies for most mass passenger transport services are weak.

- The Council's general rate should continue to be levied on a uniform basis. There are compelling reasons for rejecting variations 1 and 3 which entail the introduction of a business differential.

Appendix

The Local Government Forum

The Local Government Forum was established in 1994 to promote greater efficiency in the local government sector and to contribute to debate on policy issues affecting the sector.

The Forum comprises mainly business organisations that have a vital interest in the activities of local government. The following organisations are members of the Forum:

- Business New Zealand
- Federated Farmers of NZ
- New Zealand Business Roundtable
- New Zealand Forest Owners' Association
- New Zealand Retailers Association