

Final Report

Trends in the Use of Rating Tools Nationally to Fund Services

Prepared for

Local Government Rates Inquiry

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Executive Summary

Introduction

In 2006, The Local Government Rates Inquiry was launched to investigate increases in rates, and to offer possible solutions. This report provides some context by outlining the advantages and disadvantages of each rating tool, and examining trends in their usage.

The report begins by defining the three rating tools - general rates, UAGCs and targeted rates. It then summarises the various factors that must be considered when using each tool, plus any statutory limitations.

Evaluation

Next, the report outlines an evaluation framework against which each rating tool is assessed. The criteria are:

- ability to pay
- benefits received
- intergenerational equity
- efficiency
- simplicity and transaction costs
- stability
- sufficiency
- transparency

Where possible, we compare the effects of each tool across, and within, ratepayer groups. In many cases, however, data constraints confine the analysis to only residential ratepayers.

Match with Ability to Pay

With regards to UAGCs (and other uniform charges), there seems little to say. These charges bear no relationship to ability to pay and are thus regressive. But what about value-based rates?¹

In reality, the match between funding and ability to pay depends on policy design, particularly the choice of valuation base and the use of differentials. Putting these issues to one side, however, we can examine the degree to which property values are correlated with household incomes. This provides some insight to the link between value based funding and ability to pay.

To this end, we linked the rating information database of a large city Council to census income data and found that household incomes were strongly-correlated with both land values and capital values, but that rates based on either measure still give rise to:

- horizontal inequity – because some households on similar incomes own properties of highly varying value and, therefore, pay quite different rates, and;
- Vertically inequity – because some households with markedly different incomes own properties of similar values, and hence pay similar rates.

¹ Value-based rates are a subset of property-based rates. They include any funding related to property values, such as general rates and targeted rates.

Match with Benefits Received

Next, we consider the extent to which the distribution of funding matches the distribution of benefits received.² To begin, recall that benefits can be divided into two parts: public and private.

Now, because private benefits accrue directly to the users of services, and since most services with high private benefits are funded (at least partially) by user charges, only a small portion of private benefits are funded by rates.³ Accordingly, we confine our attention to the relationship between rates and *public* benefits.

In reality, the extent to which funding matches the distribution of public benefits depends on the service in question. Thus, if the public benefits of a service accrue to:

- each property in the district uniformly, UAGCs provide the best fit. *e.g.* refuse collection, animal control, community halls and libraries, noise control, parks and reserves.
- each property in proportion to property values, general rates provide the best fit. *e.g.* flood control and local democracy.
- only a subset of properties, either uniformly or not, targeted rates provide the best fit. *e.g.* main street programmes, and localised flood control.

In our opinion, all three scenarios seem likely (albeit to varying degrees). Thus, a blend of all three tools should be used, the exact mix of which depends on the perceived spread of public benefits across these scenarios.

Intergenerational Equity

There is no apparent difference between the rating tools with respect to intergenerational equity. Indeed, the achievement of intergenerational equity depends entirely on the way that capital costs are recovered over time. This, in turn, depends on the degree to which council uses debt (and other long-term funding mechanisms) to match the period of funding with the perceived period of benefit.

Efficiency

Uniform charges are the most efficient form of rating. This is because, although they may affect the decision to rent versus buy, uniform charges do not alter decisions about *which* property to rent or buy. Indeed, the same uniform charge applies to each rateable property, regardless of its value.

² We would like to note that the relevance of this criterion depends entirely on one's beliefs about the role of rates. That is to say, if rates are considered a tax, then the match between funding and benefits is totally irrelevant. Its inclusion here reflects the requirement (under §101(3) of the LGA) to explicitly consider benefits.

³ Unless stated otherwise, rates mean general rates, targeted rates and UAGCs.

The same cannot be said of value-based rates, however. This is because, by definition, value-based rates increase with property value. Accordingly, value based rates are more likely to distort decisions (about which property to purchase) than uniform charges. Overall, however, all rating tools are efficient compared to incomes taxes and GST.

Simplicity and Transaction Costs

UAGCs are the simplest rating tool and incur the lowest transaction costs because they do not require information on property values. Value-based rates, conversely, are more complex and incur higher costs.

Stability

UAGCs are more stable than value-based rates because they do not depend on property values, which are often volatile.

Sufficiency

Given the statutory cap of 30%, uniform charges are clearly insufficient compared to value-based rates.

Transparency

Because they do not rely on assessments of property values (the exact process for which is not well known), value-based rates are less transparent than uniform charges.

General Issues with Rates

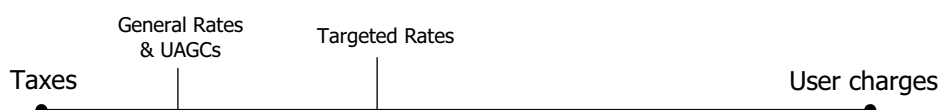
Rates have a long history in New Zealand. In this section we consider some of the high-level issues surrounding their use.

Are Rates a Tax or a Fee for Service?

A recurring theme in Local Government is the debate over whether rates are a tax or a fee for service. In our opinion, it is clear that rates are more a tax than a fee for service. Indeed, rates are compulsory and are levied by way of legislation. Ratepayers have no way to avoid payment, nor to reduce payment based on usage. The link between funding and benefit can also vary widely between ratepayers.

The logic for describing rates as a user charge is not completely without merit, however. After all, rates directly fund services. The extension of targeted rating powers under the LGRA (which some described as proxies for user charges) also reinforce this view.

Perhaps one could distinguish the three rating tools and place them on a continuum? On this basis, we would suggest the following classification:



Under this classification, rates are neither a tax nor a user charge, but a hybrid of the two. Further, general rates and UAGCs are considered to be more closely aligned with taxes than targeted rates.

Property Taxes are Inherently Regressive

One major criticism of rates is that they are patently regressive. In order to test this assertion, we analysed information from the Household Economic Survey 2003/04 - a detailed survey of New Zealand households' spending patterns.

One of the items included in the survey is "payments to local authorities". Interpreting these payments as rates contributions, and plotting them against post-tax household incomes we found that rates are indeed regressive – payments to local authorities become smaller shares of household income as income increases.

Property Values are Often Poor Indicators of Wealth

To the extent that value-based (general and targeted) rates are intended to be wealth taxes, their suitability depends on the extent to which property values reflect wealth. However, there are a number of reasons why property values and wealth may differ.

First, property is only one of many asset classes in which wealth may be held. Others include stocks, bonds, term deposits, and so on. Second, many properties have very high gearing; so that the "owner's" actual wealth is only a fraction of the property's value. Third, the actual value of a property may differ markedly from its estimated value. Finally, wealth held in property is only realised when it is sold.

Assessed Values are Inaccurate

Another fundamental criticism of value-based rates is that assessed values - the values upon which rates are struck – are wildly inaccurate. In practice, the severity of this problem depends on the variability of assessment errors. That is to say, if each property's market value is a constant fraction of its assessed value, the distribution of rates is unchanged. However, if market values are varying proportions of assessed values, the distribution of rates is skewed.

So, how serious is this problem? To answer this, we analysed the property sales database of a large city council. It covered 17,824 sales over 2 years and showed that:

- on average, properties sold for 10% above assessed value, but
- 29% sold *below* assessed value, while
- 44% sold for more than 20% above assessed value.

Digging a little deeper, we discovered that:

- assessed values are more accurate for expensive properties than they are for cheaper ones.
- the greater the gap between the date of assessment and the date of sale, the greater the difference between the selling price and the assessed value
- bare land sold for 45% above assessed value on average, while 'home & income' properties sold for 4% below.

In our opinion, there are two problems to be addressed. First, valuations are not accurate enough. Second, revaluations are too infrequent.⁴

One suggestion for overcoming inaccuracies would be to adopt valuation bands, such as those used in the UK. Under this system, each property is assigned to a band, and pays the same rates as all other properties within that band. Obvious advantages are that it is quicker, cheaper, and less sensitive to movements in property values than the use of individual values. Disadvantages include the perception that the delineation of bands is arbitrary, and that treatment of properties at the cusp (between one valuation band and another) is difficult.

Some submitters have suggested valuation averaging to help moderate volatility in rateable values. While averaging will certainly help achieve this objective, it does not resolve the issues discussed here. Indeed, valuation averaging simply insulates high-growth properties from excessive rates increases.

Resolving the revaluation problem could take two possible routes. First, the minimum revaluation period could be shortened to one or maybe two years (at considerable cost). Second, values could be updated *between revaluations* using indexation. Under this approach, the value of each property is incremented annually according to a pre-defined index. In continental Europe, this is typically done using a retail price index (such as the CPI), while in France it is done using a specially-designed index.

Other Reasons for General Discontent with Property Taxes

In addition to the factors discussed above, there are a number of other reasons why property taxes are generally disliked. These include:

- high visibility
- infrequent/lumpy payments
- unavoidability
- greater power to challenge
- perceived poor value for money
- confusion about what rates invoices mean
- GST on rates is a tax on a tax
- potential exacerbation of existing (housing) affordability issues
- perceived arbitrariness over how rates are set

Trends in the Use of Tools – Local Authorities

This report analyses local authority use of rating tools since 2002. It also investigates the use of valuation bases and differentials on general rates. In summary:

⁴ We note that an objection system exists, but this does not fully solve the problem. First, few people know that it even exists. Second, altering the assessed value of one property in isolation does not correct assessment errors in every other property. Third, the objection process does nothing to resolve the infrequency of revaluations.

- uniform charges and targeted rates have become larger shares of Local Authority rates, while general rates have become a smaller share.
- the number of local authorities raising more than half their rates from general rates fell from 28 to 20, while the number of local authorities raising more than half their rates from *targeted* rates rose from 28 to 37.
- metropolitan councils are far more reliant on general rates than provincial and rural councils, and vice versa for targeted rates.
- In 2006/07, 57 local authorities levied targeted rates. While most set between one and five targeted rates, a handful levied more than 10 (and one levied 33).
- 97% of targeted rates were levied on the basis of either LV or CV. Hence, little use is being made of extended targeted rating powers.
- Three councils raised *all* their rates from targeted rates in 2006/07.
- In 2006/07, 51% of local authorities set general rates based on land values, 46% on capital values and 3% on annual values.

Valuation Bases

With regard to the choice of valuation base, we conclude that LV rating is inferior because it:

- tends to generate unreliable rateable values (because there is so little sales data)
- provides a poor match to benefits received, and
- requires higher differentials than AV and CV, everything else being equal.

The only saving grace for LV is that it is slightly less regressive than AV and CV (across residential ratepayers). However, this is not particularly important, since differentials can be used to correct any such concerns.

For essentially the same reasons, we also prefer AV over CV. First, it is likely to generate more accurate rateable values (because there is more sales data to work with), it provides the best match with benefits received, and it reduces the need for business and rural differentials. The only shortcoming of AV is that it is more regressive across residential ratepayers. Once again, however, differentials can correct this.

General Rate Differentials

Differentials may be used for various reasons, but are most often used to either:

- increase the load on business properties,
- decrease the load on rural properties, or
- ease the burden on high-value properties

In 2007/08, 61% of metropolitan councils set business differentials with an average of 3.55, compared with 49% of provincial councils (average of 3.26), and 40% of rural councils (average of 2.74). Over the same period, 57% of metropolitan councils set rural differentials with an average of 0.66, compared with 49% of provincial councils (average of 0.59), and 48% of rural councils (average of 0.57). A much smaller number of councils used differentials to ease the burden on high value properties.

Overall, there was a distinct lack of consistency both across, and within, councils in the use of differentials. This may be a result of the convoluted process via which most differentials are set. As far as we understand, the process is as follows. First, Councils decide the total amount of rates that need to be struck. Second, they decide what proportion of rates they wish to raise from each group (residential, rural, business, and so on).⁵ Third, based on these target allocations, differentials are set.

Viewed this way, differentials are just a means to an end. Virtually any pattern of differentials can be justified simply by altering the target allocations. In our opinion, this is unacceptable. Differentials should be derived from a systematic and objective process of evaluation, not the result of an arguably arbitrary revenue allocation.

One alternative would be to work the process in reverse. Rather than starting with target allocations and using differentials to achieve them, Council's should start from a point of uniformity, then modify (*i.e.* set differentials) according to consideration of four factors listed previously:

1. Levels of Service
2. Ability to Pay
3. Willingness to Pay
4. Cost

If all these factors are the same, each group pays the same amount per dollar of rateable value. Any departures from uniformity must be clearly linked to the criteria above and properly documented.

While some Councils may find this approach unpalatable, it represents a vast improvement on the status quo. At the very least, councils should be obliged to explain their differentials in terms of the factors outlined above. Doing so would greatly enhance policy transparency.

Trends in the Use of Tools – Regional Authorities

Analysing data on regional authority use of rating tools since 2002, we found that:

⁵ While most councils insist these allocations reflect the relative benefit each ratepayer group receives from council services, this proposition is dubious on two counts. First, it is extremely difficult to assess the distribution of benefits with any reasonable degree of accuracy. Second, the target allocations often suggest that businesses receive up to 7 times as much benefit (per dollar of rateable value) as residents. We find this very difficult to believe.

- regional councils have also become increasingly reliant on uniform charges, and less reliant on general rates and targeted rates.
- the number of regional authorities raising more than half their rates from general rates has decreased dramatically.
- Of the 10 regional councils that charged general rates in 2006/07, the vast majority (80%) rated on capital value, with the remainder rating on land values.
- the number of local authorities setting uniform charges increased from only one in 2002/03 to seven in 2006/07.
- all regional councils (bar one) levied targeted rates in 2006/07. All together, 79 targeted rates were struck.
- while the majority of local authority targeted rates were set on the basis of LV or CV, *all* regional targeted rates were set on these bases.
- the number of regional authorities raising more than half their rates from targeted rates fell from six to five (with a corresponding increase in the number raising less than half their rates in this way).
- One regional council raised *all* their rates from targeted rates in 2006/07.

Sector Feedback

During the writing of this report, we spoke to a number of rating policy managers and read a number of council submissions. A summary of our findings is set out below.

New Targeted Rating Powers

The LGRA ushered in a raft of new targeted rating powers, including the ability to set rates based on floor space, the number of connections to reticulation systems, the number of water closets, and so on.

The introduction of these new powers was expected to be met with rapid uptake; but this never materialised. Reasons include:

- targeted rates comprise policy simplicity and transparency
- new targeted rating tools will incur significant transaction costs
- targeted rates give the false impression that rates are a fee for service (rather than a tax)
- councils are plagued by significant inertia, which prevents experimentation.

Overall, the consensus was that the new targeted rating powers are not particularly useful. This aligns with our own impressions. Namely that, while a useful addition to the funding toolbox, targeted rates are more akin to fees for service than property taxes. As is made clear in most submissions, council's continue to view rates as a property tax and are reluctant to make any changes that suggest otherwise.

Barriers to more Beneficial Use of Rating Tools

The next issue was whether there were any major barriers to the more beneficial use of rating tools. Although most respondents could not identify any *major* barriers, some noted that:

- consultation is too onerous
- the cap on uniform charges is unwarranted
- property market volatility causes undue fluctuation in rates
- there is significant political resistance to change
- targeted rating powers give the wrong impression
- targeted rates are not flexible enough
- the LTCCP is too complex
- ratepayers generally don't understand how rates work
- councils can't rate differentially on improved value
- invoice requirements are unhelpful

These responses are consistent with our understanding of the issues. In general, there are more troubles with compliance (*e.g.* consultation and LTCCP preparation) than with the rating tools themselves.

Practical Actions to Enhance Rating Tools

Finally, we asked respondents to name any practical actions that could be taken to enhance the use of rating tools. Once again, most could not identify practical actions. However, some suggested to:

- relax consultation requirements
- remove the 30% cap
- reword the definition of AV
- consider the use of valuation averaging
- relax LTCCP reporting requirements
- initiate national education programmes on councils and rates
- implement benchmarking
- relax invoicing requirements
- allow volumetric charging for sewerage

We consider these suggestions both prudent and timely.

1. Introduction

1.1. Context

This report is the first in a series of three on local authority funding tools. It focuses on the core rating tools available to Councils - general rates, targeted rates and UAGCs - while the second looks at other currently-available tools, and the third covers funding tools that are not currently available.

1.2. Scope for this Report

The original terms of reference for this project were to describe the advantages and disadvantages of the various rating tools, and to analyse trends in their usage. However, the scope of this report has evolved to accommodate the significant body of work already undertaken and to minimise duplication with concurrent workstreams.

The structure of this report now is as follows:

- *Section 2* defines the rating tools that form the focus of this report
- *Section 3* introduces an evaluation framework used to assess rating tools.
- *Section 4* applies the evaluation framework to each tool.
- *Section 5* discusses issues with rates in their capacity as property taxes
- *Section 6* analyses trends in the use of rating tools by local authorities
- *Section 7* analyses trends in the use of rating tools by regional authorities
- *Section 8* summarises sector feedback on the issue raised in this report.

2. The Rating Tools

This section defines the rating tools analysed in this report, namely general rates, UAGCs and targeted rates.

2.1. General Rates

General rates apply to all rateable land within a city or district, and have traditionally been the mainstay of local authority funding. In order to strike a general rate (or rates), councils must:

1. Distinguish rateable land from non-rateable land
2. Select a valuation base
3. Set differentials (optional).

2.1.1. Rateable versus Non-Rateable Land

The LGRA states that all land is non-rateable unless stated otherwise. Schedule 1 then defines a long list of land that is non-rateable, and a smaller list of land that is 50% non-rateable. All land not described in this schedule is deemed fully rateable for the purposes of setting general rates.

2.1.2. Valuation Bases

The LGRA permits rates to be set on the basis of either land value, capital value or annual value. Each is defined below.

Capital Value

This is the price that a property probably would have sold for at the date of valuation (excluding chattels etc).

Land Value

This is the price that a property's land component probably would have sold for at the date of valuation. It includes any work on draining, excavation, filling, retaining walls, reclamation, and so on.

Annual Value

Annual Value is the greater of (i) the estimated gross annual rental less 20% (or 10% for vacant land) or (ii) 5% of the property's capital value.

2.1.3. Differentials

The LGRA permits (general and targeted) rates to be set either uniformly, or at different rates per dollar of rateable value. Schedule 2 defines the land categories on which differentials may be set. They are:

- the use to which the land is put.
- the activities that are permitted, controlled, or discretionary for the area in which the land is situated, and the rules to which the land is subject under an

operative district plan or regional plan under the Resource Management Act 1991.

- the activities that are proposed to be permitted, controlled, or discretionary activities, and the proposed rules for the area in which the land is situated under a proposed district plan or proposed regional plan under the Resource Management Act 1991, but only if—
 - no submissions in opposition have been made under clause 6 of Schedule 1 of that Act on those proposed activities or rules, and the time for making submissions has expired; or
 - all submissions in opposition, and any appeals, have been determined, withdrawn, or dismissed.
- the area of land within each rating unit.
- the provision or availability to the land of a service provided by, or on behalf of, the local authority.
- where the land is situated.
- the annual value of the land.
- the capital value of the land.
- the land value of the land.

2.2. UAGCs

Under the LGRA, a local authority may set a uniform annual general charge for all rateable land within its district. This may be a fixed amount per rating unit; or a fixed amount per separately used or inhabited part of a rating unit.

2.2.1. Rating Units

Rating units are defined in the RVA, and depend primarily on the existence of a separate certificate of title. Land that does not have a certificate of title (and is not crown land) may also be deemed a rating unit if:

- the land has (or could have) a finite beginning and end, or
- there is no larger or prior estate or interest in the land, or
- the land can be sold or transferred

2.2.2. 30% Cap

The LGRA restricts the quantum of rates that can be derived from certain funding sources. Specifically, §21 of the LGRA states that the revenue sought by a local authority from UAGCs and uniform targeted rates must not exceed 30% of the total revenue from all rates. This excludes targeted rates set solely for water supply or sewage disposal.

2.3. Targeted Rates

In addition to general rates, Council's may also set targeted rates for 1 or more activities or groups of activities. However, those activities (or groups of activities) must be identified in Councils funding impact statement as being the basis for setting such rates.

The process for setting targeted rates is similar to that for general rates:

1. Distinguish rateable land from non-rateable land
2. Select a valuation base
3. Set differentials (optional).

2.3.1. Rateable versus Non-Rateable Land

The matters used to define rateable and non-rateable land for targeted rates are they same as those used for general rates.

2.3.2. Valuation Bases

Schedule 3 of the LGRA defines “Factors that may be used in calculating liability for targeted rates.” These are akin to the valuation bases on which general rates must be set, but are much broader. The contents of Schedule 3 are reproduced below.

- the annual value of the rating unit.
- the capital value of the rating unit.
- the land value of the rating unit.
- the value of improvements to the rating unit.
- the area of land within the rating unit.
- the area of land within the rating unit that is sealed, paved, or built on.
- the number of separately used or inhabited parts of the rating unit.
- the extent of provision of any service to the rating unit by the local authority, including any limits or conditions that apply to the provision of the service.
- the number or nature of connections from the land within each rating unit to any local authority reticulation system.
- the area of land within the rating unit that is protected by any amenity or facility that is provided by the local authority.
- the area of floor space of buildings within the rating unit.
- the number of water closets and urinals within the rating unit.

2.3.3. Differentials

As with general rates, targeted rates may be struck at different rates per dollar. The factors that may be used to group properties for the purpose of setting targeted rate differentials are the same as those used for general rates (see section 2.1.3).

2.3.4. Targeted Rates for Water Supply

The LGRA also permits local authorities to set a targeted rate for the quantity of water provided. These may be calculated as a fixed charge per unit of water supplied or according to a scale of charges.

3. Evaluation Framework

As with any evaluation exercise, this analysis of rating tools needs to take place within an evaluation framework. This allows the advantages and disadvantages of each tool to be assessed in a consistent and objective manner.

The evaluation framework underlying this report comprises a number of standard taxation principles. While these generally align, they may also sometimes conflict. Thus, an instrument viewed favourably by one criterion may be censured by another. Resolving these conflicts requires value judgements to be made, but doing so is beyond the scope of this report.

The aim of this report is to simply present the facts about each rating tool and allow policy makers to form their own view about the importance of criteria. Following are brief descriptions of each criterion.

3.1. Equity

Two equity criteria are commonly used to assess rates: ability to pay and benefits received. These can be considered both across ratepayer groups, and within them. Thus for instance, we may be interested in the distribution of benefits across residents, businesses and others, and we may also be interested in the distribution across ratepayers within the residential group.

3.1.1. Ability to Pay

As its name suggest, ability to pay is concerned with taxpayers' abilities to meet financial demands. Ability to pay is often considered along two dimensions: horizontal equity and vertical equity.

Horizontal equity requires people in similar (financial) situations be treated similarly, while vertical equity requires people in different situations be treated differently.

Discussions of vertical equity (the more commonly-cited of the two principles) usually centre around three related definitions:

- *regressive taxes*, where the proportion of income paid as tax decreases as income increases,
- *flat taxes*, where the proportion of income paid in tax is constant, and
- *progressive taxes*, where the proportion of income paid in tax increases as income increases.

The general consensus is that regressive taxes violate the concept of vertical equity, while progressive and flat taxes adhere to it. Beyond this, though, there is little more that can be said. Preferences for progressive taxes over flat taxes, for example, are purely a matter of opinion.

One issue that surrounds both definitions of equity is the manner in which ability to pay is measured. While many studies simply use household incomes, others adjust these to account for differences in living costs (due to differences in family size, location, and so on.) In this report, we use household income as our measure of ability to pay.

3.1.2. Benefits Received

The other main equity concept, which is somewhat unique to local government, requires funding contributions to align with benefits received. In this sense, it is more of a taxation-expenditure principle than a pure taxation principle.

There is ongoing debate (both here and overseas) about the validity of this principle. Detractors claim that rates are just a tax, and thus the distribution of benefits is irrelevant. Supporters argue that rates are more than just a tax, and that the flow of associated services matters. In New Zealand, there is little doubt that benefits count. Indeed, the LGA explicitly requires them to be considered when designing funding policies.

Most analyses of rates divided benefits into two streams:

- *Private benefits*, which accrue directly to the users of services, and
- *Public benefits*, which capture a range of non-use benefits as well as the direct-use benefits of public goods (for which the identification of users is impractical). *e.g.* street lighting.

In general, private benefits are funded by user charges, while public benefits are funded by rates.

3.1.3. Intergenerational Equity

Intergenerational equity concerns the balance between current and future funding. It requires funding loads to be justifiable according to the relative benefits received, and relative ability to pay, of different generations. For example, if future ratepayers are likely to have higher incomes than current ratepayers, or if they are likely to receive a greater share of benefits than current ratepayers, they should pay more. This concept is particularly important for the funding of infrastructure, which provides benefits over long time horizons.

3.2. Efficiency

Tax efficiency is a difficult concept to explain. In essence, tax efficiency means that a tax does not significantly alter economic decisions. Put slightly differently: in the absence of taxes, people (and businesses) would make various decisions about saving, spending, working, and leisure based on their needs and wants. An efficient tax is one that does not significantly alter those decisions.

Taxes that cause major changes to economic decisions are said to be distortionary. They erode the gains that producers and consumers receive from transacting with one another and cause “deadweight losses.” In general, the broader the tax base and the lower the tax rate, the more efficient the tax.

It is important to note though that some taxes - such as petrol taxes and excise taxes on cigarettes and alcohol - are specifically designed to alter behaviours. Their aim is to correct externalities. Externalities arise when the decisions of one person (*e.g.* a smoker) affect third parties (*i.e.* the presence of second hand smoke). Externalities represent a departure from socially-optimal outcomes, and taxes are used to steer outcomes back to their optimal path.

3.3. Simplicity and Transaction Costs

Another component of taxation efficiency concerns transactions costs. These refer to the overall cost of implementing and administering the system, as well as the cost of monitoring and enforcing compliance. In general, the lower the transactions costs, the more efficient the tax system. Simple taxes also promote compliance.

3.4. Stability

Stable revenues grow (or decline) at predictable rates and facilitate planning and budgeting. This is a desirable attribute of any tax instrument.

3.5. Sufficiency

The amount of revenue generated by the funding system should be sufficient to meet expenditure requirements. This is an important – yet often overlooked – attribute.

3.6. Transparency

Any tax system should be open and transparent, so that taxpayers fully understand the process under which tax liability is calculated. Like simplicity, transparency encourages compliance.

3.7. Legislative Considerations

In addition, or in parallel, to the factors listed above, there are a number of factors to which Councils *must* have regard when designing rates policies. Specifically, §101(3) of the LGA requires Councils to consider:

- the distribution of benefits (both temporally and spatially), and
- the extent of any cost causation, and
- the impacts of on community outcomes and policy transparency, as well as
- the likely impacts on the four well-beings, both current and future.

4. Evaluation of Rating Tools

This section assesses each rating tool against the evaluation criteria in section 3.

4.1. Ability to Pay

There is considerable debate over the extent to which local authority funding reflects ability to pay. As always, the answer depends on the frame of reference. That is to say, the answer depends on whether comparisons take place across ratepayer groups, or within them. Ideally, both should be considered.

At the outset of this project, we planned to analyse both. However, this proved difficult, because there is very little information on business and farming incomes at the sub-district (let alone property) level. This meant that our analysis was confined to only residential ratepayers. Our findings are set out below, starting with UAGCs.

It seems clear that UAGCs (and other uniform charges) bear little relationship to ability to pay. After all, these charges are flat and, thus, regressive. But what about value-based rates, such as general rates and targeted rates?

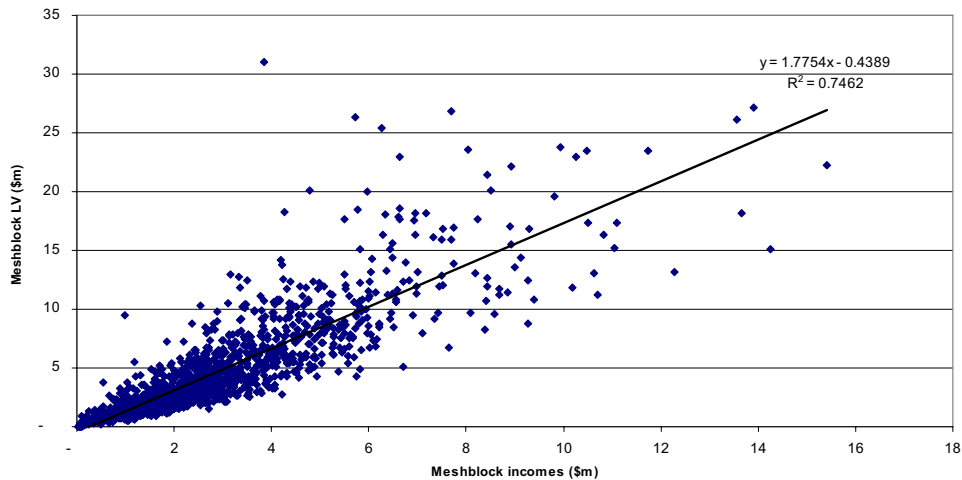
This is where the debate gets interesting. Some argue that value-based rates have a reasonable fit with ability to pay, while others lament the quality of such relationships. In reality, it depends on policy design, particularly the choice of valuation base and the use of differentials. Putting these issues to one side, however, we can examine the degree to which property values are correlated with household incomes. This provides some insight to the link between value based funding and ability to pay.⁶

In order to analyse relationships between property values and incomes across residential ratepayers, we were kindly supplied with the rating information database of a large city Council. For each rateable property, this showed the ratepayer type, the property's rateable value, and its location.

Aggregating this data to meshblocks and linking it to census meshblock information, we were able to analyse the relationship between property values and incomes (at the meshblock level). The results of our analysis are presented below.

Figure 1 plots the relationship between land values and incomes.

⁶ A discussion of the effects of valuation bases and differentials is provided in section 6.

Figure 1: Meshblock Income vs Meshblock LV (\$m)

As we can see, there is a relatively strong linear relationship between household incomes and land values (at the meshblock level). But what about capital values?

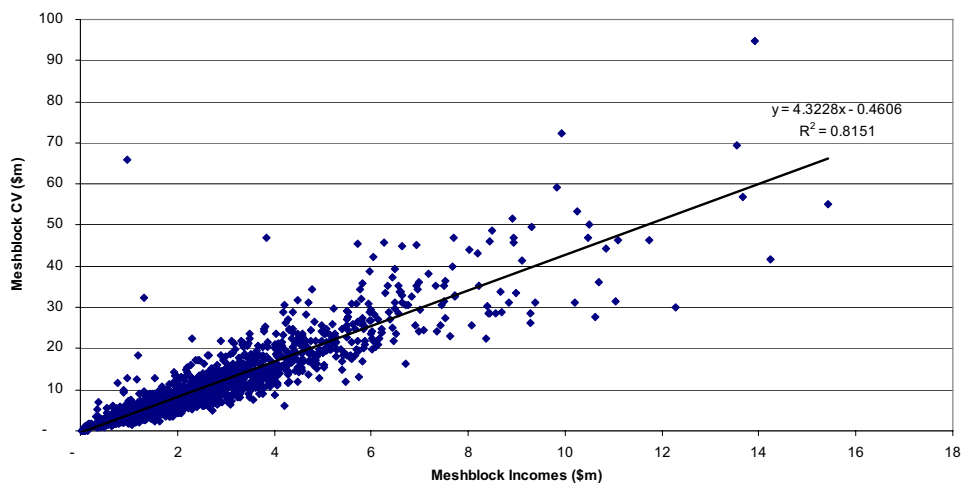
Figure 2: Meshblock Income vs Meshblock CV (\$m)

Figure 2 shows that there are also relatively strong relationships between incomes and capital values at the meshblock level.

Combining these findings, one might reasonably conclude that there is a broad relationship between rates and ability to pay. There is, however, an important caveat: these relationships are far from perfect. Consequently, the use of property values to set rates gives rise to:

- horizontal inequity – because some households on similar incomes own properties of highly varying value and, therefore, pay quite different rates, and;
- Vertically inequity – because some households with markedly different incomes own properties of similar values, and hence pay similar rates.

The most prominent example of a breakdown in the property value-income relationship is ratepayers described as “asset rich but income poor.” These people, many of whom are retired, attract high rates but have little money with which to pay. Such outcomes are commonly-cited by detractors of rates. However, three important points must be noted.

First, all councils administer rates rebate schemes - which address these sorts of anomalies - on behalf of central Government. Second, most councils also operate their own postponement and remission schemes.⁷ Finally, property-based equity can be released quite easily now using reverse equity schemes.⁸

4.2. Benefits Received

Next, we consider the extent to which the distribution of funding (under each tool) matches the distribution of benefits received.⁹ To begin, recall that benefits can be divided into two parts: public and private.

Now, because private benefits accrue directly to the users of services, and since most services with high private benefits are funded (at least partially) by user charges, only a small portion of private benefits are funded by rates.¹⁰ Accordingly, we confine our attention to the relationship between rates and *public* benefits.

In reality, the extent to which funding matches the distribution of public benefits depends on the service in question. Thus, if the public benefits of a service accrue to:

- each property in the district uniformly, UAGCs provide the best fit. *e.g.* refuse collection, animal control, community halls and libraries, noise control, parks and reserves.
- each property in proportion to property values, general rates provide the best fit. *e.g.* flood control and local democracy.
- only a subset of properties, either uniformly or not, targeted rates provide the best fit. *e.g.* main street programmes, and localised flood control.

⁷ See “Council Policies on Rates Remissions and Postponements and Māori Freehold Land” by Karen Johnston for more information.

⁸ Some might argue that the use of reverse equity schemes erodes the value of inheritances and, in turn, could exacerbate future housing affordability issues.

⁹ We would like to note that the relevance of this criterion depends entirely on one’s beliefs about the role of rates. That is to say, if rates are considered a tax, then the match between funding and benefits is totally irrelevant. Its inclusion here reflects our agnostic views about the role of rates, and because benefits must be explicitly considered under §101(3) of the LGA.

¹⁰ Unless stated otherwise, rates mean general rates, targeted rates and UAGCs.

In our opinion, all three scenarios seem likely (albeit to varying degrees). Thus, a blend of all three tools should be used, the exact mix of which depends on the perceived spread across these scenarios.

In practice, we consider it likely that a high proportion of public benefits accrue on a uniform basis. Indeed, it was much easier to find examples of services that matched UAGCs than it was for general rates and targeted rates. This suggests that, if we wish to match funding with benefits, a fairly high level of uniform charges should be set. Of course, this is not possible under existing legislation, which caps uniform charges at 30%. Veering away from high uniform charges may also be desirable if the Councils wish to avoid rates becoming too regressive.

We also note in passing that some funding-benefit studies allocate public benefits to ratepayers on the basis of property values. There is absolutely no theoretical basis for this, and it is done seemingly to create artificial linkages between funding and benefits. We consider this practice both spurious and misleading.

4.3. Intergenerational Equity

There is no apparent difference between the rating tools with respect to intergenerational equity. The achievement of intergenerational equity depends entirely on the way that capital costs are recovered over time. This, in turn, depends on the degree to which council uses debt (and other long-term funding mechanisms) to match the period of funding with the perceived period of benefit. Once raised, these loans may be repaid using any combination of rating tools, without any effect on intergenerational equity.

4.4. Efficiency

The meaning of efficiency is context-dependent. Thus, in relation to sales taxes, efficiency means not altering people's decisions to buy goods or services, while in relation to income taxes, it means not altering decisions to work. In relation to rates, efficiency means not altering decisions about owning property.

Based on this definition, it can be argued that uniform charges are the most efficient form of rating. This is because, although they may affect the decision to rent versus buy, uniform charges do not alter decisions about *which* property to rent or buy. Indeed, the same uniform charge applies to each rateable property, regardless of its value.

The same cannot be said of value-based rates, however. This is because, by definition, value-based rates increase with property value (which may create an incentive to purchase a cheaper house than would otherwise be the case). However, such effects are likely to be very minor.

It is important to note that, although uniform charges are more efficient than value-based charges, all forms of rates are efficient overall. Indeed, they are far more efficient

than income taxes and sales taxes. This is because rates are a tax on shelter, and shelter is one of the basic necessities of life.¹¹

4.5. Simplicity and Transaction Costs

UAGCs are the simplest rating tool and incur the lowest transaction costs because they do not require information on property values. Value-based rates, conversely, are more complex and incur higher costs.

4.6. Stability

UAGCs are more stable than value-based rates because they do not depend on property values, which are often quite volatile.

4.7. Sufficiency

Given the statutory cap of 30%, uniform charges are clearly insufficient compared to value-based rates.

4.8. Transparency

Because they do not rely on assessments of property values, the exact process for which is not well understood, uniform charges are more transparent than value-based rates.

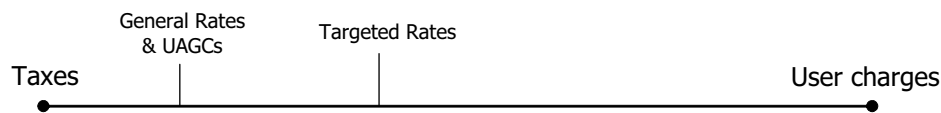
¹¹ Of course, people may elect to rent rather than buy, in which case the direct incidence of rates is borne by the landlord. However, it is widely-accepted that rates are passed on to tenants in rent.

SOLGM notes that specific sections of the LGA prove rates are not a fee for service. According to their logic, if rates truly were a fee for service, only benefits would matter when designing rating policies. But §101(3) requires council to explicitly consider a number of factors other than benefits.

In terms of legal precedent, there is significant evidence to corroborate the view that rates are a tax. Most famous is the case of *Woolworths and Others vs Wellington City Council* (1996), in which the judge stated:

“...it is implicit in the scheme of the legislation that the rating system in its diversity remains primarily a taxation system and not a system inherently based on a principle of user pays.”

Perhaps one could distinguish the three rating tools and place them on separate parts of the continuum? This would allow any differences to be adequately reflected. On this basis, we suggest the following classification:



Under this classification, rates are neither a tax nor a user charge, but a hybrid of the two. Further, general rates and UAGCs are considered to be more closely aligned with taxes than targeted rates.

5.2. Property Values are Often Poor Indicators of Wealth

To the extent that value-based (general and targeted) rates are intended to be wealth taxes, their suitability depends on the extent to which property values reflect wealth. However, there are a number of reasons why property values and wealth may differ.

First, property is only one of many asset classes in which wealth may be held. Others include stocks, bonds, term deposits, and so on.¹³ Second, many properties have very low gearing; so that the “owner’s” actual wealth is only a fraction of the property’s value.¹⁴ Third, as will be explored in more detail later, the actual value of a property may differ markedly from its estimated value. Finally, wealth held in property is only realised when it is sold.

5.3. Rates are Inherently Regressive

One major criticism of rates is that they are patently regressive. In order to test this assertion, we sourced information from the Household Economic Survey 2003/04 - a detailed survey of New Zealand households’ spending patterns.

¹³ This may have been less of a concern historically, when a greater proportion of wealth was held in property relative to today. See Ulbrich (1998) for example.

¹⁴ One obvious, but ultimately unworkable, solution would be to levy rates on *net* property wealth.

One of the items included in this survey is “payments to local authorities”. Interpreting these payments as rates contributions, and plotting them against post-tax household incomes, we derived the following figure.

Figure 3: Payments to Local Authorities as % of Household Incomes (HES 2003/04)

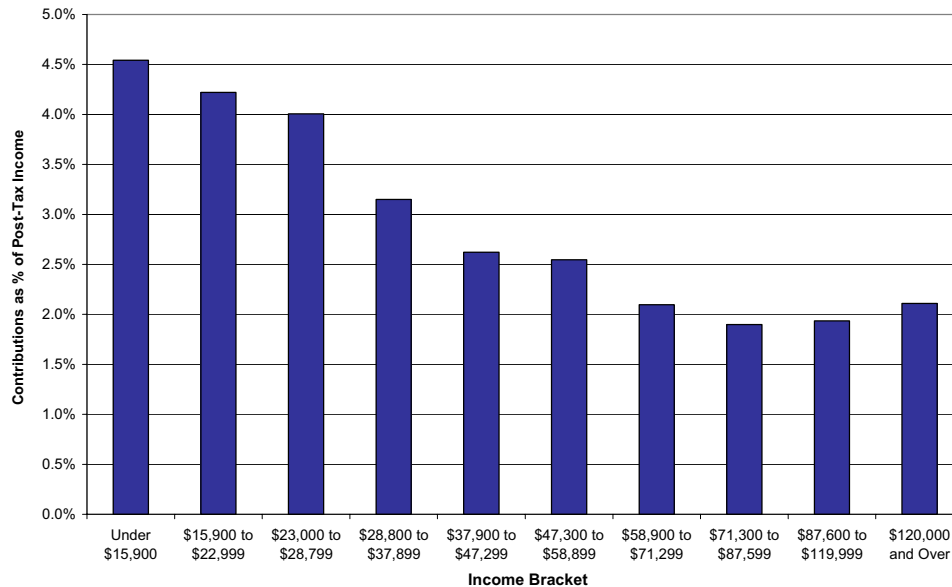


Figure 3 seems to corroborate the conjecture of regressivity by showing that payments to local authorities become smaller fractions of household income as incomes increase. LGNZ (1992) offers one possible reason for this. It asserts that the share of income dedicated to property decreases as incomes increase. However, empirical studies suggest otherwise. Kerr et al, for instance, found that a 1% rise in median income is associated with a 1.9% rise in capital value (across TLAs). The exact reason for the pattern in Figure 3 therefore remains a mystery.

5.4. Accuracy of Assessed Values

5.4.1. What is the issue?

As mentioned in section 5.2, one of the fundamental criticisms of value-based rates is that assessed values - the values upon which rates are struck – are wildly inaccurate. In other words, assessed values may be poor indicators of property-based ‘wealth.’

5.4.2. Does this Really Matter?

The severity of the problem depends entirely on the variability of assessment errors. More specifically, if each property’s market value is a constant fraction of its assessed value, the distribution of rates is unchanged. If, however, market values are varying proportions of assessed values, the distribution of rates is skewed. To see why, we need to take a quick mathematical diversion.

Within each differential rating group (or across all properties in the absence of differentials), each property's share of rates is determined by its share of total assessed value. Thus, we may write:

$$\text{Rates Share}_i = \frac{\text{Assessed Value}_i}{\sum \text{Assessed Value}_i} \quad \text{Equation 1}$$

where 'Rates Share' is the share of rates paid by property i .

Now, if each property's market value is a constant proportion of its assessed value, we can also write:

$$\text{Market Value}_i = x \text{Assessed Value}_i \quad \text{Equation 2}$$

where x is the same for all properties

Substituting equation two into equation one, we can calculate what each property's share of rates would be if market values were used rather than assessed values. This give us:

$$\begin{aligned} \text{Market - Value Rates Share}_i &= \frac{\text{Market Value}_i}{\sum \text{Market Value}} \\ &= \frac{x \text{Assessed Value}_i}{\sum x(\text{Assessed Value}_i)} \\ &= \frac{x}{x} \times \frac{\text{Assessed Value}_i}{\sum \text{Assessed Value}_i} \\ &= \frac{\text{Assessed Value}_i}{\sum \text{Assessed Value}_i} \\ &= \text{Rates Share}_i \end{aligned}$$

Thus, if each property's market value is a constant proportion (x) of its assessed value, the actual distribution of rates is that same as if rates were based on market values. However, if market values are not constant proportions of assessed values (*i.e.* the x for each property is not the same as the district-wide-average x), the distribution of rates is changed.

Obviously, the assumption that market values are a constant proportion of assessed values is unrealistic. So, to what extent do these proportions vary, and what does this imply for the distribution of rates?

To answer these questions, we sourced the property sales database of a large city. It covered 17,824 sales over a 22-month period. In summary, the data showed that:

- on average, properties sold for 10% above assessed value, but
- 29% sold *below* assessed value, while
- 44% sold for more than 20% above assessed value.

Moreover, it showed that:

- 56 properties sold for less than half their assessed value, while
- 80 properties sold for more than double their assessed value.

Digging a little deeper we discovered that, holding everything else constant:

- The ratio of selling price to assessed value increased as the selling price decreased. Thus, assessed values are more accurate for expensive properties than they are for cheaper ones.
- The greater the gap between the date of assessment and the date of sale, the higher the ratio of selling price to assessed value (ratios increased at a rate of 0.09 per 12 months)
- There was significant variation across property types. Specifically, on average:
 - bare land sold for 45% above assessed value
 - vacant land sold for 17% above.
 - home & income properties sold for 4% below
 - rental flats sold for 6% above, and
 - dwellings and flats sold for around 2% above assessed values

Clearly, there is significant variation in the ratio of market value to assessed values (which have significant implications for the distribution of rates). But what does this imply for the rates that property's are paying?

If each property had to pay rates on market values rather than assessed values, then:

- rates on bare land would increase by 32% (on average)
- rates on home & income properties would decrease by 13% (on average)
- 56 properties would face a decrease of 55% or more
- 80 properties would face an increase of 80% or more, and so on.

Hence, the inaccuracy of assessed values has significant implications for the distribution of rates.¹⁵

¹⁵ We note that an objection system exists, but this does not fully solve the problem. First, few people know that it even exists. Second, altering the assessed value of one property in isolation does not correct assessment errors in every other property. Third, the objection process does nothing to resolve the infrequency of revaluations.

5.4.3. Possible Solutions

In our opinion, there are two problems to be addressed. First, valuations are not accurate enough. Second, revaluations are too infrequent.¹⁶

Suggestions to improve the accuracy of assessed values are difficult to make without a deep understanding of the current assessment process.¹⁷ However, one suggestion would be to adopt valuation bands - such as those used in the UK - rather than assign each property an exact value. Under this system, each property is assigned to a band, and must pay the same rates as all other properties within that band.

The advantages of banding are that it is quicker, cheaper, and less sensitive to movements in property than the use of individual property values. Disadvantages include the perception that the delineation of bands is arbitrary, and that there is significant variation in actual property values within bands. In addition there are - as always - issues at the margin *i.e.* where properties sit on the cusp between one valuation band and another.

Another option - which is being used elsewhere - is to allow ratepayers to self-assess their property's value. While this is a very low cost option, there are some obvious downsides. These include systematic under-estimation and the need for robust verification systems.¹⁸

Resolving the revaluation problem could take two possible routes. First, the minimum revaluation period could be shortened to one or maybe two years. Of course, this would increase the costs of valuation quite significantly. However, the use of computer-assisted valuation methods might moderate any financial pressures.

The other possible option is to update values *between revaluations* using indexation. Under this approach, the value of each property is incremented annually according to a pre-defined index (but still valued triennially). In continental Europe, this is typically done using a retail price index (such as the CPI), while in France it is done using a specially-designed index.

¹⁶ Note that triennial revaluations are nowhere near as infrequent as in other countries, however. For instance, in Northern Ireland, the last revaluation of residential properties took place in 1976. Even worse, Cyprus adopts a valuation base of 1909 for some of its property-related taxes.

¹⁷ Overseas, the trend appears to be a movement towards the use of computer-assisted mass appraisal. These rely primarily on multiple regression approaches or artificial neural network programs to assess each property's value.

¹⁸ Some submitters have suggested valuation averaging to help moderate volatility in rateable values. While averaging will certainly achieved this objective, it does not resolve the issues discussed here. *i.e.* variability in the accuracy of assessed values and the infrequency of revaluations. Indeed, valuation averaging simply protects high-growth properties from excessive rates increases – nothing more, nothing less.

Naturally, there would need to be more than one index, otherwise the relative values of properties (and hence the incidence of rates) would be unchanged. At the very least, separate indices could be used for residential, rural and business properties.

5.5. Other Reasons for General Discontent with Rates

In addition to the factors discussed above, there are a number of other reasons why rates are generally disliked. These include:

- *Visibility* – unlike GST (which is already built into retail prices) and income taxes (which are usually deducted on our behalf), rates are highly visible. This makes them a clear target for protest.
- *Lumpiness* - Because rates assessments are issued infrequently (usually quarterly), they appear more onerous than they would do if they were issued more frequently.
- *Unavoidability* – since shelter is one of the necessities of life, and because rates are levied on forms of shelter, they are practically unavoidable. Although people can choose to rent, and therefore escape direct liability, rates are typically passed on from landlord to tenant. Accordingly, property taxes are sometimes described as unavoidable.
- *Power to Challenge* – while taxpayers may equally dislike other forms of (centrally-imposed) taxation, such as income tax or GST, they feel relatively powerless to challenge them. Rates, on the other hand, are levied locally and are subject to quite rigorous consultation and submission processes. These make them somewhat easier to challenge.
- *Value for Money* – some ratepayers perceive many council-provided services to be superfluous or totally unnecessary. This leads many to question the value they receive from rates.¹⁹
- *Confusion* – rates assessment notices are often complicated and difficult to understand, as are the methods used to assess property values.²⁰ Other forms of taxation, such as GST, are much more straightforward.
- *Tax on a tax* – many ratepayers dislike the fact that they must pay GST on rates, because this is perceived as a “tax on a tax.”

¹⁹ Some authors note the unwillingness of ratepayers to accept the positive influence that council services have on property values. They claim that not only is the cost of rates capitalised in house prices; so too is the value of council services funded by those rates.

²⁰ Related to this is the perception that rating policies are rather ad hoc, and have evolved over time into overly-complex and inconsistent systems.

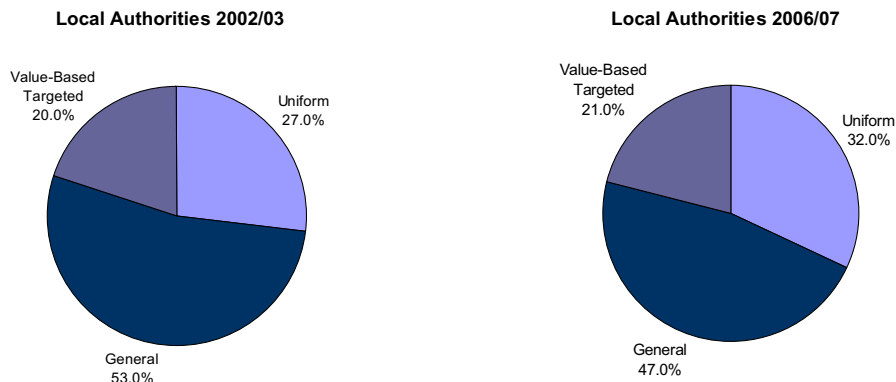
- *Affect on Housing Affordability* – for many people, housing is simply unaffordable. To the extent that rates shift an already-marginal purchasing decision to the point of being unaffordable, they may be seen as exacerbating existing affordability issues.
- *Arbitrariness*– the flexibility afforded local government in the selection of a valuation base (and the setting of rates per dollar of rateable value) gives some people the impression that rates are totally arbitrary and unjustifiable.

6. Use of Rating Tools – Local Authorities

This section provides an overview of the recent use of rating tools by local authorities. It also analyses the use of valuation bases and differentials for general rates.

6.1. Allocation over Time

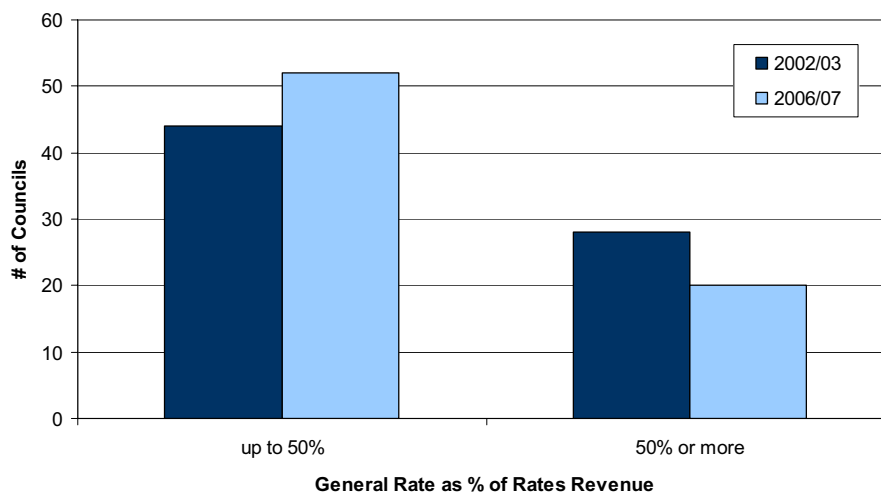
Since 2002, uniform charges and targeted rates have become larger shares of Local Authority rates, while general rates have become a smaller share.²¹ The increased use of uniform charges is worrying given their regressive nature.



6.2. General Rates

In 2002/03, 66 local authorities charged general rates, compared to 69 in 2006/07. Figure 4 shows that the number of local authorities raising more than half their rates from general rates fell from 28 to 20, while the number raising less than half their rates from general rates increased from 44 to 52.

Figure 4: General Rates as % of Total Rates Revenue



²¹ Throughout this section, uniform charges means UAGCs and uniform targeted rates.

Figure 5 provides a more detailed breakdown of general rates (as a percentage of total rates revenue) in 2006/07.

Figure 5: General Rates as % of Total Rates Revenue 2006/07

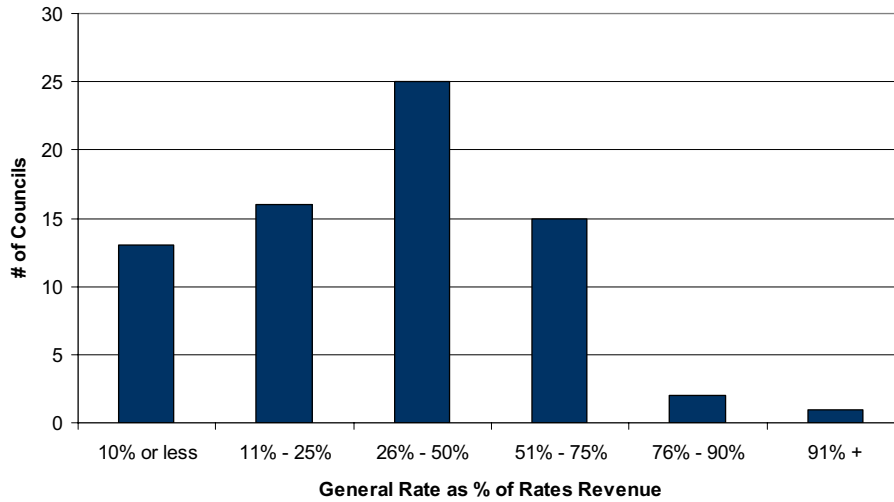
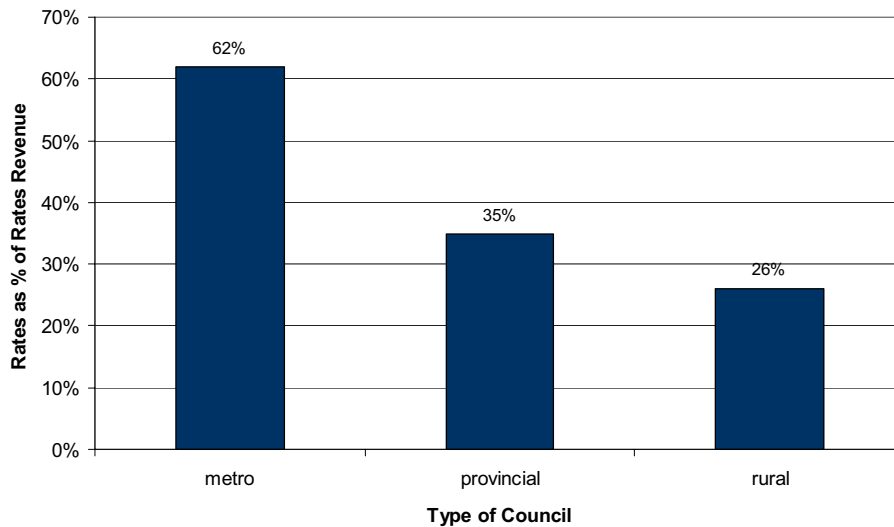


Figure 6 examines the extent to which the reliance on general rates differs by type.²² It appears that metropolitan councils are far more reliant on general rates than their provincial and rural counterparts.

Figure 6: General Rates as % of Total Rates Revenue - Comparison



6.3. Valuation Bases

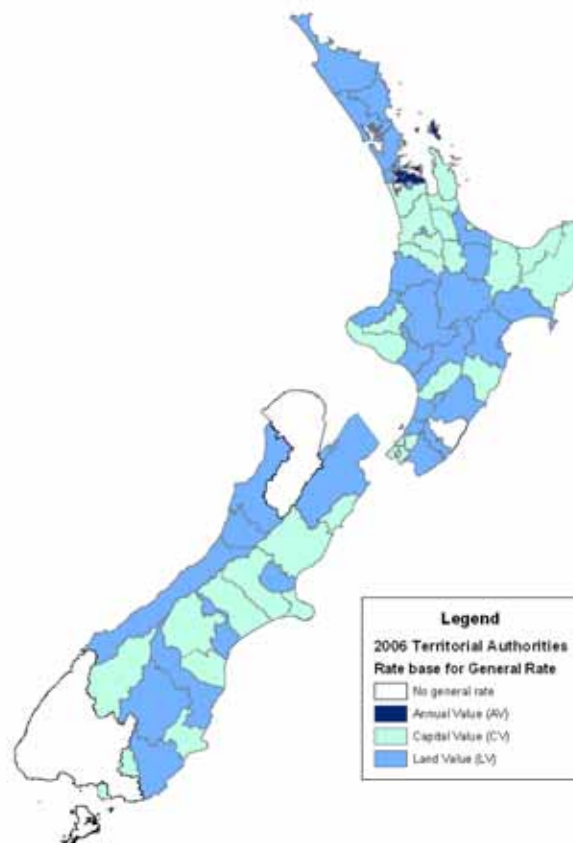
The LGRA permits councils to select one of three valuation bases when setting general rates (plus a handful of others when setting targeted rates). As we shall soon see, the

²² This classification is based on LGNZ groupings, as set out in the appendix.

choice of valuation can have material effects, not least on the incidence of rates. Here we analyse the advantages and disadvantages of each valuation base, and provide some concluding remarks.

6.3.1. What is the current pattern of usage?

The map below shows the spatial distribution of valuation bases across local authorities in 2006/07. Land value dominates (used by 51% of local authorities), followed by capital value (46%) and then annual value (3%).



6.3.2. What are the Advantages and Disadvantages of Each Base?

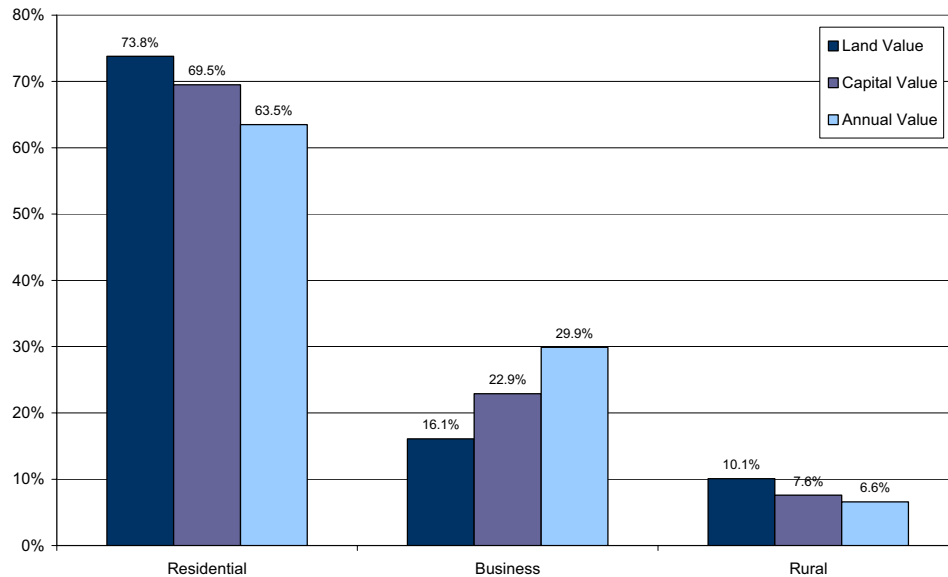
Distribution of Rates

One primary consideration is the effect each base has on the incidence of rates, both across and within ratepayer groups. Across ratepayer groups, LV tends to favour businesses at the expense of residences rural properties, while CV tends to favour residences and rural properties at the expense of businesses. AV is similar to CV, except that it shifts an even greater burden on to businesses.²³

²³ This is because rental yields are generally higher on commercial and industrial properties than on residential and rural properties.

The following chart shows the distribution of property values in Manukau City in 2006 under each base. It supports our conjecture about the distribution across groups.

Figure 7: Shares of Property Value in Manukau City 2006



Ok, but what about the distribution of rates *within* ratepayer groups? Unfortunately, we do not have any data to analyse the impacts within business and rural ratepayer groups. We do, however, have data for residential ratepayers.

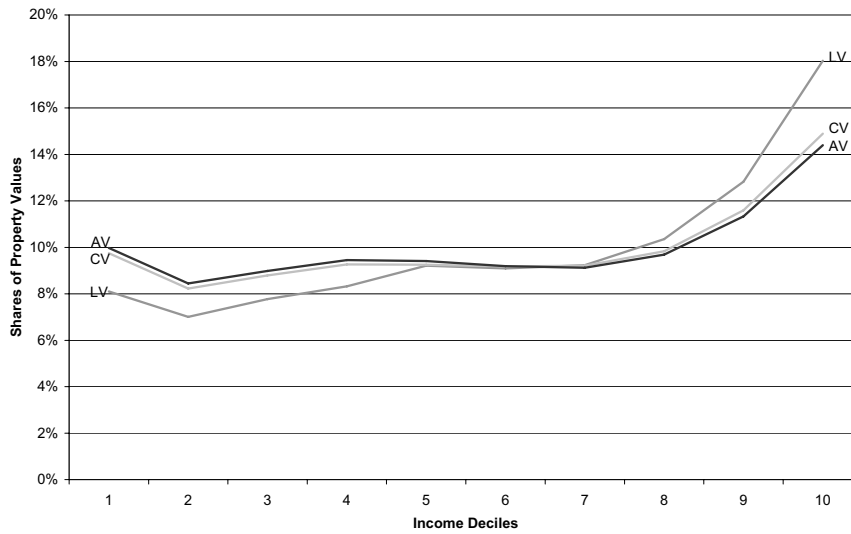
Using the data introduced in section 4 we plotted the distribution of property values against income deciles under each valuation system. Ignoring any differentials, these directly indicate the funding burden that each income decile will bear.

As we can see in Figure 8, lower deciles account for higher shares of CV and AV than they do of LV, and vice versa for higher deciles. Thus, ignoring any differentials, LV is more progressive than CV, which is more progressive than AV. But what explains these distributional variations?

Differences in the distribution of LV and CV stem from the fact that the ratio of improved value to land value falls as income increases. From this it follows that lower deciles account for a higher share of capital values than they do of land values.²⁴ Differences in the distribution of CV and AV stem from differences in rental yields.

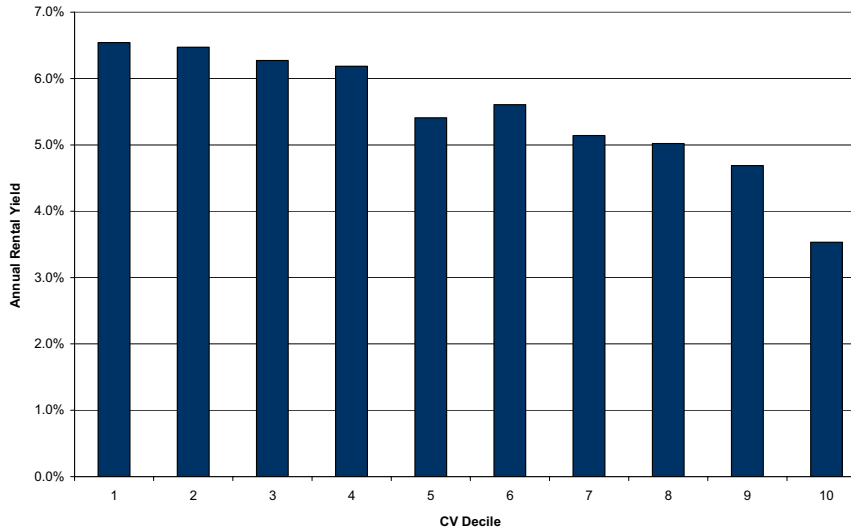
²⁴ Kerr et al (2004) also found that, for *every* local authority in New Zealand, the ratio of improved value to land value falls significantly as income increases.

Figure 8: Distribution of Property Values across Income Deciles



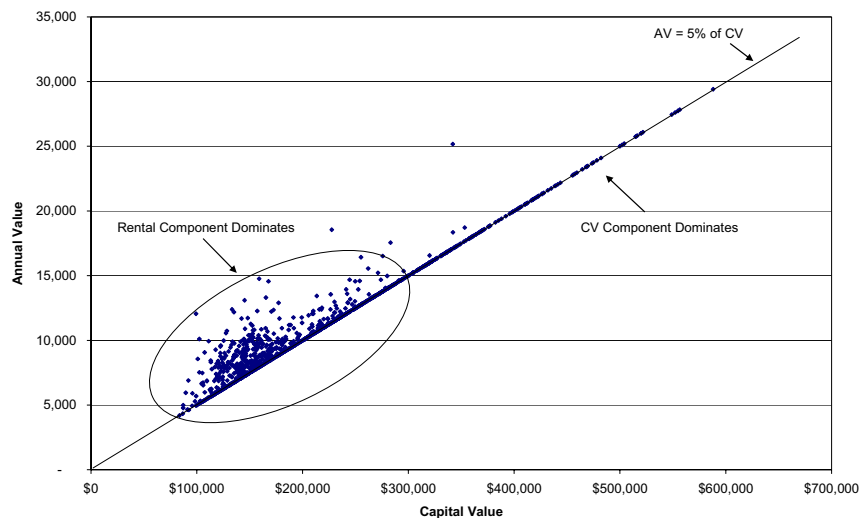
That is to say, because rental yields generally decrease as property values increase (see Figure 9), the rental element of the AV equation dominates at lower values, while the CV component dominates at higher values (see Figure 10). This flattens out the distribution of AV relative to CV.²⁵

Figure 9: Rental Yields by CV Decile



In summary, land value appears more progressive (and hence vertically equitable) than capital value or annual value. Of course, any concerns over the regressive nature of CV and AV can easily be resolved using differentials.

²⁵ Grimes and Aitken (2007), who also found significantly higher rental yields in lower socio-economic areas, hypothesise that this is due to higher costs of ownership (higher tenant turnover etc).

Figure 10: Annual Values as a function of Capital Values

Reliability of Assessed Values

As discussed in section 5.4, the reliability of assessed values is essential for the equitable distribution of rates. Indeed, even minor discrepancies can materially affect their incidence.

Because assessed values are based primarily on market transactions, it follows that, everything else being equal, the valuation base with the richest transaction data will generate the most accurate assessments.

In the case of LV-rating, where rateable values are based on recent land sales, one might reasonably express concern. Indeed, in most areas (particularly urban ones) there are very few land sales upon which rateable values can be generated.²⁶ This raises concern about the reliability of assessed values under LV rating.

CV-rating, on the other hand, benefits from the availability of much richer sales information. For instance, in two Auckland cities over the last few years, there was around 50 sales of dwellings for every one sale of land. Thus, assessed values are likely to be far more reliable under CV-rating than under LV-rating. But what about AV-rating?

Market rental information is readily available at more frequent intervals and at even higher volumes than property sales information. This is thanks to the bond lodgement scheme operated by Tenancy Service. Under the scheme, each time a new tenancy commences, the landlord must lodge the bond and record information about the

²⁶ Even in areas with a higher number of land sales, land transactions tend to be concentrated in peripheral (greenfields) areas. The value of land in these areas is often not representative of the value of land in other areas of the city or district. Hence, the accuracy of assessed values depends not only on the depth of market transactions, but also how representative those transactions are.

tenancy. This includes the address of the property, the number of bedrooms, the weekly rental, and so on.

This information provides a lush dataset upon which the rental values of other properties (and hence their AV) can be derived. On this basis, we conclude that AV-rating generates more accurate assessed values than CV or LV.²⁷

Matching of Funding with Benefits Received

Like the distribution of rates, the matching of funding and benefits can also be considered at two levels: across and within ratepayer groups. Again, however, it is difficult to say much across groups. Here we consider the impact within residential ratepayers.

Land values are likely to provide a poor match between funding and benefits received. To see why, consider the following example. Suppose a district contains two identical lots, one of which contains an occupied dwelling and one of which does not. It seems fair to conclude that, for the majority of council services, the occupied dwelling will receive more benefit than the empty lot. However, under LV rating, both properties pay the same level of rates. Clearly, then, land values produce a poor fit between funding and benefits.

So what about CV and LV? Continuing our simple example, the empty lot would continue to receive a lower level of benefit than its occupied counterpart, but would also pay a lower level of rates. Thus, CV and AV rating provide a better match between funding and benefit (at least in this example).

More generally, neither CV nor AV provides consistently good matches. For example, a house worth \$2m will pay five times as much as a house worth \$400k (ignoring any differentials) but is highly unlikely to receive five times as much benefit. Indeed, benefits are more likely to accrue according to household size than property value. Thus, while better than LV, CV and AV are far from perfect.

Is there any reason to prefer CV over AV, or vice versa? Manukau City Council, which recently adopted AV rating, provides some interesting views.

“AV is a reflection of what a property can be expected to yield by way of rent. For residential property, rents are determined primarily by the number of bedrooms and the number of bedrooms provides an indication of the number of persons that can potentially be accommodated. Given that demand for services is in general driven by people, it follows that the number of persons that a property can accommodate is a reasonable proxy for benefits received. For the business property, rents are aligned to potential profitability and more intense use often results in greater profits. More intense use also generally results in a greater draw on infrastructural services and this results in a loose linkage between AV and benefits received. The rural sector is a mixture of residential combined with business - farms are businesses which also include residences and life-style blocks are primarily

²⁷ Of course, the robustness of AV rating depends not only on the robustness of rental information, but also the extent to which properties are assessed on this basis (rather than as 5% of CV).

residential. It follows therefore that the linkages between benefits and annual values are also present in the rural sector.

In terms of the above analysis, there is no apparent connection between LV and potential benefits received. CV shows some linkage but it remains somewhat vague. AV provides the clearest linkage to potential benefit from Council supplied services.²⁸

We agree with these statements.

Incentives to Develop/Improve

Some commentators claim that, unlike land value, capital value and annual value create disincentives to develop land or improve buildings. While this may be true (at least in theory), I doubt its practical significance. The incremental effect on rates of improving an existing building would be very minor.

Required Tax Rate

In general, the broader the tax base, the lower the tax rate. Moreover, the lower the tax rate, the more efficient the tax. So, which valuation base creates the broadest tax base? The answer is capital value, followed by land value, then annual value.

Need for Differentials

As we shall see in the next section, most councils use differentials to increase the funding load on business properties and decrease the load on rural properties. This raises an interesting question: to what extent could these differentials be removed or reduced if a different valuation base was used?

Assuming that councils wish to continue increasing the load on businesses and decreasing it on rural properties (and recalling the property distributions in Figure 7), it follows that AV requires lower differentials than CV, which requires lower differentials than LV.

6.3.3. Discussion

The choice of valuation base is clearly a difficult task and there are many factors to be considered. In our opinion, though, LV rating is an inferior choice. It typically generates unreliable rateable values (because there is so little sales data to work with) and also provides a poor match between funding and benefits received. It also requires higher differentials than AV and CV, everything else being equal.

The only saving grace for LV is that it is slightly less regressive (across residential ratepayers). However, this is not particularly important, since differentials can be used to correct any perceived regressivity with CV and AV.

For essentially the same reasons, we also prefer AV over CV. First, it is likely to generate more accurate rateable values, it provides the best match with benefits received, and it reduces the need for business and rural differentials (relative to CV and LV). The only

²⁸ Manukau City Council Rating Review 2006 LTCCP, p10.

shortcoming of AV is that it is more regressive across residential ratepayers. Once again, however, differentials can be used to correct this.

6.4. Rating Differentials

The LGRA permits Councils to set different rates (per \$ of rateable value) for different types of properties. These are usually expressed as multipliers of the residential rate, and are described as ‘differentials.’ For example, if the residential rate is \$1.00 per \$1,000 of property value and the business rate is \$2.50, the business differential is said to be 2.5.

Differentials may be used for various reasons, but are most often used to either:

- increase the load on business properties,
- decrease the load on rural properties, or
- ease the burden on high-value properties

In this section, we analyse the use of general rate differentials for each of these purposes.

6.4.1. Increasing the Load on Business Properties

In 2006/07, 40 local councils (and one regional council) set business differentials on general rates. Many set more than one. The chart below shows the distribution of *average* business differentials across local councils in 2006/07.

Figure 11: Average Business Differentials – General Rate (2006/07)

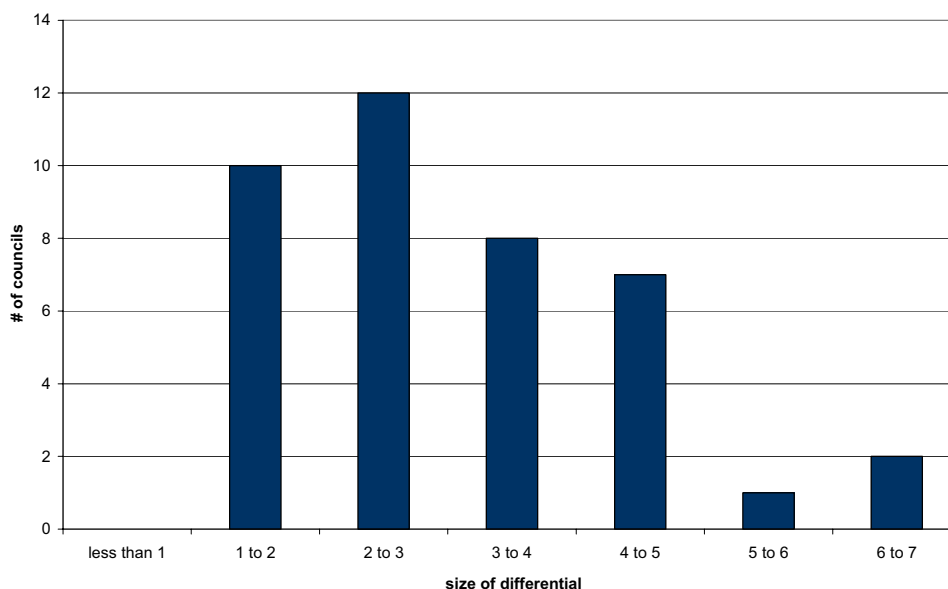


Figure 11 shows that differentials are indeed being used to increase the incidence of rates on businesses. This can be seen from the fact that there are no differentials less than one, but many that are greater than one.

There also seem to be differences across council types. This is summarised in the table below.

Table 1: Summary by Council Type

Type	Proportion	Average
Metropolitan	86%	3.55
Provincial	58%	3.26
Rural	40%	2.74
All Types	54%	3.20

Table 1 shows that metropolitan councils are more reliant on business differentials than provincial and rural councils. Specifically, 86% of metropolitan councils set business differentials with an average of 3.55, compared with 58% of provincial councils (average of 3.26), and 40% of rural councils (average of 2.74).

There are also a handful of extremely high business differentials for specialised industries. *e.g.* Clutha District sets a differential on hydro-electricity of 51, while Central Otago sets a hydro differential of 129.

Business differentials have long been a point of contention. Debate typically surrounds both their use (at any level), as well as the specific levels at which they are set. So, on what grounds could business differentials be justified? In general, differentials could be justified based on differences in:

- *Levels of Service* - if one group receives a higher level of service than other groups, or receives a disproportionate share of benefits, they should be charged more.
- *Ability to Pay* – if one group has greater means from which to pay rates, they should pay more.
- *Willingness to Pay* – if one group is willing to pay more than another group, it should bear a higher proportion of costs.²⁹
- *Cost* – if the cost of providing services to one group is higher than others, they should pay more.

In most cases, businesses receive the same level of service as other ratepayers, and at a similar cost to Council. This means that, in order to be justifiable, business differentials must reflect higher ability and/or willingness to pay. The first of these seems plausible.³⁰

²⁹ This may sound like an odd proposition, but it is based on the concept of Ramsey pricing, Ramsey pricing promotes economic efficiency by requiring groups with inelastic demand to face higher charges than those with more elastic demand. It minimises the deadweight loss of taxation, and is used in many industries. In this context, demand elasticity would be proxied by mobility. Thus, ratepayers that are relatively free (or willing) to move would be charged less than relatively immobile ratepayers.

³⁰ Whether or not they also have a higher *willingness* to pay depends on the relative steepness of the demand curves for property.

Indeed, even in the presence of differentials, business rates are a relatively small fraction of operating revenue (compared to residential rates as a fraction of disposable incomes).³¹

An extension of the ability to pay argument – which many councils use to justify their business differentials – rests on the observation that businesses treat rates as a tax-deductible and GST-refundable expense, while residents must pay the full amount.³²

Suppose, we wish to neutralise these differences in tax treatment by setting a business differential. What sort of differential would be set? The answer can be found by solving the following equation:

$$\text{Business} \times (1 - \text{GST}) \times (1 - \text{Income Tax}) = \text{Residential}$$

where:

- Business = business rate per \$ of rateable value
- Residential = residential rate per \$ of rateable value
- GST = the GST component of GST-inclusive prices (1/9th)
- Income Tax = business income tax rate (33%)

Thus, we need:

$$\text{Business} \times (1 - 1/9) \times (1 - 0.33) = \text{Residential}$$

Rearranging and simplifying, this becomes:

$$\text{Business} = 1.679 \times \text{Residential}$$

Hence, if we wish to accommodate differences in the tax treatment of rates, we should set a business differential of 1.679. Any differential in excess of this must be justified on other grounds.

However, the vast majority of business differentials *do* exceed this level. This means that either (i) business differentials reflect more than just tax differences, or (ii) most business differentials are too high.

We note in passing that even differentials based on tax differences are not universally accepted. The business round table, amongst others, continually attacks this approach (as well as the claim that businesses may pass costs on). Their reasoning is as follows:³³

³¹ Our work with a large Auckland council showed that, on average, business rates were less than 0.5% of operating revenues, while residential rates were around 2-5% of disposable incomes.

³² Yet another is that businesses can pass costs on, so should be charged more anyway.

³³ Seven Deadly Sins in Local Government: A presentation to Queenstown Lakes District Chamber of Commerce and Industry.

“First, there is minimal scope for businesses today to pass on higher costs in prices. Typically they are trading in competitive markets: the cost-plus days have gone. Many do not have to locate in high-rate districts. If the proposition were true, its implication would be that councils were really rating customers, most of whom would ultimately be residential ratepayers, in which case it would be more transparent to rate residential ratepayers directly.

Second, as the mayoral taskforce pointed out, all businesses are ultimately owned by individuals, who are generally treated on a consistent basis for income tax purposes by central government. Rates are a legitimate business expense to be deducted from gross income before tax is assessed. Just as wage earners do not get a tax deduction for residential rates, owners of businesses are also unable to deduct their residential rates from income. In respect of rates and taxation, the owners of businesses and other citizens are treated exactly the same.

Third, GST is a tax on final consumption spending. A deduction may be claimed on inputs, including rates, but businesses pay GST on all taxable output. This enables GST to be collected in stages and ensures that the correct amount of tax is applied to final consumption spending. The owners of businesses which distribute profits pay GST just like other consumers when their income is spent. Owners of businesses gain no special advantages through the operation of GST.

It follows that rating differentials should not be imposed in the belief that central government’s taxation policies favour businesses.”

We refute these claims. First, profit levels and the ability to pass costs on are largely unrelated. Indeed, even firms in fierce competition are predicted to pass the majority of their costs on (under the hypothetical model of ‘perfect competition’). Second, many customers are located outside the district in which the firm operates, and hence customers are not always residential ratepayers to the same local authority.

The second paragraph makes little sense and therefore requires no rebuttal. The third paragraph is also unconvincing. GST is not a tax on final consumption, it is a tax on value-added. Thus, holding everything else constant, the profit of a firm increases in direct proportion to its GST refunds.

6.4.2. Decreasing the Load on Rural Properties

In 2006/07, 39 local councils set rural differentials on general rates. No regional councils set any. The chart below shows the distribution of *average* rural differentials across local councils in 2006/07.

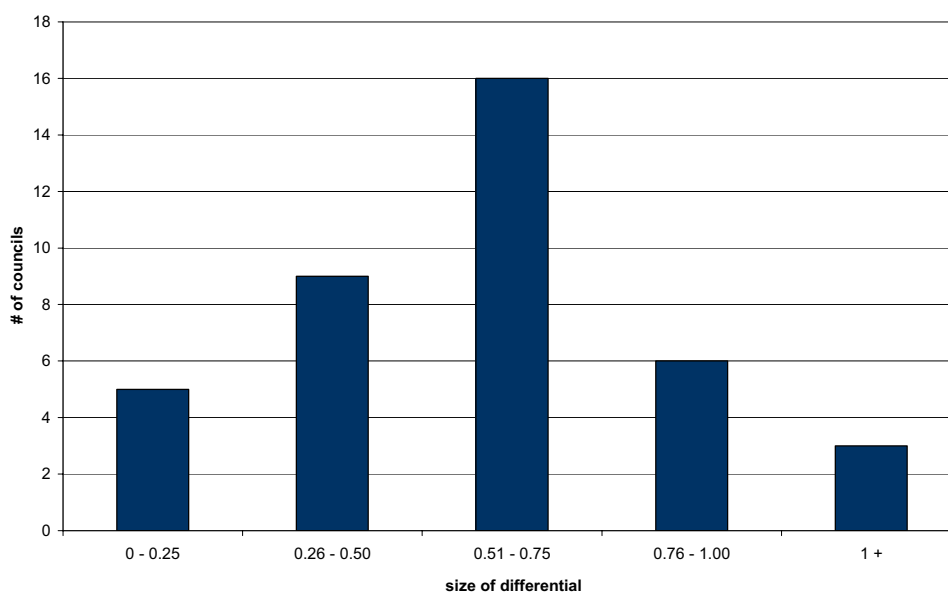
Figure 12: Average Rural Differentials (2006/07)

Figure 12 clearly shows that rural differentials are being used to ease the incidence of rates on rural ratepayers. Indeed, the overwhelming majority of differentials are less than one, with only a few greater than one.

Once again, there seem to be differences across council types in the use of differentials.

Table 2: Summary by Council Type

Type	Proportion	Average
Metropolitan	64%	0.66
Provincial	58%	0.59
Rural	48%	0.57
All Types	53%	0.60

Table 2 shows that metropolitan councils are more reliant on rural differentials than their provincial and rural counterparts. Specifically, 64% of metropolitan councils set rural differentials with an average of 0.66, compared with 58% of provincial councils (average of 0.59), and 48% of rural councils (average of 0.57).

We do not have any obvious explanation for this. Perhaps it reflects the possibility that, in metropolitan areas, rural properties are more disadvantaged (relative to other ratepayers) than in more rural areas?

Regardless of the reason, it seems useful to consider the grounds on which rural differentials may be justified. This can be done using the factors listed in section 6.4.1.

It is difficult to convincingly argue any differences in cost, ability to pay or willingness to pay. However, it can be argued that rural properties receive lower levels of service than urban properties. Indeed, most rural properties are distant from council facilities (such as parks, libraries and swimming pools) and thus use them less than other

ratepayers. Rural properties are often also more self-sufficient than urban properties. *e.g.* many rural properties supply their own water and stormwater services. Both justify a lower rate for rural properties.

6.4.3. Easing the Burden on High-Value Properties

The third main use of differentials is to ease the burden on high-value properties. For instance, Papakura District sets a differential of 0.75 per \$1 of residential value above \$320,000, while Kapiti charges a lower rate per hectare of rural land beyond 50 hectares (see the appendix).

While the intentions of these differentials are good (*i.e.* they seek to alleviate excess burdens), the outcomes they produce are far from desirable. In particular, the use of such differentials make rates more regressive than they would be otherwise. This can be seen in the following diagram.

Figure 13: Effect of High-Value Differentials

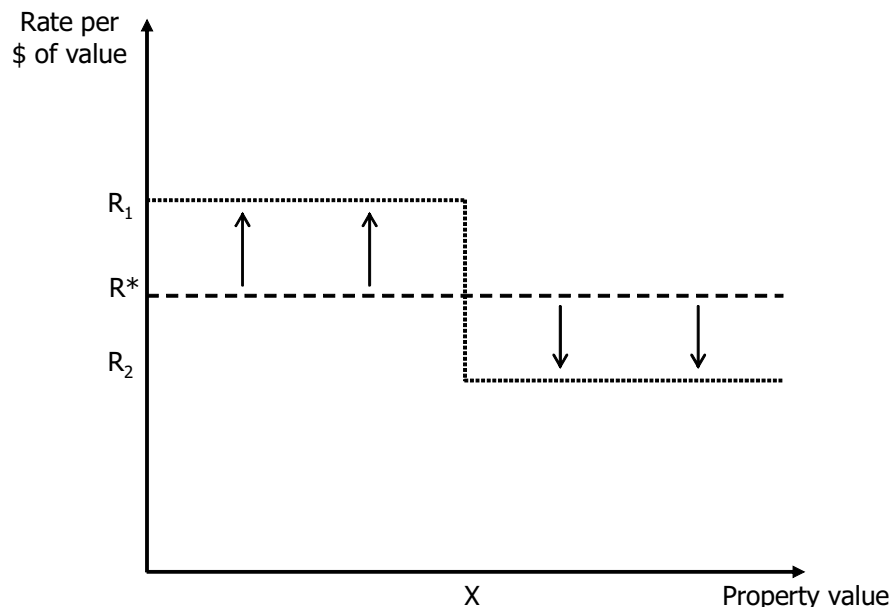


Figure 13 compares the rates (per dollar of rateable value) under two scenarios: one with the high-value differential, the other without. Under the “without” scenario, each property pays the same rate (of R^* per dollar of rateable value). Under the “with” scenario, the differential reduces the rate paid on every dollar beyond x (from R^* to R_2).

Because the rate (per dollar above x) has fallen, the total rates received from higher value properties falls. In order to balance the books, the rate applying up to x must increase. This can be seen by an upward shift of the curve from R^* to R_1 . The end result is patently regressive, because the rate per dollar of property value falls as property values increase.

6.4.4. Discussion

In addition to the three specific uses set out above, we have also reviewed broader uses of differentials. This was based on the sample of differentials set out in the appendix.

One of the most striking features of these tables was the lack of consistency between councils. For example, North Shore City charges a business differential of 6.55, while Auckland City charges a business differential of either 2.18 or 2.60.

There also appears to be a degree of variation *within* councils. For example, Clutha District sets a differential of 54.4 for properties in the Kaitangata Township, but only 2.20 for properties in the nearby township of Balclutha. This difference is difficult to understand (and is not explained in Council's Funding Impact Statement).

So, what has led to such divergent outcomes? The answer probably lies in the convoluted process via which most differentials are set. As far as we understand, the process is as follows. First, Councils decide the total amount of rates that need to be struck. Second, they decide what proportion of rates they wish to raise from each group (residential, rural, business, and so on).³⁴ Third, based on these target allocations, differentials are set.

Viewed this way, differentials are just a means to an end. Virtually any pattern of differentials can be justified simply by altering the target allocations. In our opinion, this is unacceptable. Differentials should be derived from a systematic and objective process of evaluation, not the result of an arguably arbitrary revenue allocation.

One alternative would be to work the process in reverse. Rather than starting with target allocations and using differentials to achieve them, Council's should start from a point of uniformity, then modify (*i.e.* set differentials) according to consideration of four factors listed previously:

1. Levels of Service
2. Ability to Pay
3. Willingness to Pay
4. Cost

If all these factors are the same, each group pays the same amount per dollar of rateable value. Any departures from uniformity must be clearly linked to the criteria above and properly documented.

While some Councils may find this approach unpalatable, it represents a vast improvement on the status quo. At the very least, councils should be obliged to explain

³⁴ While most councils insist these allocations reflect the relative benefit each ratepayer group receives from council services, this proposition is dubious on two counts. First, it is extremely difficult to assess the distribution of benefits with any reasonable degree of accuracy. Second, the target allocations often suggest that businesses receive up to 7 times as much benefit (per dollar of rateable value) as residents. We find this very difficult to believe.

their differentials in terms of the factors outlined above. Doing so would greatly enhance policy transparency.

6.5. Uniform Charges

The number of local authorities setting uniform charges decreased marginally from 58 in 2002/03 to 57 in 2006/07. Despite this drop, however, they accounted for a larger share of rates than in 2002/03.

Figure 14 shows that there has been a noticeable increase in the number of councils that raise more than 15% of total rates revenue from uniform charges.

Figure 14: Uniform Charges as % of Rates Revenue

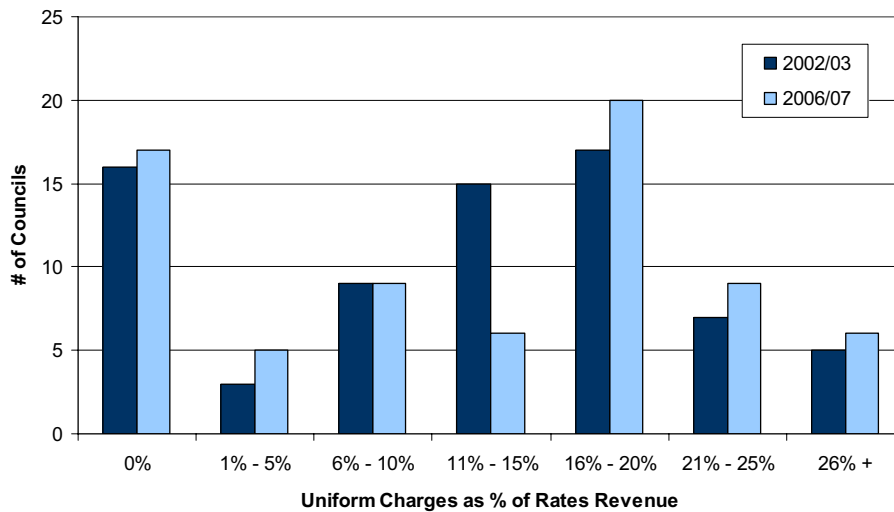
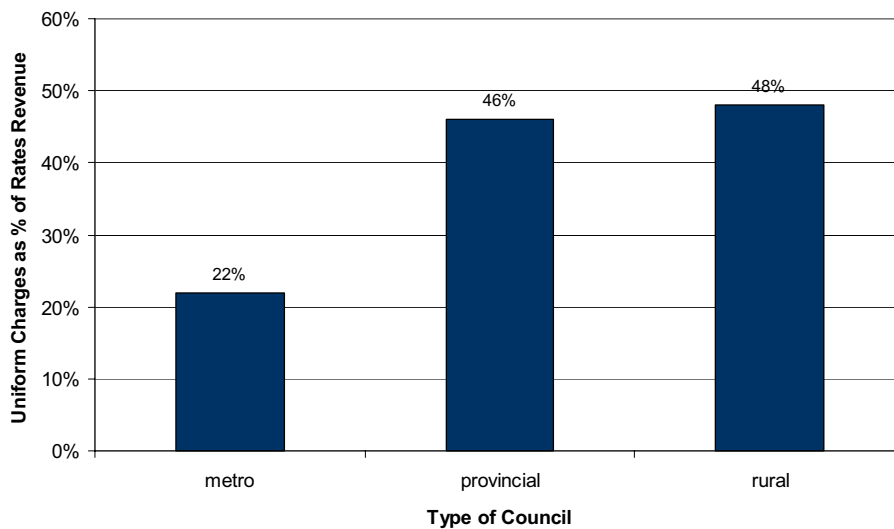


Figure 15 tests whether reliance on uniform charges differs by council type.

Figure 15: Comparison by Council Type 2006/07



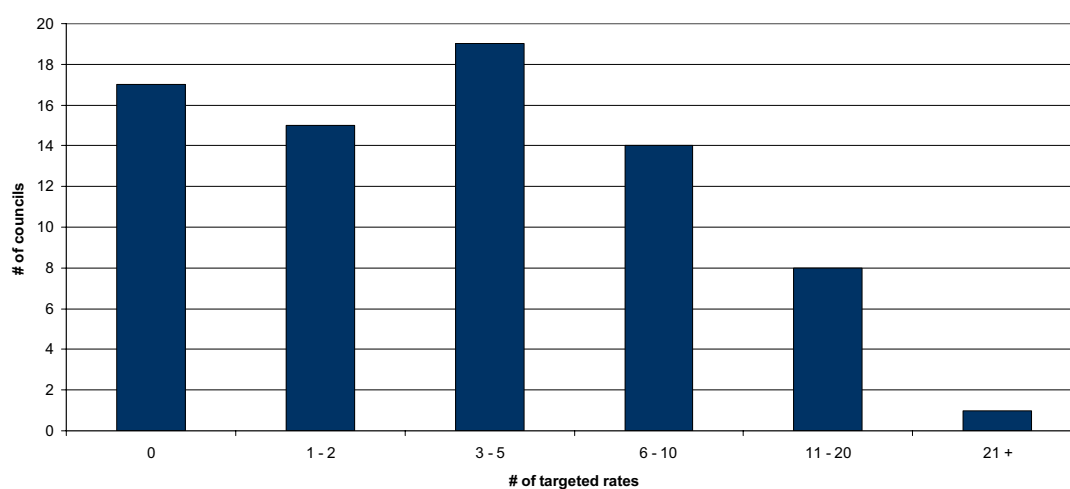
UAGCs appear to be far more important to rural and provincial councils than metropolitan councils.

6.6. Value-Based Targeted Rates

6.6.1. Number of Targeted Rates

In 2006/07, 57 local authorities levied a total of 355 targeted rates.³⁵ While the majority of Councils levied between one and five targeted rates, a handful levied more than 10.³⁶ The chart below depicts the number of targeted rates levied in 2006/07.

Figure 16: Number of Targeted Rates 2006/07 (Local Councils)



6.6.2. Valuation Bases

Despite significant variation in the means to which targeted rates were put, there was little variation in the valuation bases on which they were levied.

³⁵ Seventeen local authorities levied no targeted rates.

³⁶ One council levied 33 targeted rates in 2006/07, while, three councils that set no general rates levied 20 targeted rates each. This suggests that targeted rates are sometimes being used as substitutes for general rates.

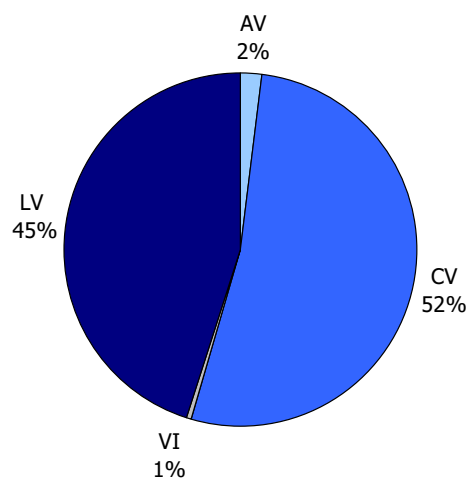
Figure 17: Valuation Bases for Targeted Rates (Local Councils)

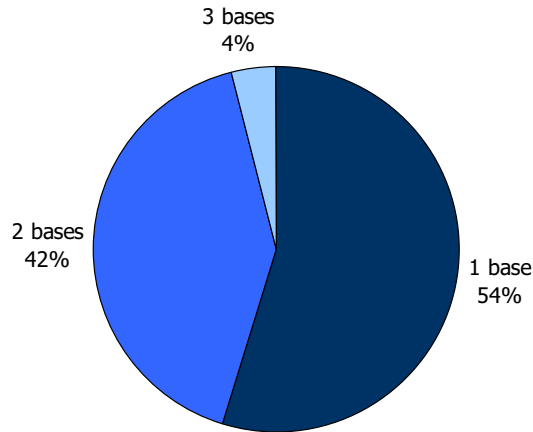
Figure 17 shows that 97% of targeted rates were levied on the basis of either LV or CV, with the remaining 3% on the basis of AV or VI.³⁷ In addition, one council levied a targeted rate for private drainage on the basis of the “value of work done.”

Given the large number of valuation bases on which targeted rates may be set, this suggests that very little use is being made of the extended charging powers under the LGRA. This finding corroborates earlier reports.

58% of councils that levied multiple target rates used the same valuation base for each. In contrast, 42% of councils that levied multiple target rates used 2 valuation bases and a further 4% used three different valuation bases. Thus, there seems to be some degree of thought put into using the most appropriate base for each rate.

³⁷ The two councils that used AV as the basis of targeted rates (Auckland City and Manukau City) also use AV for general rates. This choice may therefore simply reflect a desire for consistency, rather than anything more meaningful. Southland District used VI for its targeted rate on building regulation, while Thames-Coromandel used VI for its targeted rate on economic development.

Figure 18; Number of Bases Used for Targeted Rates (Local Councils)



6.6.3. Share of Rates Revenue

Figure 19 shows that the number of local authorities raising more than half their rates from targeted rates rose from 28 to 37, while the number raising less than half their rates from targeted rates decreased from 44 to 35. Three councils raised *all* their rates from targeted rates in 2006/07.

Figure 19: Targeted Rates as % of Total Rates Revenue

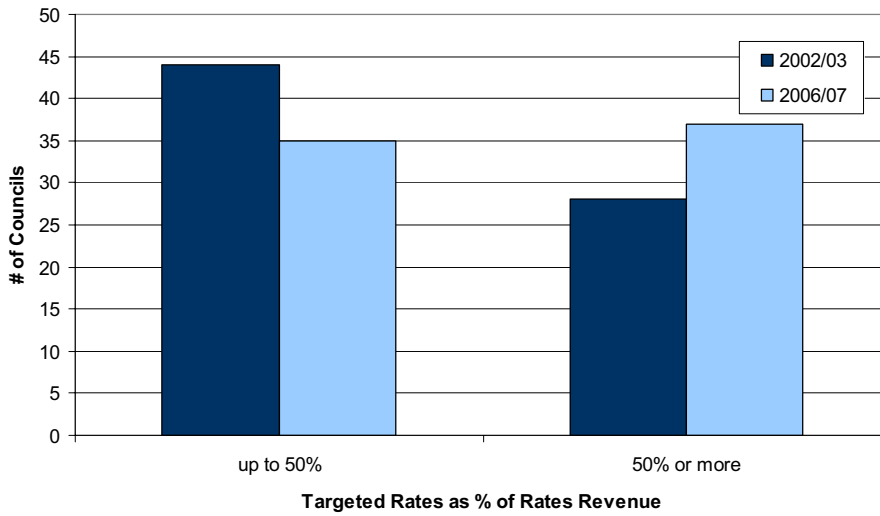


Figure 20 provides a more detailed distribution of targeted rates (as a percentage of total rates revenue) for 2006/07.

Figure 20: Targeted Rates as % of Total Rates Revenue 2006/07

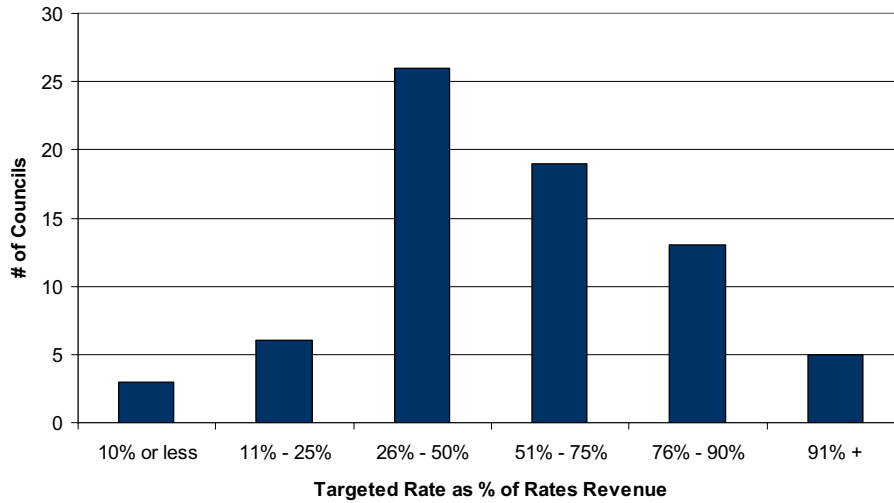
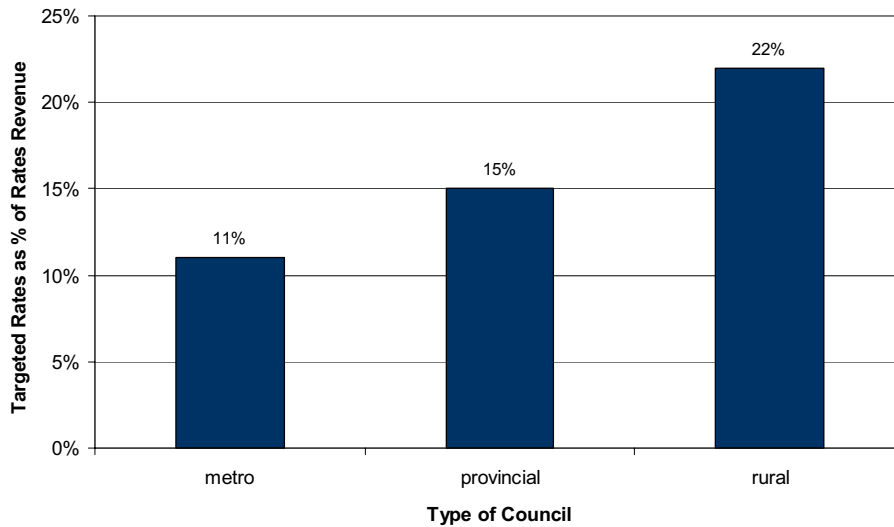


Figure 21 examines the extent to which reliance on targeted rates differs between metropolitan, provincial and rural local authorities. Like uniform charges, targeted rates are more important to rural councils than provincial or metropolitan councils.

Figure 21: Comparison by Council Type 2006/07

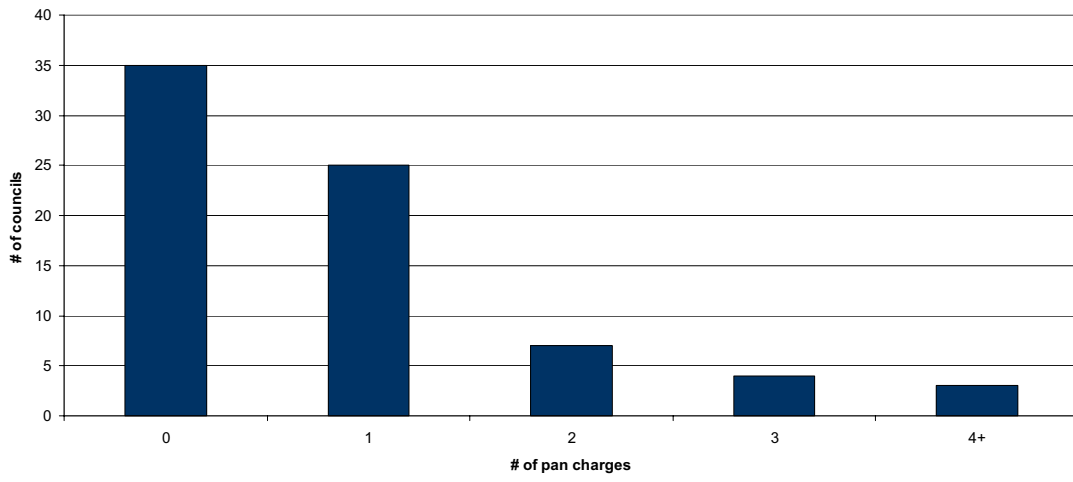


6.7. Pan Charges

‘Pan charges’ are essentially targeted rates for wastewater. They are usually based on the number of pans (or urinals) per property, or the number of connections to the wastewater network. In 2006/07, 39 local authorities levied pan charges, with a total value of \$120 million. The remaining 35 local authorities (and all regional councils) set no pan charges.

While the vast majority of councils struck either one pan charge (or no charge at all), a handful struck two or more. Once council levied 22 separate pan charges in 2006/07.

Figure 22: Number of Pan Charges in 2006/07 (Local Councils)

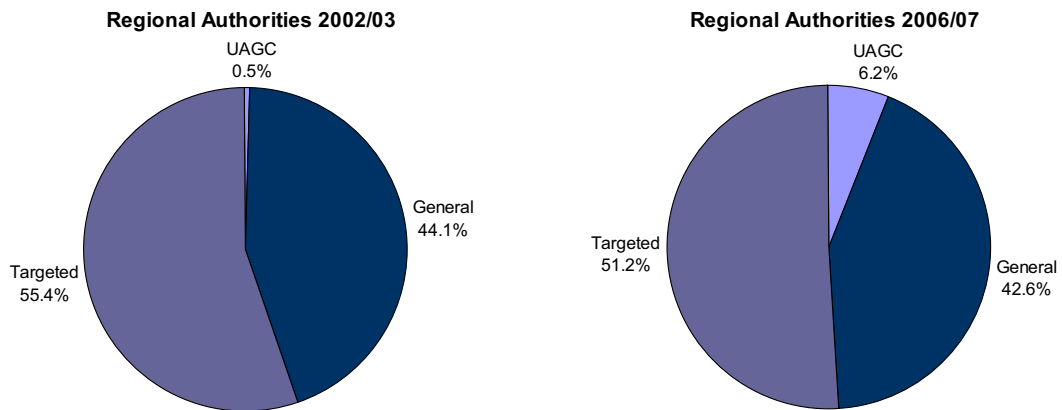


7. Use of Rating Tools – Regional Authorities

This section provides an overview of the use of rating tools by regional authorities since the introduction of the LGRA. It does not replicate the discussion of valuation bases and differentials in the previous section, however.

7.1. Allocation Over Time

Since 2002/03, regional councils have become increasingly reliant on uniform charges, and less reliant on general rates and targeted rates.



7.2. General Rates

In 2002/03, all regional authorities charged general rates. However, by 2006/07, two had ceased doing so. Figure 23 shows that the number of regional authorities raising more than half their rates from general rates has decreased dramatically.

Figure 23: General Rates as % of Total Rates Revenue

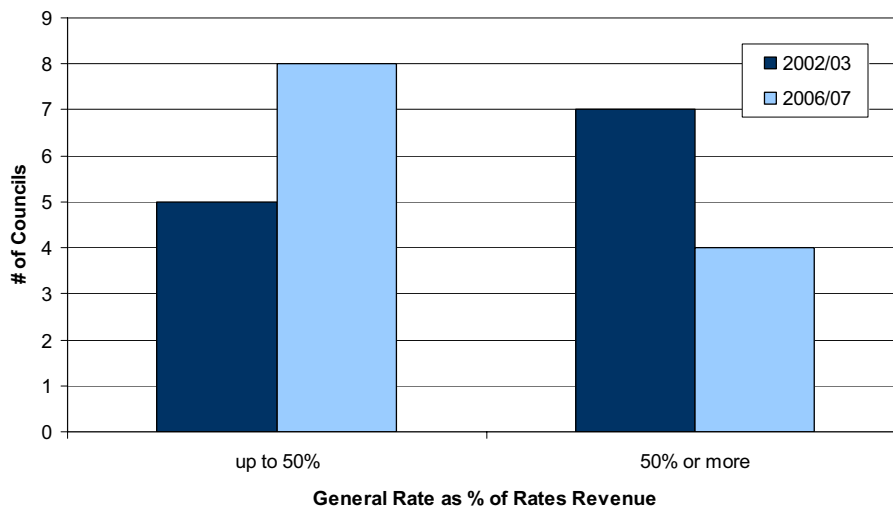
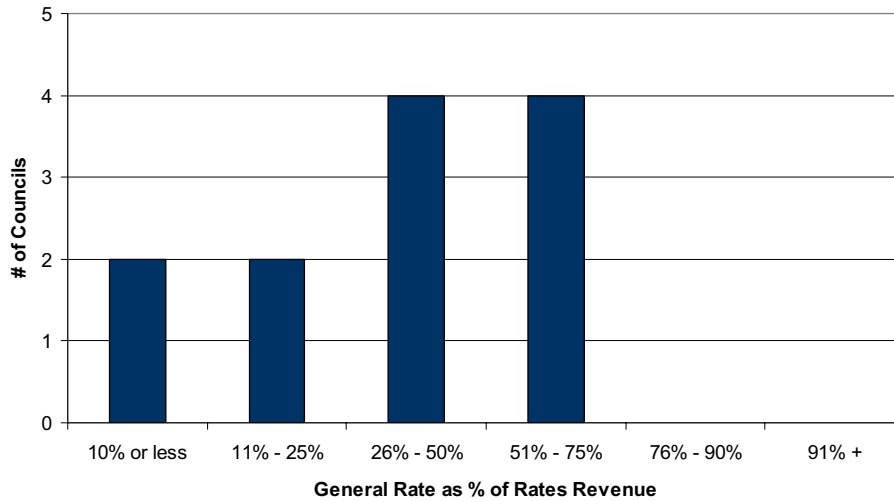


Figure 24 provides a more detailed distribution of general rates (as a percentage of total rates revenue) in 2006/07.

Figure 24: General Rates as % of Total Rates Revenue 2006/07



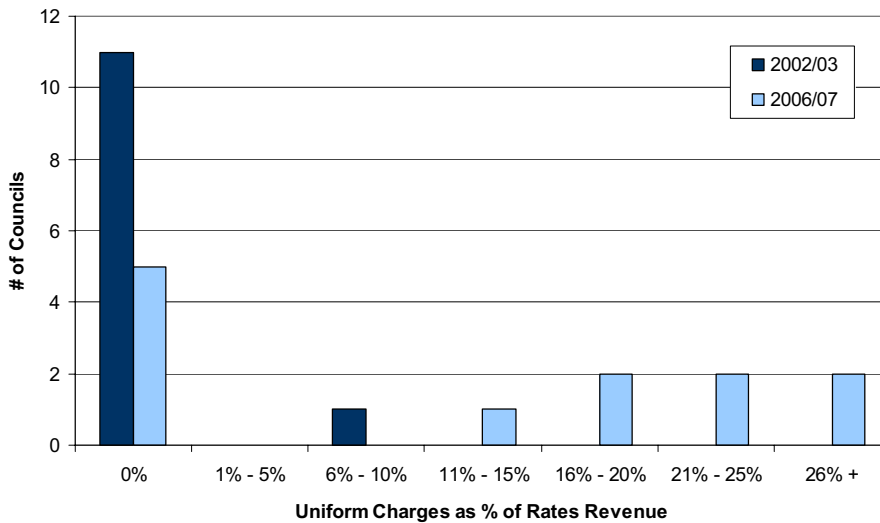
7.2.1. Valuation Bases

Of the 10 regional councils that charged general rates in 2006/07, the vast majority (80%) rated on capital value, with the remainder rating on land values.

7.3. Uniform Charges

The number of local authorities setting uniform charges increased from only one in 2002/03 to seven in 2006/07. Accordingly, there have been significant shifts in the share of rates earned from uniform charges.

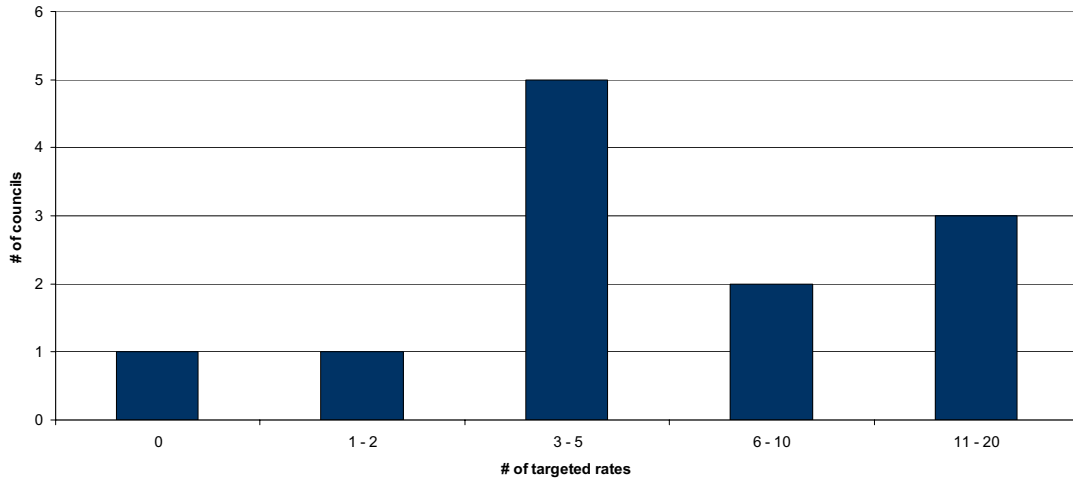
Figure 25: Uniform Charges as % of Rates Revenue



7.4. Value-Based Targeted Rates

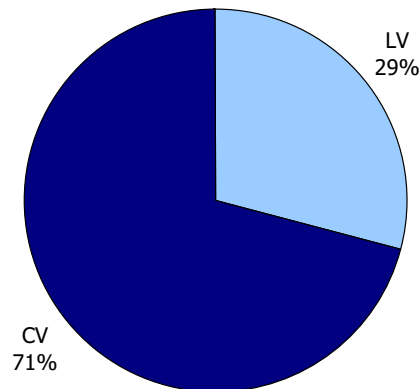
All regional councils (bar one) levied targeted rates in 2006/07. All together, 79 targeted rates were struck. The chart below summarises the number of targeted rates levied by regional authorities.

Figure 26: Number of Targeted Rates 2006/07 (Regional Councils)



While the *majority* of local authority targeted rates were set on the basis of LV or CV, *all* regional targeted rates were set on these bases.

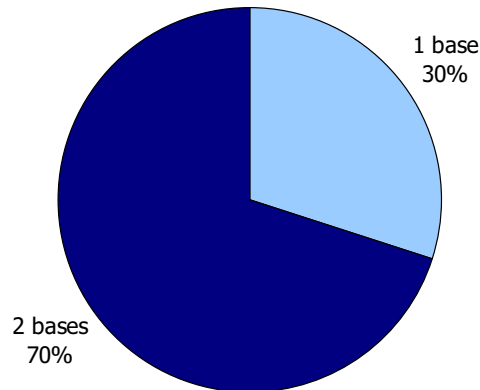
Figure 27: Valuation Bases for Targeted Rates (Regional Councils)



Hence, regional authorities are also making little use of new (targeted) rating powers.

Seven of the 10 regional councils that levied more than one targeted rate used more than one valuation base to do so.

Figure 28; Number of Bases Used for Targeted Rates (Regional Councils)



7.4.1. Share of Rates Revenue

Figure 29 shows that the number of regional authorities raising more than half their rates from targeted rates fell from six to five (with a corresponding increase in the number raising less than half their rates in this way). One regional council raised *all* their rates from targeted rates in 2006/07.

Figure 29: Targeted Rates as % of Total Rates Revenue

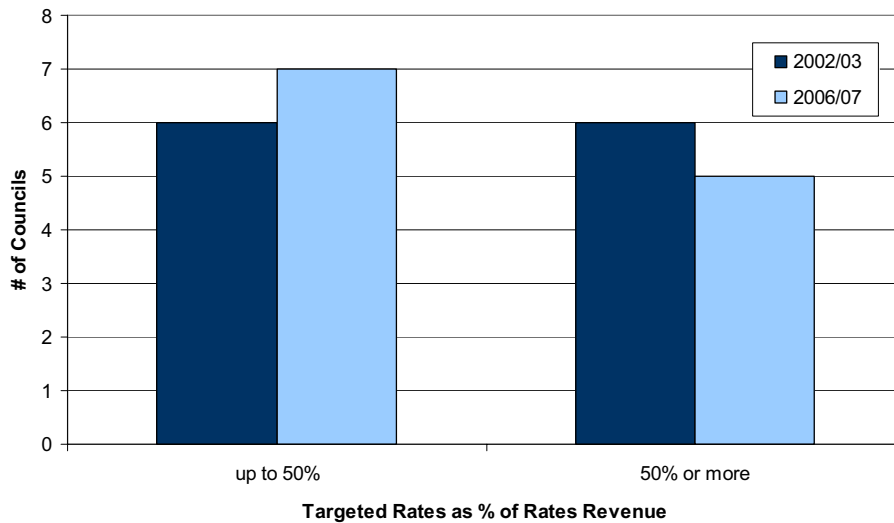
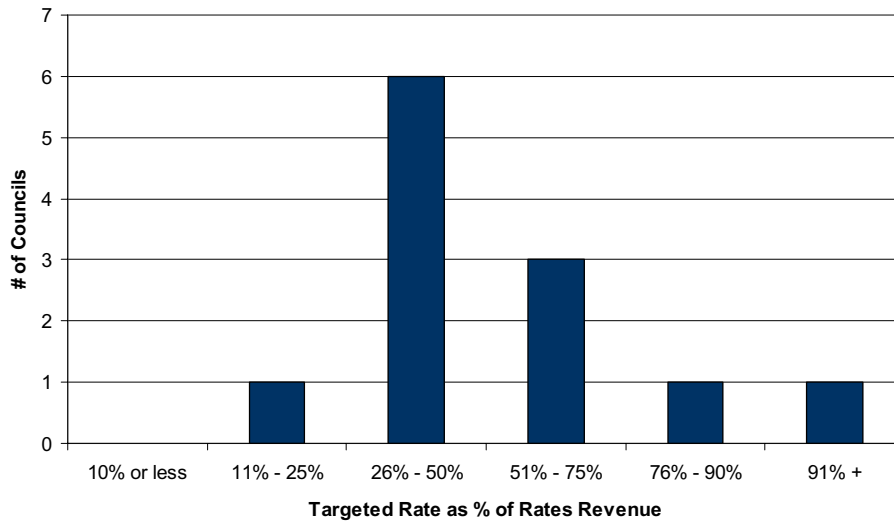


Figure 30 provides a more detailed distribution of targeted rates (as a percentage of total rates revenue) for 2006/07.

Figure 30: Targeted Rates as % of Total Rates Revenue 2006/07



8. Sector Feedback

During the writing of this report, we spoke to a number of rating policy managers and read a number of council submissions. The main topics of interest were:

- What use are you making of the extended targeted rating powers under the LGRA (if at all)?
- Do you think these changes were useful?
- What barriers do you face to the more beneficial use of rating tools, and how could these be overcome?
- Are there any practical actions that could enhance the use of rating tools?

A summary of our findings is set out below.

8.1.1. New Targeted Rating Powers

The LGRA amalgamated powers to set separate rates (under the old Rating Powers Act), and extended the means by which targeted rates could be calculated. For example, targeted rates may now be calculated with reference to floor space, the number of connections to reticulation systems, the number of water closets, and so on.

The introduction of these new powers was expected to be met with rapid uptake; but this never materialised. Even the office of the auditor general, in its first review of the LGRA, noted that:

“...we have yet to see the more innovative approaches that were expected to emerge with flexible targeted rating powers, such as rating for particular services. At this stage, most local authorities are merely using the targeted rating power to continue rates formerly levied as separate rates under the Rating Powers Act 1988.”

These sentiments were echoed by the various people we talked to, and also in submissions. But, why aren't councils making use of these powers? Reasons include:

- *Simplicity and transparency* – while these new targeted rating tools may provide a better alignment between funding and benefits, this will be at the expense of policy simplicity. Many consider simplicity more important for ratepayer acceptance than (seemingly marginal) improvements in the distribution of rates.
- *Transaction costs* – another manager noted that the uptake of these extended powers often entails the collection and collation of more information about each property. This was considered to be a prohibitively-expensive exercise (for little perceived benefit).
- *False Impressions* – yet another manager noted that rates (including targeted rates) are really just a tax. To this end, one should not give the false impression that rates are a fee for service by trying to align funding with benefits.

- *Inertia* – one manager noted that there was little internal or external drive for change (particularly at the councillor level), so little attention was paid to these new powers.

When asked whether these new powers were useful, the consensus was “not really.”

Our impression is that, while a useful addition to the funding toolbox, targeted rates are at odds with the premise that ‘rates’ are a tax and not a fee for service. Indeed, most council submissions have stated unequivocally that rates are a tax. It therefore follows that, to avoid the perception that rates are *not* a tax, the use of targeted rating powers is minimal.

8.1.2. Barriers to more Beneficial Use of Rating Tools

The next issue was whether there were any major barriers to the more beneficial use of rating tools. Although most respondents could not identify any *major* barriers, some noted that:

- *Consultation is too onerous* – under the LGA, councils must engage in unprecedented levels of consultation. While this has some obvious benefits, it also consumes a significant amount of council resources. It was argued that relaxing these requirements might allow councils to focus more on the task at hand, rather than being constantly held accountable to the (largely non-representative and inevitably divergent) views promulgated via consultation.
- *The cap on uniform charges is unwarranted* – several people thought that the 30% cap on uniform charges was at odds with the power of general competence afforded local authorities, and it should therefore be removed.
- *Property market volatility causes undue fluctuation in rates* – some officers noted that volatility in price changes across properties causes unmanageable swings in rating liability, and that this variability undermines confidence in the rating system generally.
- *There is significant political resistance to change* – many felt that the greatest hurdle was resistance at the councillor level. Despite wanting to try new things, it was simply too difficult to motivate the need for change amongst councillors.
- *Targeted rating powers give wrong impressions* – the same respondent that quashed the idea of using targeted rates to align funding with benefits also thought that the sheer availability of targeted rates was a bad thing. The rationale was the same as that given above – targeted rates provide a false impression that rates are a fee for service, when really they are just a property tax.
- *Targeted Rates are not flexible enough* – in direct contrast to the bullet above, one respondent claimed that targeted rating powers were not flexible enough. They

would like the ability to target absentee ratepayers and those that benefit from council's tourism initiatives.

- *The LTCCP is too complex* – one council noted that the sheer volume of information in the LTCCP makes it difficult to interpret, and that important information can easily be overlooked.
- *Ratepayers generally don't understand how rates work* – yet another respondent noted that there is a distinct lack of understanding amongst ratepayers in relation to rates and other council funding tools. This hampers efforts to try new approaches to setting rates.
- *Can't rate differentially on improved value* – one council would like to be able to rate differentially on the basis of improved value.
- *Invoice requirements are unhelpful* – some respondents claimed that invoice content requirements (as dictated by §46 of the Act) are more confusing than helpful, and should be relaxed.

These responses are consistent with our understanding of the issues. In general, there are more troubles with compliance (e.g. consultation and LTCCP preparation) than with the rating tools themselves.

8.1.3. Practical Actions to Enhance Rating Tools

Finally, we asked respondents to name any practical actions that could be taken to enhance the use of rating tools. Once again, most could not identify practical actions. However, some suggested to:

- *Relax consultation requirements* – as above, relaxing the consultative requirement of the LGA may free up resources, which are already very scarce.
- *Remove the 30% cap* – some want the 30% cap on uniform charges to be removed so that councils can decide the appropriate level.
- *Reword the definition of AV* - at present only 2 councils rate on the basis of AV. One of the apparent limitations of this approach is the way in which annual values are defined. At present, AV is the greater of (i) 80% of rental value or (ii) 5% of capital value. It was claimed that the 5% scalar on capital value is too inflexible, and causes the AV of most properties to revert to 5% of CV. One respondent requested that councils be allowed to set this CV scalar themselves to ensure that a sufficient number of properties are assessed on their rental potential. Otherwise, AV rating is just an overly-complicated version of CV.
- *Consider the use of valuation averaging* – this would help smooth volatility in the incidence of rates from one revaluation to the next. We note however, that it does not overcome issues with the accuracy of assessments though.

- *Relax LTCCP reporting requirements* – many of the details in the LTCCP are irrelevant to the majority of ratepayers and obscure those details that are more important. Relaxing the LTCCP reporting requirements might help overcome this.
- *Initiate national education programmes on councils and rates* – councils struggle to convey their mandate as well as explain the way rates are set each year. Centrally-led education initiatives may help address these issues.
- *Implement benchmarking* – many submissions noted a desire to be benchmarked against fellow councils. This could be implemented quite easily using web-based submission and distribution of data.
- *Relax invoicing requirements* - §46 of the Act should be reworded to provide more flexibility in the way that council's present invoices for rates. The current format is too detailed and confusing.
- *Allow volumetric charging for sewerage* – many submissions noted a desire for volumetric charging of sewerage. At present, council-controlled-organisations (CCOs) can charge in this manner, but councils themselves cannot. We support this recommendation.

We consider these suggestions prudent and timely.

Abbreviations

AV	Annual Value
CV	Capital Value
LGA	Local Government Act 2002
LGRA	Local Government (Rating) Act 2002
LV	Land Value
RVA	Rating Valuations Act 1998
UAGC	Uniform Annual General Charges
VI	Value of Improvements (=CV-LV)

Sample of General Rate Differentials

Auckland City

Differentials for general rates (and a number of targeted rates) are set for residential, non-residential, CBD non-residential, offshore non-residential and 3 rural categories. The third rural category is effectively exempt from general rates.

Table 3: Auckland City Differentials

Category	Differentials
Residential	1.00
Non-residential	2.18
CBD non-residential	2.60
Outer Island non-residential	1.86
Rural 1	0.86
Rural 2	0.27
Rural 3	0.00

Christchurch City

Three differentials - residential, business and rural - are set for general rates in Christchurch. Interestingly, the rural rate is higher than both the residential and business rates.

Table 4: Christchurch City Differentials

Category	Differentials
Residential & Other	1.00
Business	1.45
Rural	0.75

Clutha

Differentials are mainly used in Clutha to separate individual townships, but they are also used to rate separately for hydro-electric power generators.

Table 5: Clutha District Differentials

Category	Differentials
Rural	1.00
Balclutha Township	2.20
Tapanui Township	9.65
Milton Township	2.08
Kaitangata Township	54.40
Lawrence Township	2.73
Hydro Electric Generation	51.69
Clinton Township	6.62
Kaka Point Township	0.87
Owaka Township	3.99
Stirling Township	2.86
Waiholo Township	0.81

Kaikoura

Kaikoura sets rates differentially for four categories of land – residential, rural, commercial and special accommodation.

Table 6: Kaikoura District Differentials

Category	Differentials
Residential	1.00
Rural	1.20
Special Accommodation	1.20
Commercial	3.00

Kapiti

Kapiti Coast uses differentials to distinguish urban land from rural land. Two rural differentials are set: one for land up to 50 hectares, and one for land greater than 50 hectares.

Table 7: Kapiti Coast District Differentials

Category	Differentials
Urban	1.00
Rural (<50ha)	0.33
Rural (>=50 ha)	0.19

North Shore

North Shore City sets differentials for residential and rural, business, civic and other.

Table 8: North Shore City Differentials

Category	Differentials
Residential & Rural	1.00
Business	6.55
Civic	5.00
Other	6.55

Papakura

Papakura sets differentials across, and within, all ratepayer groups

Table 9: Papakura District Differentials

Category	Differentials
Residential (up to \$320k)	1.00
Residential (per \$ over \$320k)	0.75
Rural (up to \$1.45m)	0.62
Rural (per \$ over \$1.45m)	0.42
Business (general)	4.52
Drury Business	4.34
Business in residential zones	2.18
Business in rural zones	n/a

Tasman

Tasman uses differentials only to make infrastructural utilities exempt from general rates.

Table 10: Tasman District Differentials

Category	Differentials
Infrastructural Utilities	0.00
All other rateable properties	1.00

Wellington

Wellington City sets only two differentials: one for rural, residential and non-profit land uses; the other for commercial, industrial and business uses.

Table 11: Wellington City Differentials

Category	Differentials
Rural, Residential & Non-Profit	1.00
Commercial/industrial/Business	5.50

Westland

Westland district applies a number of differentials, many of which are residential.

Table 12: Westland District Differentials

Category	Differentials
Rural General	1.00
Small Holdings	1.42
Rural Residential	2.43
Rural Commercial	3.93
Commercial in Rural Res.	5.31
Hokitika Res. 1	6.24
Hokitika Res. 2	7.51
Hokitika Res. 3	8.78
Hokitika Res. 4	10.01
Hokitika Res. 6	11.25
Hokitika Commercial	9.38

Classification of Councils

Following is the classification of Councils into Metropolitan, provincial and rural (as used by LGNZ).

Metropolitan Councils

Auckland City Council
Christchurch City Council
Dunedin City Council
Franklin District Council
Hamilton City Council
Hutt City Council
Manukau City Council
North Shore City Council
Papakura District Council
Porirua City Council
Rodney District Council
Tauranga City Council
Waitakere City Council
Wellington City Council

Provincial Councils

Ashburton District Council
Far North District Council
Gisborne District Council
Hastings District Council
Horowhenua District Council
Invercargill City Council
Kapiti Coast District Council
Manawatu District Council
Marlborough District Council
Masterton District Council
Matamata-Piako District Council
Napier City Council
Nelson City Council
New Plymouth District Council
Palmerston North City Council
Queenstown-Lakes District Council
Rotorua District Council
Selwyn District Council
South Taranaki District Council
South Waikato District Council
Southland District Council
Tasman District Council
Taupo District Council

Provincial Councils

Thames-Coromandel District Council
Timaru District Council
Upper Hutt City Council
Waikato District Council
Waimakariri District Council
Waipa District Council
Wanganui District Council
Western Bay of Plenty District Council
Whakatane District Council
Whangarei District Council

Rural Councils

Buller District Council
Carterton District Council
Central Hawke's Bay District Council
Central Otago District Council
Clutha District Council
Gore District Council
Grey District Council
Hauraki District Council
Hurunui District Council
Kaikoura District Council
Kaipara District Council
Kawerau District Council
Mackenzie District Council
Opotiki District Council
Otorohanga District Council
Rangitikei District Council
Ruapehu District Council
South Wairarapa District Council
Stratford District Council
Taranaki District Council
Waimate District Council
Wairoa District Council
Waitaki District Council
Waitomo District Council
Westland District Council

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