New Zealand Business Roundtable

Submission on the Wellington City Council's
Draft Annual Plan 1997/98
Draft Long Term Financial Strategy 1997-2007
Draft Funding Policy 1997-99

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Summary

The Council can most efficiently contribute to the welfare of citizens in Wellington by focusing on its core activities, exiting non-core activities, and keeping its rate and regulatory burdens as low as possible. In our view, the Council is not sufficiently focused on these objectives.

In previous submissions we have supported the Council's stated objective of identifying its core services and abandoning non-core activities. We have noted, however, that progress towards achieving these objectives has been very slow. We remain concerned about the minimal progress being made.

The Council has stated that until the core services review project is completed in the second half of 1997, all services are assumed to be core. However, in our view some activities are so clearly outside the core responsibilities of the Council that they should be divested forthwith. These include marinas, off-street car parking, the Council's shareholding in the airport company and much of the commercial property it owns. Its proposed sale of $15 million of assets represents a modest step in the right direction.

The Council continues to fund and/or provide a number of services that are private or 'club' goods. There is no 'market failure' involved in the provision of these goods since people who benefit from them can be excluded if they do not pay for them. None of the services could be considered as 'essential'. In many cases they compete with similar private sector-provided services. Examples include swimming pools, recreation centres, and libraries. Full user charging, or privatisation, may see a reduction in the services provided - but only if the people who use the services do not value them sufficiently to cover the costs.

As we noted in last year's submission, divestment of private activities or the implementation of full user pays for private goods would substantially reduce the Council's reliance on rate funding of outputs.

The Council has adopted a number of equity criteria for deciding how to allocate the costs of the services that it provides. These criteria include the benefit principle, ability to pay, an affordability criterion, a requirement that essential functions continue to be funded, and a polluter pays requirement. These criteria conflict in many situations. Not surprisingly, the proposed cost allocations are arbitrary and inconsistent.

In our view, the Council's primary criterion for determining what services to provide and how to recover its costs should be economic efficiency. An economic efficiency standard is consistent with the benefit principle in many applications (although the economic efficiency standard requires additional conditions to be met).

While the annual plan and draft funding policy take some tentative steps towards requiring that private and 'club' goods be funded by users, the Council's application of its own mixed criteria has resulted in some strange allocations of costs. The supposed level of public benefit and therefore the proposed level of ratepayer funding for some Council activities defies logic. An example is the suggestion that 75 percent of the benefits of a library accrue to people who do not use it!

The Council proposes that commercial properties should bear a disproportionate share of the burden of funding public good activities on the basis of the taxation treatment of rates and a supposed greater ability to bear the rate burden.

The tax deductibility of rates and GST are not relevant to rating differentials. We have presented a number of submissions to the Council demonstrating why the tax status of ratepayers is irrelevant to decisions on rate differentials. This is a purely technical matter. If councillors have any remaining doubts on this issue, we would be happy to join with the Council in seeking a court or other independent ruling on it.

The Council's belief that commercial ratepayers have a greater ability to pay rates is not supported by any analysis. Businesses are owned by individuals. The services businesses produce are created by individuals, and the outputs are bought by individuals. The cost of higher rates to businesses will fall on these individuals. In a competitive market, once businesses have downsized in response to the higher rates, the higher costs will be largely borne by consumers. There is no evidence to suggest that consumers on average are better able to bear the tax burden imposed by rates than residential ratepayers.

Since none of the reasons proposed by the Council in support of allocating a disproportionate share of general rates on to the commercial sector stand up to scrutiny. Therefore the allocation of the rates burden between the commercial and residential sectors should be based solely on capital value. On this basis, commercial ratepayers should pay 22 percent (the capital value of commercial properties is around 22 percent) with residential ratepayers paying 78 percent of general rates. The Council's Option A (commercial ratepayers pay 36 percent and residential ratepayers pay 64 percent of general rates) is a move towards better reflecting the capital value of the commercial and residential sectors.

1 Introduction

This submission on the Wellington City Council's *Draft Annual Plan 1997/98*, *Draft Funding Policy 1997-99* and *Draft Long Term Financial Strategy 1997-2007* is made by the New Zealand Business Roundtable (NZBR). The purpose of the NZBR is to contribute to the development of sound policies that reflect New Zealand's overall interests. The NZBR has commented on the Council's four most recent annual plans as well as a number of its other discussion papers over the past four years.

The Wellington City Council is to be commended for working towards implementation of the requirements of the Local Government Amendment Act (No 3) 1996. We believe that the Act provides a helpful framework which will improve the accountability of councils. We therefore support the Council's moves to develop funding options based on the new provisions of the Act. However, we have serious reservations with some of the Council's analysis. Our reservations are discussed in more detail in sections 3 and 4 of our submission.

This submission is structured as follows:

- Section 2 comments on the process by which the Council determines its core and non-core activities. We note our concern at the possibility that public consultation might be seen as a substitute for sound policy analysis in determining the appropriate role of local government.

- In section 3 we present our view on what constitute the 'core' activities of councils. We note the slow progress being made by the Council in identifying and divesting non-core activities.

- Section 4 examines the Council's funding principles. We believe that the Council should adopt funding arrangements which conform as far as possible with the new provisions of the Act. However, we consider the analysis conducted by the Council to date is deficient. We point out that the Council has adopted a number of conflicting objectives which, not surprisingly, have resulted in an inconsistent and arbitrary approach to funding its services. We explain why the tax status of ratepayers is irrelevant to the recovery of rates.

2 Process of Determining the Proper Scope of Council Activities

The determination of the activities the Council is to be engaged in and how they are undertaken and funded needs to be based on sound public policy analysis. Consultation about council activities is an important part of the democratic process but is no substitute for good analysis and discharging the responsibilities of representative government.

There are numerous reasons why the overall interests of the community cannot simply be determined by collecting expressions of view through meetings, polls and submissions. Many people do not take part in such processes; the information available to elected representatives cannot be provided to the public in the same depth; individuals cannot be expected to devote the same amount of time to reviewing the relevant issues as do councillors; the cost implications of options are often not fully considered; trade-offs are difficult to assess; and the political process is vulnerable to the interests of organised and vocal minority interest groups - which benefit from successful lobbying - taking precedence over those of the unorganised and inactive majority.

Good representative government involves more than responsiveness to community pressures: it requires principled decision making and active leadership by elected representatives to promote, explain and justify sound council actions.

Similar arguments apply to councils' responsibilities for considering the interests of the business sector. The community's material welfare is ultimately dependent on the ability of businesses to operate productively and supply desired goods and services at the lowest possible cost. Business people are primarily focused on running their businesses efficiently and meeting consumer needs, especially in today's competitive environment. They are not focused on political decision making. Indeed, a major benefit of New Zealand's recent reform programme is that businesses are able to get on with their proper tasks with less political interference. Rather than attend meetings, make individual submissions and the like, business people typically present views through representative organisations and expect them to be weighed up on the basis of their merits not their numbers. Their attendance at meetings is no indicator of their concerns or the issues at stake for them.

The firms represented on the New Zealand Business Roundtable account for around 10 percent of New Zealand's gross domestic product and it is likely that they account for a similar fraction of economic activity in the Wellington region. It follows that they have a major stake in Council policies. It is sometimes suggested that the business sector should generate many individual and complementary submissions in response to consultation documents issued by councils on the grounds that some councillors are more influenced by 'counting heads' than by weight of argument, and that the interests of the commercial sector are neglected in favour of the interests of the residential sector which has more voting power. However, we regard such an approach as a waste of resources for both businesses and councils, and a travesty of sound public decision making. Our approach to Wellington City Council policies is not motivated by a goal of extracting advantages for businesses and is based on a public policy analysis of the role of local government and the principles of the legislation which now governs it. We hope the Council's deliberations focus on the merits of the analysis presented and any competing analyses.

3 Role of the Council

3.1 Introduction

The Local Government Amendment Act (No 3) 1996 requires the Council to give the "reasons why activities giving rise to the estimated expenses are to be engaged in". The Council is currently reviewing its activities with the objective of determining what are core and non-core services. The project is expected to be completed in the second half of 1997.

3.2 The Council's Role

The Council defines a core service as:[1]

"a) an output which contributes towards achieving Wellington City Council's strategic outcomes as defined by the Council's strategic plan, and

b) market failure exists: the private sector does not provide the output to the required level and/or quality and/or

c) there are no other effective options available for ensuring the output is provided."

The Council does not specify a criterion for determining its core activities. However, its statements are consistent with an efficiency standard.

Economic efficiency is about obtaining the greatest possible benefit from scarce resources. The efficiency standard is concerned with ensuring that the mix of outputs that individuals want is produced at minimum cost. The standard suggests that goods and services be produced by the provider that has the best incentives to satisfy individuals' needs at least cost.

Defining the role of the Council involves determining which activities are best (most efficiently) undertaken by households, firms and voluntary organisations and which necessitate Council intervention. Most goods and services that are valued by the community are provided privately. The fact that particular goods and services are considered valuable, or even desired by most people, does not constitute a sufficient case for Council involvement. Instead, the Council needs to demonstrate that the benefits of its intervention outweigh the costs, both absolutely and compared with alternative arrangements.

[1] Wellington City Council, *Draft Long Term Financial Strategy 1997-2007*, p. 7.

The prime justification for government involvement is that public goods[2] might be under-provided by the private sector, or that the existence of (large) externalities might lead to the under- or over-provision of some outputs. Governments have a role in regulating private activity when this can improve on economic outcomes.

A further legitimate governmental concern is equity (fairness) issues. In our view, equity objectives are generally addressed most effectively by central rather than local government. The view that local government should not undertake an income distribution role is broadly accepted within the sector. If, contrary to this view, the Council believes there is a strong case on equity grounds for providing some services to low income groups, this objective can be achieved more effectively by subsidising specific target groups rather than by providing services free or on a generally subsidised basis.

The focus of local as opposed to central government should be on the performance of regulatory functions conferred on it by central government and the provision of local public goods - i.e. public goods which provide benefits that are restricted to a particular region.

The existence of local public goods or externalities is not in itself sufficient justification for council involvement. Many activities produce third party effects, but are privately provided. Account must be taken of how councils operate in practice rather than how they might operate in a perfect world. Assessment of the relative efficiency of different providers requires careful assessment of the relative roles of central and local government, and of private, not-for-profit and for-profit organisations.

The demand for ratepayer-funded services will generally be excessive from an efficiency perspective if the people and groups using particular services do not face their full marginal social costs. Ratepayers are generally compelled to bear the costs that are imposed on them. Their opportunities to move to a more fiscally attractive region are constrained. For these reasons, the Council should not use its coercive powers lightly to force ratepayers to fund activities which they could readily fund themselves but which they choose not to fund. Likewise, it should not fund activities of a public good nature where the social costs outweigh the benefits. Rates distort behaviour and impose economic (deadweight) costs on the community which are additional to the losses in well-being arising from forcing some ratepayers to spend money against their will.

In general, goods and services are more efficiently produced by the private sector rather than by councils where production can occur on a commercial basis. Private providers normally have the best incentive to ascertain and satisfy individuals' needs

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[2] To qualify as a public good, a good must meet two conditions: one person's consumption of the good does not reduce its availability to another (it is 'non-rival' in consumption); and if the good is provided, the producer cannot prevent anyone from consuming it (the good is 'non-excludable').

at least cost. This suggests that the Council should exit from the production of private goods unless there are special reasons for continuing involvement.

3.3 Application to Council Services

In the *Annual Plan*, the Council proposes selling assets to the value of $15 million in 1997/98. Potential sales include:

- surplus land and property;
- Featherston Street (it is not entirely clear in the *Annual Plan* what the Council has in mind); and
- the Kilbirnie bus depot.

We support the divestment of these non-core activities, but do not believe that the Council has gone far enough.

The Council notes in the *Draft Long Term Financial Strategy 1997-2007* that "until the core services review project is completed in the second half of 1997, all services are assumed to be core".

This conclusion is not justified. The Council has been reviewing its activities for the past four years. In the 1993/94 annual plan, the Council concluded that off-street parking facilities and marinas were non-core services. These facilities provide private benefits; individuals can be excluded from using them if they do not pay; and such facilities can be (and are) provided by the private sector. They are clearly not core services and should be disposed of forthwith. The Council's reluctance to divest itself of activities that are so clearly outside its core responsibilities raises concerns as to its commitment to restrict itself to core activities.

We have argued previously that the Council's holdings of purely commercial activities should be divested. We remain of this view. The convention that income-generating activities 'hold down' rates is fallacious. The Council should divest its shareholding in the airport company and its substantial portfolio of property investments, since none of these constitutes a local public good. Little information is provided in the *Annual Plan* to enable scrutiny of these investments, including the risks they impose on ratepayers or the rates of return being achieved.

We are also concerned about the substantial costs that appear to be generated by the slowdown in the development of Lambton Harbour. There is insufficient information in the *Annual Plan* to allow us to comment in more detail on this issue. In our view, the Council should not be involved in the high risk activity of property development. It should transparently fund the development of open spaces and the like, and leave property development to the private sector.

In our view, the Council should not be in the business of providing or subsidising rental accommodation. Rental services are largely private, with few if any public

benefits. The vast majority of New Zealanders satisfy their housing needs through the private market for housing services, suggesting any problems in this market are not caused by a lack of housing stock but rather by a lack of income. The problem is tackled most effectively by supplementing income, for example through the accommodation supplement provided by central government, rather than through the public provision of housing. Central government through Housing New Zealand also owns a substantial portfolio of housing stock. The Council does not need to duplicate central government's functions at a high cost to ratepayers. The Council should dispose of the bulk of its housing stock as soon as practicable, as the Hutt City Council, the Auckland City Council and others are doing.

The Council produces a number of 'club' goods - swimming pools, the libraries, museums, and enclosed sports grounds. Club goods are goods which have some 'public' character - one person's consumption of the good or service does not prevent another's consumption up to the point of congestion - but people can be excluded from access if they do not pay. Since non-users can be excluded from these outputs, there is no market failure that might lead to their under-production. The Council should review its ownership and charging policies for these activities. If users are not prepared to pay for them, this should be seen as a signal that they do not value them compared with alternative expenditures.

Civil defence, stormwater (but not sewage) disposal, open access parks, reserves and spaces are examples of public goods which should be funded from rates. In some situations there may be a case for partial rate-based funding where the willingness to pay by direct users falls short of the costs of providing the services, and others who benefit cannot be directly levied.

The Council proposes a number of new activities or expansion of existing initiatives. Some of the more doubtful propositions and our brief comments on them are listed below:

- establishing a $10 million 'energy efficiency fund'. The interest from the fund would generate around $1 million per year to be used to encourage Wellington property owners to conserve energy. In our view there is no evidence that the market will under-provide energy efficiency investments. Central government already funds the Energy Efficiency and Conservation Authority to encourage energy efficiency investments - funding which is also questionable on market failure grounds. The proposal that the Council funds energy efficiency appears to be another example of duplication of the central government's functions at ratepayers' expense;

- combining current expenditure on marketing tourism, events and retail activities into a single fund administered by a single trust and funded by a levy on downtown commercial properties ($3.2 million per year). The Council has not demonstrated that the benefits of such expenditure outweigh the costs or

that those who benefit could not cooperate to provide the outputs without Council involvement;

- provision of free weekend parking (at a cost of $450,000). Parking provides a clear private benefit to the user. Free car parking also discourages private provision of car parks. The full costs should be recovered from users;

- development of an e (vision) centre (at a cost of $100,000). The Council has not demonstrated that this is a public good that would be under-provided by the private market, or that the benefits of its provision outweigh the costs. This development, along with other activities of the Capital Development Agency, provide private services which are better undertaken in the private sector. The Council can most effectively encourage businesses by minimising their rate and regulatory burdens;

- improvements to the Michael Fowler Centre, pool facility improvements and renovation of the Kilbirnie recreation centre. In our view these facilities should be sold; and

- development of a waterfront tram (at a capital cost of $1.5 million). Such a development will be undertaken by the private sector if it is commercially viable. A similar project in Christchurch has incurred regular losses. Such a transport facility provides private benefits and should not be funded or provided by the Council. If it is not commercially viable, ratepayers would be forced to fund operating losses into the future in addition to the capital costs.

In summary, the Council can make the best possible contribution to the welfare of citizens in Wellington by focusing on its core activities, exiting those that are inappropriate, and keeping its rate and regulatory burdens as low as possible. We are concerned that the Council is not sufficiently focused on these objectives.

4. Funding Principles

4.1 Introduction

The Local Government Amendment Act (No 3) 1996 provides a framework for determining how activities undertaken by councils are to be funded. The Act provides for analysis to be conducted in two steps: in the first step the benefit and efficiency principles are to be used to determine funding; the second step allows modification of the allocation of costs on other equity grounds.

In our view, the efficiency standard should be the primary criterion for determining the allocation of the Council's costs. Although the Act allows equity criteria to be used in determining funding, the result is likely to be inconsistent and arbitrary cost allocations.

We support the Council's moves to base its funding on the provisions of the Act rather than continuing with the status quo (or a modification thereof). However, we have serious concerns with the criteria the Council has adopted, the Council's application of its principles to specific services, and its reasons for imposing a disproportionate share of the rates burden on the commercial sector.

4.2 Funding Criteria

The Council uses a number of equity criteria in discussing how it should recover the costs of providing services. The criteria proposed include the benefit principle (those who benefit from an output should pay for it), an ability to pay criterion (those with high incomes should pay more than those with low incomes), affordability, and a requirement that essential services should be available to all.

The various equity criteria lead to conflicting cost allocations. The Council provides no guidance on what trade-offs are to be made when this occurs. For example, the benefit principle does not seek to equalise the distribution of wealth or make that distribution of wealth more equal. The costs of the output are imposed on the beneficiaries of the output who may be relatively wealthy or relatively poor. In many circumstances, the benefit principle will conflict with the ability to pay criterion which requires that those with a higher income should pay more. Not surprisingly, the allocation of costs using these conflicting criteria is inconsistent and arbitrary. In our view, competing and arbitrary equity standards do not provide a sound basis for recovering the costs of services provided by local government. Equity considerations are generally best dealt with through central government's social policies. Councils generally do not have the information or ability to effectively pursue income distribution goals.

The Council does not explicitly mention efficiency as a funding criterion despite the reference in Section 122F of the amended Local Government Act to economic efficiency. An efficiency standard applied to cost recovery would promote efficient pricing which balances the costs and benefits of services. Where the costs of producing outputs exceed the benefits, the efficiency standard suggests that output should be reduced.

An efficiency standard, like a benefit standard, would seek to recover the costs of private goods from those who use them. However, the efficiency standard asks what funding regime is likely to best balance the costs and benefits of producing more or less output, whereas the benefit standard is only concerned about ensuring that those who benefit, pay.

For public goods with an identifiable group of beneficiaries, the efficiency standard would support levying beneficiaries if that was more likely to lead to the production of the optimal level of output at minimum cost. In many (but not all) circumstances, an efficiency standard is consistent with the benefit principle (an equity standard),

although more stringent requirements must be met before a funding regime that is consistent with the benefit principle is also consistent with efficiency. The efficiency standard is consistent with the benefit principle if levying the costs on to those who benefit provides them with the incentives and ability to ensure that a given programme does not grow too large, and that the costs of production are minimised. If services are provided to a narrow group and their costs are spread thinly over all ratepayers, the group is likely to lobby for excessive levels of the service to be provided. Thus in many cases the benefit principle can be supported on efficiency grounds.

If the beneficiaries cannot influence the level of output produced, or the costs of production, the efficiency standard would not support levying that group. Instead, it would support raising the funds in a way that minimises distortions to behaviour. Generally, this would suggest funding from all ratepayers rather than from a sub-set of ratepayers.

The efficiency standard generally supports using rates to pay for public good outputs. If wealthier households are less responsive to the level of rates than poorer ones, and this effect is captured through rating on the basis of the capital value of properties, the ability to pay criterion (an equity criterion) may be consistent with the efficiency standard. This consideration would not, however, suggest that commercial properties should be levied at a higher rate than residential properties since it is by no means clear that commercial ratepayers have a greater ability to pay than residential ratepayers. (This latter point is discussed in more detail below.)

4.3 Efficient Recovery of the Costs of Council Activities

As discussed earlier in the submission, the Council should not in our view be in the business of providing private or club goods.

If, despite this argument, the Council continues to provide such goods, they should (on the basis of both the efficiency and benefit criteria) be funded from user charges. User charges enable consumers to directly express their preferences for goods and services through their spending decisions. They provide important information on the quantities and quality of services that consumers would prefer. Users are encouraged to conserve resources when they directly bear the costs of goods and services. When prices or charges track marginal costs, producers and users have incentives to modify their behaviour to better balance costs and benefits. It is this balancing of costs and benefits for the last units produced which leads to the better use of society's resources.

It may be efficient to recover the cost of club goods through two-part tariffs - a fixed fee to cover fixed costs (a 'membership' fee) and relatively low per visit fees. If the total costs are imposed on users, the consumers of these goods will fund them only if the total benefits outweigh the total costs. If users are not prepared to pay the total costs the outputs should not be provided. If ratepayers fund the fixed costs of these services, there will be no mechanism to ensure that the correct level of output is

produced. Given that the voices of the relatively few who benefit from the club goods are more likely to be heard than the voices of the many forced to pay the bulk of the costs, the likely outcome of ratepayer funding is over-provision of the good or service.

When user charges are levied, producers other than the Council are encouraged to enter the market and provide a greater diversity of services. Competition between suppliers helps to ensure that outputs are produced at the lowest possible cost. User charges also impose the costs of a service on the user whether or not he or she is a visitor or resident.

One of the major purposes of charging is to obtain signals from users as to the relative value they place on outputs. If individuals who use a service are not prepared to meet the costs of providing it, this means that they would rather spend their money on other things. This illustrates why an affordability criterion is generally undesirable.

Where goods are public (they are non-rival in consumption and it is very costly to exclude non-payers from benefiting from them), user charges may not be feasible and rate-based funding is justified.

The benefit principle would support allocating rates between the commercial and residential sectors on the basis of the relative value of the services provided to each after taking account of direct charges. The efficiency standard would support such an allocation to the extent that this better ensured that there was a balancing of the benefits and costs of the services provided.

In a political regime where councillors are elected by the votes of residential ratepayers, it is not surprising that councillors are tempted to 'win' votes by favouring residential ratepayers in the allocation of rate burdens. Although residential ratepayers might appear to receive a 'free lunch', in the longer term such a policy imposes substantial costs on all. In the short term, commercial property owners have substantial sunk cost investments in the city. Their decisions on location may not be immediately affected by opportunistic allocations of the rate burden. But in the longer term, disproportionately high rate burdens will change business decisions. Fewer business will locate in Wellington. Employment opportunities will be lost. Profits will be reduced, prices to consumers increased and shareholders adversely affected.

4.4 Funding of Specific Services

The Council has reviewed most of the services that it provides, assessing whether or not the output is a public or private good, and the degree to which benefits are private (accrue to individuals who could be identified and charged for the service) or the community more widely (public). It proposes a cost recovery regime based on the allocation of benefits.

The Council's general approach is in line with the new financial management legislation. However, the application of its own principles appears to have been

strongly influenced by political considerations rather than by rigorous analysis. The estimates of public and private benefits of different services have changed dramatically over the course of the first six months of the year. A process that can result in such arbitrary changes in allocations gives no comfort that it will provide a satisfactory basis for allocating costs and creates uncertainty for households and firms.

We note below some of the services where the assessment of private and public benefits is most questionable.

Water and Sewerage

The Council suggests that only 25 percent of the benefits from the supply of water accrue to the individuals receiving the service. This lacks credibility. While there are some public benefits from a private household's use of water (there may be some public health effects), these are relatively small compared with the private benefit. All or most of the costs of water supply should be recovered from users.

The Council proposes that uniform annual charges of $100 be imposed for sewerage and water ($200 in total) on each ratepayer. The proposal is a step in the right direction given that these services tend to benefit households on a per capita basis rather than on a property value basis. A uniform charge increases the transparency of the costs of these services, and is a useful move towards a more commercial approach to their provision. The Council's move to voluntary metering represents some progress towards a more efficient user pays regime for water use. On both economic and environmental (water conservation) grounds, a more comprehensive metering policy should be introduced as soon as possible.

We support the proposal to put the task of repairing and maintaining the water supply system out to competitive tender.

Library Services

The suggestion that the public benefit from library use is as high as 75 percent defies logic. It implies that whenever someone borrows a book from the library or otherwise uses the library resources, other people receive 75 percent of the benefit. On the other hand, if someone buys a book from a private bookshop, the implication is that there is no public benefit (otherwise by its logic the Council should propose that this activity be subsidised).

Given that library facilities (particularly those libraries sited in some of Wellington's more affluent suburbs) are predominantly used by better-off people, undercharging for library services may in fact have a negative impact on income distribution. The suggestion that the library be subsidised because it is a meeting place for people is also strange given the wide range of private alternatives (such as cafes, private homes, etc).

The costs of most library services should be wholly or largely recovered from users.

Swimming Pools

The benefits from swimming accrue to individuals using swimming pools. Health benefits are private benefits. Learning to swim is a private benefit. Public swimming pools are just one of many competing activities that individuals can engage in to become fit or learn to swim. The costs of swimming pools should be wholly or largely recovered from users.

Recreation Centres and Community Halls

The benefits of these centres accrue to those who use them. The benefits to the public in general are small. The costs should be fully recovered from users. If the Council wants to subsidise particular groups that use the facilities it should do so by explicit grants.

Housing

The Council provides 2,340 subsidised housing units. It suggests that "having the streets empty of homeless and the avoidance of shanty towns" justifies a 75 percent subsidy from the community.

In our view, the benefits from housing are almost entirely private so that the costs of housing should be fully recovered from users. Other New Zealand cities where council housing is not provided do not have homeless people on the streets, or shanty towns. If there are any problems with access to housing, these are better handled by central government's tax and welfare policies rather than by local government provision of housing.

4.5 The Council's Approach to Funding Public Benefit Outputs

The Council has proposed six funding options for recovering those costs that are not covered by user charges: three are based on the analysis that will be required by the Local Government Amendment Act (No 3) 1996 when it comes into effect and three are based on the same methodology as used last year.

The first three options allocate rates between commercial and residential ratepayers on the basis of the benefit principle, with a residual amount allocated between commercial and residential ratepayers on other equity considerations.

The second three funding approaches do not first allocate the costs of services on the basis of the benefit principle. Instead, they allocate the full burden of rates between the sectors on arbitrary equity grounds.

The equity considerations which the council has taken into account in allocating the rate burden between residential and commercial ratepayers are the following:[3]

(a) concerns about residents' ability to pay - particularly those with low incomes or on welfare benefits;

(b) the 'taxation advantages' purported to accrue to commercial ratepayers;

(c) the ability of businesses to pass on costs through higher prices;

(d) the Council's desire that costs be passed on to visitors to the city and people who work but do not live in the city; and

(e) concerns that an increase in residential rates would reduce residential discretionary income with a consequent adverse impact on commercial ratepayers.

We comment on these criteria below.

Concerns About Ability of Residents to Pay

The efficiency criterion focuses on levying rates to pay for public benefits in a way that minimises distortions to individuals' decisions. If rates are too high, individuals will choose to locate in other areas or will build or purchase houses that are of lower value (since this reduces rates).

The point was made earlier that the Council has no direct and systematic way of directly determining who is wealthy or poor, and can only rely on the proxy of capital value which will sometimes but not always be related to wealth. There is no evidence to suggest that businesses (their owners, customers etc) have a greater ability to pay than residents.

Taxation 'Advantages'

The tax deductibility of rates and GST is not relevant to rating differentials. Because of the continuing confusion on this issue, we attach as an Appendix a letter recently sent to the Council. Our arguments are summarised below.

The focus on the deductibility of rates payable by businesses overlooks the assessability of related business income (i.e. excluding implicit rents). A firm can only deduct expenditure on rates if it uses the relevant property in an income-earning activity. Deductibility and assessability generally go hand in hand.

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[3] Wellington City Council, *Draft Annual Plan 1997/98*, p. 38.

Provided that a business earns a profit, which is the aim of all businesses, its before-tax income will be reduced by taxes. The business would be better off if it were free of tax and unable to deduct rates and other expenditure.

The householder appears to be disadvantaged because he or she is unable to claim a deduction for rates whereas a business is able to do so, but this is only half the story. The income for the business is taxed, whereas the income that accrues to the householder (the imputed rents deriving from home ownership) is not.

If businesses were offered the opportunity to be exempted from income tax, provided they gave up the right to claim tax deductions, most would be keen to do so. However, few households would want to be taxed on the gross economic income that accrues from owner-occupation if deductions were allowed for related expenditures such as rates.

Owners of rental housing are already in a disadvantaged position vis-a-vis owner-occupiers. Although they can deduct rates expenditure in calculating their tax, they must pay income tax on the net rental income. Thus, if they obtain some net income from the rental property they must pay tax on it whereas owner-occupiers pay no tax on the implicit rental value of their homes.

GST is intended to be a tax on final consumption spending. For this reason firms, but not consumers, can claim a deduction 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 consumption spending. It avoids a cascade effect where the amount of tax is affected by the number of traders involved in the production and distribution of goods and services. The owners of businesses which distribute profits pay GST just like other consumers. Owners of businesses gain no special advantages through the operation of GST.

This incorrect approach to the issue of differential rating is a matter of technical analysis which should be disposed of once and for all. Arguments for differential rating should be advanced on other grounds.

Superior Ability of Businesses to Pay

Rates are a cost that must be met by individual people. 'Businesses' are not entities separate from individuals. Ultimately the costs are borne by individuals. If rates are levied on businesses, the costs will be borne by individuals. These individuals may be shareholders, employees, consumers or other input suppliers. If the rates burden is increased in Wellington, profits will be reduced and some businesses will be forced to close, downsize, or relocate, imposing costs on shareholders. Adjustments will occur to the point where the remaining businesses can earn the normal risk-adjusted rate of return for that activity. The businesses facing higher costs will pass some of these costs on to consumers - their ability to do so will depend on whether or not competing businesses face similar costs. Employees may also bear some of the higher rate

burden. Some employees will lose their jobs, or may have to accept lower wages. Owners of land and buildings may suffer a capital loss if businesses move out of the Wellington area. If the relative level of rates is higher in Wellington than in other regions, businesses will relocate to those other regions and consumers will tend to shop at cheaper locations. Once adjustments have been made to the higher rates (through the downsizing of businesses) the costs of higher rates will be largely borne by consumers. The Council has produced no evidence that consumers or the other individuals affected have a greater ability to pay for Council-provided services than residential ratepayers.

Imposing Costs on Outsiders

The Council suggests that by levying commercial properties it can pass some of the costs of public goods on to non-residents. This suggestion recognises that if higher costs are imposed on businesses, they will attempt to pass them on to their customers. To the extent that their customers live outside Wellington city, this would result in some of the Council's costs being shifted to non-residents. It is not clear how significant this impact might be - it is likely to vary greatly between businesses and be quite arbitrary.

If the Council relies to a much greater extent on user charges, it will be able to directly recover the costs of services from those non-residents who benefit from them. This is a far more efficient and fair way of financing services than applying a crude rating differential.

Impacts on Commercial Activity

The argument that an increase in residential rates reduces residential discretionary income and hence has an adverse effect on businesses has some validity. However, an increase in commercial rates similarly affects the discretionary income of owners of businesses and their employees. In addition, businesses are hurt by higher rates and will try to pass on higher costs to their customers. Residents who buy goods and services from Wellington-based businesses will face higher prices. The conclusion to be drawn is not that rates should be reallocated in favour of residents but that overall Council spending and hence rates should be held down if business activity and employment in Wellington are not to suffer.

4.6 Summary

The proposed rate increases for 1997/98 and the higher increases foreshadowed for future years are contrary to expectations generated at the time of the sale of Capital Power and are harmful for regional development. The Council should be aiming for rate reductions, along the lines of central government's programme of tax reductions, by focusing on its core activities and pursuing a more aggressive strategy for cost reductions. This would achieve a substantial downsizing of the Council's activities.

We support the Council's move to implement the provisions of the Local Government Amendment Act (No 3) 1996. We therefore favour the funding options proposed by the Council based on this approach. However, the Council must adopt a more rigorous approach to determining the allocation of costs. As discussed above, the supposed level of public benefit for some Council actvities is unsupportable.

The residual costs for public outputs that cannot be attributed to particular groups should be funded from general rates as the Council has proposed. None of the equity or taxation reasons proposed by the Council in support of allocating a disproportionate share of general rates on to the commercial sector stands up to scrutiny. Therefore the allocation of the rates burden between the commercial and residential sectors should be based solely on capital value. On this basis, commercial ratepayers should pay 22 percent (the capital value of commercial properties is around 22 percent) with residential ratepayers paying 78 percent of general rates. The Council's Option A (commercial ratepayers pay 36 percent and residential ratepayers pay 64 percent of general rates) is a move towards better reflecting the capital value of the commercial and residential sectors. Further steps should be taken in a medium-term (3 - 5 year) timeframe.

12 May 1997

Mr Mark Blumsky
Mayor
Wellington City Council
P O Box 2199
WELLINGTON

Dear Mr Blumsky

I am writing to you about the relevance of income tax and GST to the allocation of rates between residents and businesses. We believe that the Council's proposal to take income tax and GST into account in allocating rates between these sectors is based on a mistaken analysis. We think this is a purely technical issue on which it should be possible to reach a clear-cut agreement.

We appreciate the constructive approach that the Council has adopted in reviewing its funding policy. The mayoral taskforce and similar initiatives facilitated input from business and other groups and helped to raise the level of debate. We have also had useful discussions on this matter with Council officers Messrs Bill McDonald and Andrew McKenzie.

The treatment of income tax and GST in allocating rates between the commercial and residential sectors is an important issue for the community. A number of councils and the courts believe that businesses are advantaged by their ability to deduct rates for income tax purposes and to claim an input credit for GST paid in respect of rates. We believe that this view is simplistic. The attached paper presents our analysis of the issue. The argument is summarised in the following paragraphs.

While firms are able to claim an income tax deduction for rates, their revenue is assessable for tax purposes. The deductibility of expenditure and the assessability of revenue need to be considered together because firms are taxed on their net income. Economic analysis unambiguously shows that taxable activities are penalised relative to tax-exempt activities, such as homeownership. This is the reason why many homeowners oppose any suggestion that the implicit net rental income that arises from homeownership should be taxed. (We are not suggesting that such rents should be taxed.)

In the case of GST, the key argument is that parliament deliberately sought to tax final consumption spending by individuals rather than intermediate inputs, such as raw materials, which are used by firms to produce goods and services. There are administrative, compliance and other efficiency advantages in collecting GST progressively through firms rather than directly from consumers, for example via a retail sales tax. The Council's decision to take GST into account in allocating rates effectively changes the class of tax that parliament approved. Businesses do not typically charge different prices (exclusive of GST) for comparable goods and services supplied to GST-registered traders and final consumers. We see no valid reason why the Council should do so in respect of those services which are funded by rates.

If the Council is serious in its view that an income tax deduction and a GST input credit for rates should be taken into account in allocating rates, it should reclassify all rateable property to reflect the related treatment of rates for income tax and GST purposes. This would, for example, require rates on houses that are rented to be levied at a level that reflects the claimed income tax advantage. It would also require residential houses that are used in conducting business activities to be similarly treated. On the other hand, properties that are used by businesses in undertaking charitable and other tax-exempt activities would be treated on a more favourable basis than other commercial property. Property used in GST-exempt activities, notably most financial services, would be subject to a lower level of rates than other commercial property. A consistent application of the Council's view would be a major undertaking and could have significant revenue implications for the Council.

The purpose of this analysis is not to argue that there are no grounds for setting differential rates - merely that tax should not be a factor. Other possible grounds should be considered on their merits.

The Council's draft long-term financial strategy, funding policy for 1997-99 and annual plan for 1997/98 confirm the Council's intention to take income tax and GST into account in allocating rates. We believe that the Council's proposal should be reconsidered now. For that reason, I have written to you before making submissions on these documents. I would appreciate your comments on this analysis and an opportunity to discuss it with you.

Yours sincerely

R L Kerr
EXECUTIVE DIRECTOR

INCOME TAX, GST AND RATES

The previous Wellington City Council argued that if business and residential ratepayers were to face the same effective rate burden, businesses would generally need to be charged $1.68 for each $1 of rates imposed on residents. This view was predicated on the assumption that businesses were advantaged by their ability to claim an income tax deduction for rates and a credit for GST paid in respect of rates. It was based on the calculation shown below:

	$
Business rates including GST	1.68
Less GST ($1.68/1.125)	0.19
Rates exclusive of GST	1.49
Less income tax deduction at 33 percent	0.49
Effective rate burden	1.00

INCOME TAX

The draft report on the councillor funding review workshop summary of 12 December 1996 concluded that the ability to claim an income tax deduction for rates is not relevant in allocating the rate burden between the commercial and residential sectors. We believe the workshop's conclusion was correct. This finding was reflected in an early draft of the Council's funding policy by the omission of income tax as a factor to be taken into account by the Council in making funding decisions. The workshop summary noted that if a business does not make a profit it receives no benefit from the tax deduction and thus higher rates would leave the affected business worse off. While this argument is valid, most firms earn a profit.

The Council has changed its conclusion on the relevance of income tax deductions to the allocation of rates between the business and residential sectors. The draft funding policy of April 1997 states that income tax *is* a relevant consideration. The ability of firms to claim an income tax deduction for rates is also cited as a reason for the allocation of rates presented in options B to D and is implied in options E and F of the Council's draft plan for 1997/98. This factor is not, however, listed as a funding principle on page 19 of the draft plan whereas the ability to claim an input tax credit for GST is noted.

We understand that the Council's argument for taking income tax into account in allocating rates between businesses and residents is reflected in the simple example shown in table 1, columns 1 to 3 (see below). The example appears to suggest that businesses are advantaged because they can deduct rates for income taxes. The flaw in this argument is that the analysis does not provide a like-for-like comparison.

Residential ratepayers are not taxed on the economic income that arises from the private and domestic activity, homeownership, that gives rise to their obligation to

pay rates. This income is equivalent to the rent that would accrue to the homeowner if the property were let. Homeowners avoid the need to pay rent and they derive housing services, such as shelter, rather than a market income from their capital. These economic benefits are not reflected in column 3. The gross income included in column 3 presumably arises from employment because it is taxable. Implicit rental income, which is not taxed, needs to replace the gross income of the residential ratepayer to put the comparison on a like-for-like basis. This is shown in column 4. Implicit rents are assumed to amount to $50,000. (The actual amount of implicit rents would reflect the value of the house and other factors that are not considered.)

Table 1
Comparison of Business and Residential Ratepayers

Income and Wealth	**Council Analysis**		**Adjusted Analysis**
	Business Ratepayer	**Residential Ratepayer**	**Residential Ratepayer**
Column 1	**Column 2**	**Column 3**	**Column 4**
	$	$	$
Gross income	50,000	50,000	50,000
Deductible expenses (rates)	5,000		
Net taxable income	45,000	50,000	Nil
Tax (33 percent)	14,850	16,500	Nil
Non-deductible expenses (rates)		5,000	5,000
Net income after tax	30,150	28,500	45,000
Net addition to wealth	30,150	28,500	45,000

If the gross income that is earned by the residential ratepayer ($50,000) arose from a taxable activity that was directly related to the expenditure incurred on rates, the residential ratepayer would be entitled to claim a deduction for his or her rates and would be in precisely the same position as the business ratepayer. People who operate businesses from their homes are entitled to claim a deduction for rates and other occupancy costs in computing their taxable incomes. Because the income shown in column 3 of the table is unrelated to the homeowning activity, an income tax deduction for rates is not allowed.

The critical point is that firms are not advantaged by the ability to deduct rates for tax purposes because they are required to pay tax on their net income. The deductibility of rates should not be considered separately from the taxation of related revenue. The imposition of an income tax (other things being equal) reduces the after-tax return to investors relative to tax-exempt activities such as homeownership.

The following simple example may help to explain this point.

Consider two people. A owns a house which is let for $7,000 a year with outgoings of $2,000 a year. This is a business activity. A also rents an equivalent house for $7,000 a year which he occupies. This is a domestic activity. A is subject to tax on his rental business whereas his rental costs are not deductible because they constitute private and domestic expenditure. A pays tax at 33 percent on his rental

profit of $5,000. He incurs a net outflow of $3,650 in respect of personal and business housing activities.

B is an owner occupier. Her only outflow is $2,000 on outgoings which are not deductible.

Table 2 below shows the net outgoings on housing for A and B.

Table 2
Comparison of Renter and Owner

Housing Flow Statement	**A**	**B**
	$	$
Rental income	7,000	
Outgoings on rented house	2,000	
Net rental income	5,000	
Rent paid	7,000	
Outgoings on owner-occupied house		2,000
Total inflow before-tax	-2,000	-2,000
Tax on rental business	1,650	N A.
Net inflow	-3,650	-2,000

A is worse off than B because A pays tax on his net income. A's ability to deduct outgoings does not confer an advantage. The imposition of higher rates on A than on B because A has a taxable rental business would be a step in the wrong direction.

Table 3 includes the value of implicit rents which A and B enjoy. If such rents were taxable (which we are not advocating) both would be in the same position. The uneven treatment of commercial and residential activities arises from the failure to tax implicit rents on owner-occupied houses rather than from any advantage conferred on business activities.

This analysis can be tested by posing the following hypothetical question. If owner-occupiers were given the option of deducting rates (and other costs) for income tax purposes provided that related implicit rents were taxable, how many would take up the offer? The answer is that very few would do so. On the other hand, if businesses could elect to become tax-exempt provided that they gave up the right to tax deductions, there would be a rush of acceptances.

Table 3
Comparison of Renter and Owner
with Imputed Rents

Housing Flow Statement	**A**	**B**
	$	$
Rental income	7,000	
Outgoings on rented house	2,000	
Net rental income	5,000	
Imputed rent for occupied house	7,000	7,000
Rent paid	7,000	
Outgoings on owner-occupied house		2,000
Total inflow before-tax	5,000	5,000
Tax	1,650	1,650
Net inflow	3,350	3,350

GST

Although the councillor funding review workshop summary concluded that businesses do not receive an advantage by deducting rates for income tax purposes, it found that GST-registered businesses are favoured relative to other ratepayers. The review observed that the ability to claim an input credit for GST paid in respect of rates increases the wealth of GST-registered businesses compared to other ratepayers. The reality is that GST leaves registered businesses unaffected (ignoring compliance costs) but imposes a tax on consumption spending as intended by parliament.

A simple example is shown in table 4. A business ratepayer is assumed to sell goods for $50,000 (GST-exclusive basis) to a final consumer (that is, a resident person or firm that is not required to be registered for GST purposes). The goods are subject to GST at the current rate of 12.5 percent. The business incurs rates of $5,000 on which GST is charged by the Council. The business collects GST, net of GST paid to the Council, of $5,625 which is paid to the Inland Revenue Department (IRD). There is no net gain to the business.

Table 4
Comparison of Business and Residential Ratepayers

Income and Wealth	Business Ratepayer		Residential Ratepayer	
	GST-exclusive Accounts	GST Charged, Credited or Paid	GST-exclusive Accounts	GST Charged
	$	$	$	$
Taxable outputs	50,000	6,250		
Inputs (rates)	5,000	625		
Net value added	45,000			
Net GST collected	5,625	5,625		Nil
GST paid to IRD	5,625	5,625		Nil
Net gain from GST	Nil	Nil		
Residential rates			5,000	625
Net GST paid				625
Net cost of GST				625

Final consumers bear GST of $6,250 which is the intended effect of the tax. GST is a tax on consumption spending - it is not a tax on businesses, income, or inputs (intermediate consumption) used by firms. The government collects the total tax in stages through the business ($5,625) and the Council ($625).

The residential ratepayer is treated as a final consumer for GST purposes and is charged GST on rates (and on other consumption spending). In the example the residential ratepayer bears GST of $625 in respect of rates. The same situation applies in respect of other goods and services that are used by firms and final consumers. Rates are not a special case. Firms do not normally change their GST-exclusive prices depending on whether the buyer is a GST-registered firm or a final consumer. (A possible exception is the so-called 'cash job' where the supplier conspires with the buyer to evade GST and/or income tax for mutual advantage. Such unlawful practices are not condoned.)

GST belongs to the consumption tax family. It is intended to be a tax on final consumption spending. In the national accounting framework, the GST tax base can be derived as follows:

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

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

Consumption could be taxed directly (equation 5) with the same effect as equation 6 but that is infeasible on administrative grounds. A retail sales tax would be the closest practicable option. If GST were collected directly, the question of any tax advantage for firms from claiming a credit for GST on inputs would not arise. This factor alone suggests that the argument contained in the draft funding policy is doubtful.

The application of GST to outputs with credit for GST paid on inputs enables GST to be collected in stages. One advantage of this approach is that it treats vertically integrated and other firms on a neutral basis as the amount of tax paid does not reflect the number of transactions involved. It also provides incentives which reduce the risk of avoidance. The collection of GST in stages is illustrated by the simple example presented in Table 5.

The example assumes that GST is added to the GST-exclusive price. Firms A and B are GST registered whereas the consumer is not. Firm A imports goods worth $100.00 and pays $12.50 in GST (at 12.5 percent) to Customs. The goods are later sold to Firm B for $120.00 (GST-exclusive price). Firm A charges Firm B GST of $15.00 on the GST-exclusive amount of the sale. Firm A is required to pay the net

amount of GST to IRD, that is $15.00 less the $12.50 paid to Customs when the goods were imported. In this case Firm A pays the full amount of GST to the government but does so in two stages. Firm B then sells the goods to a consumer for $160.00 before GST. The consumer is charged GST of $20. Firm B pays GST of $5.00 to IRD being the difference between GST charged to the consumer and that which Firm B paid to Firm A.

The overall result is that the GST is paid by the consumer but the government collects it in stages from registered firms. The full amount of GST is paid to the government (see last column). There is no wealth gain that accrues to registered firms. They are in the same position as they would have been had GST not been introduced. A relaxation of the assumptions implicit in the example would not alter this conclusion.

Table 5
Staged Collection of GST

Transactions	Price Before GST	GST Paid on Imports and Inputs or Charged on Outputs	Net GST Collected by Customs and IRD	Cumulative GST Collections
	$	$	$	$
Firm A imports goods	100.00	12.50	12.50	12.50
Firm A sells goods to Firm B	120.00	15.00	2.50	15.00
Firm B sells goods to a consumer	160.00	20.00	5.00	20.00

Because GST is intended to apply to consumption spending only, the income of businesses should be unaffected. Consumption taxes do not alter before- and after-tax rates of return. Thus the net effect of taxing outputs with a credit for tax paid on inputs should be to leave income unchanged. This assumes that GST is fully passed on to consumers and ignores any macroeconomic adjustments that may arise on the introduction of GST.

We can therefore pose the question: Does an input credit for GST on rates (or any other input) alter the profitability of the ratepaying firm relative to its before-GST position? If the review's conclusion is valid, a credit for GST should increase the firm's taxable income, i.e. confer an advantage that it did not previously enjoy. Any advantage should, according to this view, be taxed away by higher rates than otherwise. (The question of whether this is the proper function of the Council is not addressed.)

Consider the example shown in Table 6 in which GST-exclusive rates remain unchanged on the introduction of GST (i.e. rates are increased by GST only). The accounts are shown on both GST-exclusive and GST-inclusive bases. The example clearly shows that the present treatment is the neutral one. Both before- and after-tax profit is unaffected by the introduction of GST. It is apparent from the example that if the GST-exclusive amount of rates is increased, because the firm is said to gain an advantage, its profit will fall relative to the before-GST position.

The final price to the consumer includes $5.00 of GST, $2.50 of which is collected through the firm included in the example and a further $2.50 is collected at an earlier stage in production and distribution (i.e. the firm's inputs are the outputs of another firm or imports). The consumer bears the full amount of GST. If GST had been collected directly from the consumer, rather than through businesses, the amount of GST paid would have been the same. This would not be the case if a wealth advantage were conferred on businesses.

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

Table 6

Effect on Profitability of GST

Item	**Before GST**	**With GST**	
		GST-Exclusive Accounts	**GST-Inclusive Accounts**
	$	$	$
Output (O)	40.00	40.00	45.00
Inputs (rates) (P)	20.00	20.00	22.50
GST payable			2.50
Profit before-tax	20.00	20.00	20.00
Tax (33 percent)	6.60	6.60	6.60
Profit after-tax	13.40	13.40	13.40
Memorandum item:			
GST Payable	Nil	2.50	2.50

Note: GST payable is not reflected in the income statement when accounts are kept on a GST-exclusive basis. On a GST-exclusive basis GST is equal to 12.5 percent of outputs net of inputs. On a GST-inclusive basis it is equal to one-ninth of outputs net of inputs.

It could be argued that owner-occupation should be treated as a taxable activity for GST purposes. If this were the case, GST on rates and other inputs would be deductible but imputed consumption (implicit rents which represent the value of housing services consumed) would be subject to GST. Homeowners would then be taxed on the net value added from their owner-occupation business. This escapes GST at present because it is infeasible to apply GST directly to owner-occupiers. Homeownership is somewhat more favourably treated under GST than most other consumption activities.

The argument for ignoring GST in allocating the tax burden is similar to that for excluding income tax. The ability of businesses to claim a credit for GST paid on their inputs is directly related to the taxation of their output. GST is largely borne by final consumers as intended with a consumption tax.

CONCLUSION

In summary, we do not believe that either income tax or GST should be taken into account in determining the allocation of rates between businesses and residents. Businesses do not generally charge different GST-exclusive prices for goods and services supplied to firms and final consumers on the grounds that the former are advantaged for income or GST purposes. This is not to say that there are no grounds for setting differential rates - merely that tax should not be a factor. Other possible grounds should be considered on their merits.