Local Body Rates: Their Impact on Superannuitants and the Question of Equity.

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Abstract

This paper presents a brief summary of the literature on the use of property based taxes to fund local authorities and their impact on superannuitants. It notes that when income alone is considered the evidence supports the view that superannuitants are disadvantaged, but that this is not the case when both income and wealth are considered.. It then explores the concept of equity of taxation and in particular how property based taxes (rates) as a means of revenue generation evaluate against this criterion. It concludes by suggesting policy options for Grey Power to consider in seeking to alleviate any hardship faced by superannuitants in meeting their local body tax obligations

Introduction

It is widely acknowledges that although people have different opinions about the fairness of any given tax, most agree that they would prefer someone else paid it[1]. It is important therefore that our policies are based on a sound theoretical and practical basis, not anecdote or schemes designed to give preference to one group over another.

The Grey Power Federation policy on Local Bodies and Housing has an objective of establishing an equitable funding system for local authorities. This background paper is intended to inform their debate and that of the wider Grey power community. It focuses on property based systems of taxation, explores the degree to which Superannuitants are affected compared to the population at large, and the equity of rates as a mechanism in funding public authorities. It is concerned only with the principles of taxation and the types used to meet the funding required. Ways to control demand side will be considered separately.

The current system of funding local government is based on a mixture of taxes. The historical use of a land based tax (rates) has been supplemented by taxes designed to target consumers more directly either through consumption based charging or ability to use charging (uniform annual general charges or UAGCs). These all have differing impacts and levels of equity. An argument for the inclusion of a wide variety of tax bases is that this minimises distortionary economic effects [2]. Nonetheless, it can be argued that all these tax forms address the same tax base. This paper therefore concentrates on property based taxes and only mentions other options in passing.

Principles of Taxation

Four criteria for a successful and sustainable system of taxation were established in the eighteenth century by Adam Smith [3]. Translated into modern terminology, the tax should be:

- Fair,
- Administratively simple
- Convenient to pay and transparent,
- Economically efficient

In addition, two basic premises have been developed as a basis for implementation of any tax. These are the Benefit received principle and the Ability to pay principle.

Benefit Received Principle

The benefit-received principle is based on the purchase of public goods in the same way as private goods. The contribution should be in proportion to the benefit received. Consumption taxes such as road user charges on fuel are an obvious example. However, a practical problems is that individuals perception of benefits received tend to differ when the benefit delivered lies wholly or principally in the domain of public good rather than private and the resulting disputes, or the potential for them, can effectively limit the utility of this approach in those areas.

Ability to Pay Principle

The ability-to-pay principle rests on the idea that the tax burden should be geared directly to one's income and wealth. Those with more should contribute more both absolutely and relatively. An example being New Zealand graduated income tax.

In New Zealand, as in most developed countries, taxation at national and local level is based on a mixture of these two approaches. For local bodies, targeted rates and UAGCs are usually based on the benefits principle, whilst property based ‘rates’ are generally based on ability to pay.

Equity

In most Western economies the accepted framework for taxation addresses both vertical and horizontal equity. Horizontal equity states that equals should be treated equally, whilst vertical equity is based on the principle that people with higher income and wealth should pay proportionately more tax.

In addressing Horizontal equity income is not the only criterion. It must also consider expense, so that of two people, the one with higher necessary expense should pay less tax than those with equal income but without the expenses.

These principles are established in New Zealand through the universal graduated income tax, which addresses vertical equity, whilst horizontal equity is addressed through targeted rebates and allowances.

Ability to pay and the question of wealth

How is ability to pay decided? Although the phrase is frequently used as if it were a simple concept, as soon as the complications of a modern society are considered, it becomes very difficult to define[4]. Writing in the American economic review in 1939, Kendrick dismisses the idea that only income should be considered as a ‘narrow and literal interpretation’ that ‘clearly will not do’ [5]. Rather, ability to pay rests on the combination of the income and wealth [2, 4, 6]. This principle applies whether one considers a subjective or objective approach to the determination of equity.

Since the received benefit principle is often quoted as an argument by those opposed to the rating system, it should also be noted that wealth is also considered an appropriate proxy for received benefit[7].

The Current system – or why do people hate paying rates?

Property based taxes are generally considered to be good taxes by economist, and although they make up a large proportion of the taxes that fund local authorities, property based 'Rates', are a small proportion of the total taxes paid in New Zealand. Why is it then that they are singled out for more hatred and opposition than any other? An attitude that appears to be universal across all jurisdictions[8].

There are multiple reasons, but two appear to be dominant. First in following the admirable principle of transparency[3] they are obvious. We get repeated reminders of what we have paid or have to pay. Secondly, they are unavoidable; you can't hide land in a trust, send it to a tax haven or do 'under the counter' deals. Of the two it seems that the visibility of rates payments is the greater problem. A view expressed by the Local Government Inquiry Panel, and supported by a recent study which found that where rates payments were made as part of a consolidated deduction, and were not immediately visible, users dissatisfaction with the level of rates was far lower [9].

Land taxes

New Zealand has a comparatively low rate of taxation on property when considered as a proportion of total tax take, less than 6%, and the lowest rate within the English speaking countries of the OECD However, virtually all NZ property tax is collected from a recurring tax, 'Rates' [10]

Taxes on land, whether based on the unimproved or improved value, are very efficient. They also have the great advantage of being unavoidable [11]. Tax based on the unimproved value of land has long been recognised as an equitable form of tax [12], with the unearned rent from land coming in for especial criticism from George. Ricardo also described the rent gained from land ownership as an anomaly[13]. In more modern times Milton Freidman considered it 'the least worst of taxes' whilst political supporters include Churchill. In the UK, the Conservatives are the only party without a campaign group advocating a land tax.

Aside from economic arguments, local property taxes are seen to promote local autonomy and accountability, a feature that communities have consistently shown they value highly.

Capital value versus Land Value

New Zealand Treasury data shown below (Chart 1), indicates that a tax on capital value (land plus improvements) is regressive. Some councils justify the use of capital value as a basis for rating on presumed equity grounds, arguing that a large investment in the property implies greater wealth and is a better proxy for benefits received. This is not born out by theory or in practice with land value being a higher proportion of total value for those on higher incomes. The authors of a Motu research paper consider Land value is progressive as the value of the land owned by those with higher income is a greater share of the total land value in a Territorial Local Authority (TLA) [14]. This view has been endorsed by the Productivity Commission in its 2015 Draft Report on land supply. However it is not universally held, with Professor Scott of Victoria University of Wellington, taking a contrary view.

Regardless of whether land or capital value is used, the majority of perceived problems with a land value tax appear to rise from complex application of differentials[15] which undermine their essential simplicity and efficiency.

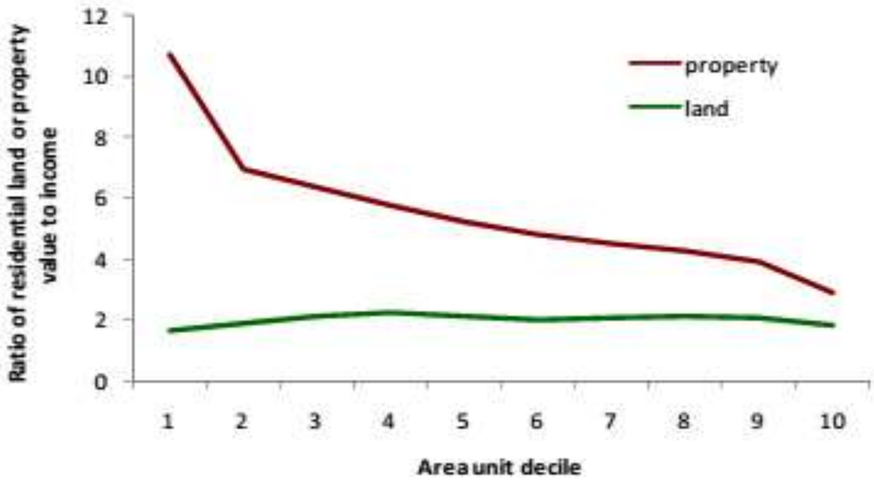
Efficiency

Tax efficiency minimizes the cost of compliance both by cutting the work undertaken by the payor and the payee, and by minimizing any distortions in the economy caused by the tax. Taxing land and property is one of the most efficient and least distorting. Since the amount of land is fixed, taxing it cannot distort supply and it forms a stable revenue source. An OECD study [16]also suggests that taxes on immovable property are the most growth-friendly of all major taxes.

Impact of rates on Superannuitants

The elevated impact of rates on low or fixed income groups is most commonly cited within Grey Power as a reason for altering the basis for local government funding away from a land based tax system. Across New Zealand, local authorities vary on the basis for rates, using either land value or capital value. When these tax burden for these systems are considered in relation to income, land value is neutral, but it is clear that the use of Capital Value is highly regressive, being heavily weighted against those on low income (Chart 1) [10].

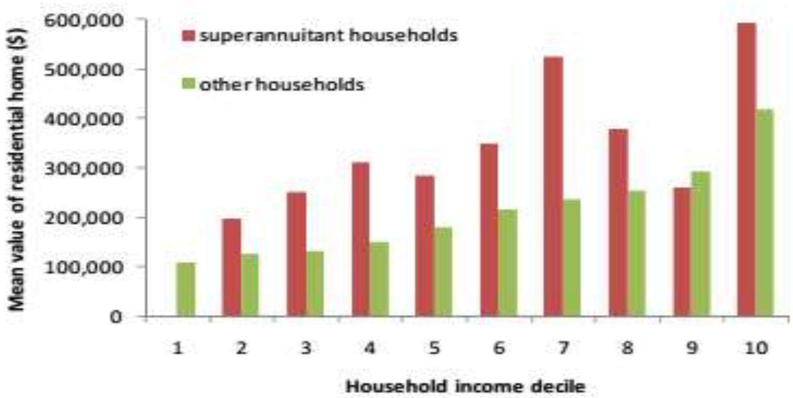
Chart 1: Property and Land as a Ratio of Each Decile's Income



Source: Treasury using QVNZ and SoFIE data [10]

Looking specifically at Superannuitants, the Treasury and IRD report noted that Superannuitants' homes were on average of higher value than those of non-superannuitants with similar income, (Chart 2) and that there was no evidence that this was caused by postretirement income reductions pushing lifetime-wealthy retirees into lower income deciles. As a consequence, superannuitants with incomes in deciles 2-8 need to devote a larger proportion of their income to paying a land or property based tax than other property owners with a similar income (chart 2).

Chart 2: Mean value of property of superannuitant and non-superannuitant households by income decile



Source: Treasury using SoFIE data. (Superannuitant households are defined as those with at least one member aged 65+ who is retired, and with no other workers in the household [10].)

It is clear from the data presented above that when income alone is considered, Superannuitants are on the whole disadvantaged when paying a property based tax since they have a comparatively low income whilst owning homes of higher value than others in their income decile. Over half (56%) in income deciles 2 and 3, and 81% in income deciles 1 – 5, have homes that incur higher rates than those of other people on equivalent income levels [10].

However, the picture is far less clear when total wealth is considered rather than just income.

Other options

Although comprehensively researched, most recently in New Zealand by the Local Government Rates Inquiry in 2007, the alternative tax bases available to local authorities are limited. Of those in current and widespread use, UAGCs are the most economically efficient, but also the most regressive. This aspect is recognised in the Local Government Act through the capping of income from UAGCs at 30% of total rates income.

Direct consumption tax tied to specific goods or services such as petrol and water use, are also efficient, and both support and promote sustainable use. Although not regressive of themselves, such taxes can have a regressive effect when considered in the context of other social factors e.g. the requirement for low paid workers to travel long distances to get work.

In contrast, generic consumption taxes, such as a locally set value added tax, have high administrative and compliance costs, and are subject to market distortions when trading takes place between authorities with different rates.

One of the most justified criticism of property taxes is the complex manner in which they are applied, with a maze of differentials applied in attempts to further political or social objectives. An alternative approach of a highly progressive property tax rate such as used for stamp duty in the UK, could potentially increase revenue whilst simplifying the system and benefiting those most in need. It is however likely to meet strong opposition, particularly in those areas of the country dominated by the agricultural sector where it would be perceived, correctly, as a disincentive to increasing farm size.

Targeted rates can also be a useful tool if used with care, although they are also open to the criticism of adding complexity. They tend to work best where there is a clear linkage between the service being funded and the tax base, such as a bed tax in a tourist dominated area.

Local income taxes have often been posited as a means of widening the tax base from property owners. However, the underlying assumption of critics that the property tax base is narrow has been found to underestimate the levels of transfer involved. Local income taxes are also considered inefficient, creating disincentives for work, and having high cost of administration. Overall efficiency and equity would be eroded if a relatively non-distorting property tax was replaced by a more distorting income or sales taxes.

Subsidiarity – local accountability

Any scheme that seeks to replace a local tax by a national one would lead to a loss of local accountability. In particular, the benefit received basis of taxation relies on the allocation of cost and value of services to the community at large through the political process. These allocations can and do vary widely between communities based on local preference. Where local costs are met by transfers from a central source, this link is broken and rather than being held to account for failing to manage expenditure efficiently, councillors are as likely to be rewarded for their ability to negotiate a higher transfer.

It is also evident from submissions to the Local Government Commission, that the ability to control expenditure and taxation at a local level is of high importance to New Zealand communities.

In contrast, where a public good is constant across all communities central government has the most appropriate tools. This is recognised through central government's funding of targeted benefits such as the rates rebate scheme

Conclusion

Despite the overwhelming consensus amongst economists that property based taxes are essential, efficient and equitable; and decades of recommendations from international agencies to increase their usage, there is a clear and large disconnect between this view and the perception of the general public. This divide is exacerbated when rates liability is seen as threatening to the sanctity of the home. Although some politicians both internationally and within New Zealand have supported the populist view, those that have been tempted to follow through and reduce property taxes have found to their cost that as Rosengard notes, in this case economics trumps politics, and that voter opposition to consequent loss of services is greater than that in favour of the cuts[8].

Although it cannot be concluded that property based rates are inequitable, capital based rates are seen to be regressive. It is also clear that although superannuitants as a whole spend more of their income on rates than others with similar income levels, they cannot be said to be disadvantaged from an ability to pay perspective unless a narrow criterion based on income only, is used.

Alternative sources of revenue for local bodies have been extensively investigated and although some are able to be increased, most ether fall foul of Central Government policy, are distortionary, or are politically or socially unacceptable.

A move to a land based tax rather than capital base would be potentially beneficial to superannuitants. In addition, a move to a progressive land tax may also assist, although further research into the distribution of land values within the 65+ age cohort and the wider population should be undertaken before pursuing this course

In practical terms, the ability of 'Asset rich, cash poor' superannuitants to meet their tax obligations is not seen as a product of inequity in the tax system. Rather it is the availability of appropriate mechanisms to enable them to meet this cost in ways that do not adversely impact their ability to remain in their home for as long as they wish and their wider ability to enjoy life in their community in accordance with the principles of 'Ageing in place'. Here the means to decummulate assets is a major issue. The ability to defer rates against the estate already exists in some areas, and providing this is underpinned by a guarantee of occupancy for the lifetime of those resident when the agreement is entered into, would seem to meet the required standards. The greatest resistance to this approach appears to be a concern by superannuitants that this will diminish or extinguish their ability to pass on an inheritance. What is unclear is how real, or widespread this concern actually is. Recent research suggests that this is a generational rather than age based concern[17], and may not be so relevant to the 'Baby boomers' and subsequent generations. Other ways to decummulate assets in a controlled manner, such as 'down sizing' clearly exist, but depend on personal choices outside the area of public provision. The availability of local authority postponement schemes, the conditions imposed to access them, and the conditions they impose, are very much within the province of public policy.

Finally, anecdotal evidence suggests that uptake of benefits available is very limited amongst members and it is suggested that in addition to undertaking research to quantify the problem, policies to maximise eligibility and uptake of rates rebates should be sought.

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