Opinion on the proposal to lower the commercial rates differential in Wellington, by economist Peter Harris.

Peter Harris is an economist with extensive experience in the trade union movement, including a decade as CTU Economist. He is currently an economic consultant. He was Economic Advisor to Michael Cullen, Minister of Finance from 1999 to 2002. He has also been a member of the Wellington City Council Finance Audit and Risk Committee. He has served on the Reserve Bank's Monetary Policy Committee.

The basic question

You have asked what effect a reduction in the differential between the commercial and residential rate would have on investment and employment in Wellington.

The answer is no significant or discernible effect.

Any analysis of the impact of a change has to look at what drives decisions on employment. The purpose here is not to record how much each sector pays, but to assess if any reduction in the commercial rate will increase employment in that sector.

The main drivers of employment in Wellington are:

Central government. Employment determined by Budget allocations.

Local government. Council decision

Hospital and other health providers. Budget allocations.

University, polytechnics, schools and other education providers. Substantially rates exempt so commercial rates not a substantial influence on employment levels.

Supermarket chains. Highly profitable: rates relief simply adds to surplus.

Banks and other financial service providers. As for supermarkets.

Accounting and legal firms. Overheads not a factor in determining levels of activity.

Telecommunications and computer related activity. Driven by demand, not cost.

Transport and distribution. Fixed premises not a main cost.

Small scale retail and hospitality. Thin margins and can be cost sensitive.

Council officials should be able to provide Councillors with a breakdown of the proportions of commercial rates paid by each of these categories. They know who is paying the rates.

If they cannot, decisions on rates allocations are being made in the dark, or on theoretical rather than evidence bases

It is the small scale retail and hospitality segment that ***may*** respond to rates relief.

Responses to rates relief

The response will depend on a number of factors.

For most of the large employment sectors listed above, (government departments, supermarkets, banks, accounting and legal firms) rates relief simply generates a windfall gain to the landlords they lease properties from, or a windfall profit gain.

For other low rated employers (health and education providers) and sectors with a low property footprint (telecommunications, transport services etc) the commercial rate is a very minor factor in decisions on employment.

Many (if not most - it would be good to get reliable data) in the small business sector rent on fixed terms.

The Council will know who pays the rates depending on the category of the entity paying the rates.

If they do not know, or will not say, policy is being made in the dark or on theoretical rather than evidence bases.

There can be close to zero confidence that any landlords will pass the rate cut on to tenants.

Again, the rate cut is a windfall for landlords and it is very hard to argue that this will drive employment and investment.

What will happen next?

With any policy change subsidiary questions are

at what cost, and

how material will the response be?

A reduction in the commercial rate is not free. The revenue lost has to be recovered, and within the narrow financing options that local government has, that means it is entirely offset by an increase in residential rates.

The total amount collected from rates in Wellington is almost exactly split between residential (52 percent) and commercial (48 percent) rates. This means that there is an almost directly proportional increase in the burden on residents from the relief given to businesses. (more later).

So will a response be material? Businesses do not invest and employ because of their costs. They invest and employ if they think they can make a profit. Of course cost is a factor with profitability. But it is a secondary factor. The primary driver is revenue: if customers are buying what they are selling.

At the moment, there are three factors squeezing businesses. Employment cuts in government departments are reducing incomes and making consumers uneasy. Cost of living pressures (electricity, petrol and food prices, rising interest rate) are reducing discretionary incomes in households, which are exactly the balances that are spent in small scale retail and hospitality. Those same pressures (electricity, transport) are also adding to business costs.

A very small proportion of the rate cut will go to property owning small businesses.

The questions posed earlier should allow an approximation of what that would be. On a broad rule of thumb, it looks like property owning small businesses would almost certainly employ less than 5 percent of the total labour force in Wellington.

What can the employment gain from a rate cut be? 10 percent? That would be a generous assumption. So the net employment gain from a rate cut would be half a percent at the very most.

The vast bulk of a cut in the commercial rate cut will go to big businesses and landlords. But by contrast, the **whole** of any cut will be passed on to residents.

Residents

This brings us back to the residential rate.

Residential rates are already high. The burden across ratepayers will vary depending on the value of the properties they own, and their incomes. For some categories of residents, the burden is close to unsustainable. The most at risk are asset rich (because they bought their homes when they were working) income poor (because they are retired) and living alone (often because they are widowed).

A fairly standard rate (the Regional Council rate has to be added to the City rate because residents cannot choose to pay only one of them) of $7,000 p.a is already close to a quarter of the single living alone level of NZ Superannuation. Add insurance and the cost of owning a home starts to eat into a very large share of it.

Some low income ratepayers qualify for rates relief, but to the extent that relief is significant, the cost simply shifts to non-qualifying ratepayers.

The City faces mounting cost pressures from rising expenses and the need to spend large amounts on earthquake repairs and remediation, and decaying and inadequate infrastructure. (Think Town Hall, Moa Point, flood control). A projection of regular ten percent annual rates increases is not unrealistic. (It could be conservative). Rates increases of 10% pa means they **double** every seven years!

Incomes (including wage linked NZS) will also increase during that time, but it is inconceivable that they will do so at 10 percent per annum compounded. A very optimistic assumption would be 5 percent sustained. On that scenario rates double every seven years as incomes rise by 50 percent.

Any shift in the commercial differential simply adds to that divergence in the affordability of the residential rates burden.

Overall conclusion

The policy logic of a reduction in the differential is that it will generate social benefits by stimulating investment and employment.

This overview suggests that the social benefit is *extremely* low (maybe at the absolute outset a half percent increase in employment) and the private costs very high (through a further boost to residential rates).

What is to be done?

There is no doubt that local government across the motu is heading towards a funding crisis.

The problem is that none of them, on their own (or even collectively) has the authority to effect an effective local body income reset. Yet that is what is now needed. This is one of those moments in central and local government policy setting when a fundamental reset is now urgent.

There are a number of interventions that could be considered, but this is not the time or place to discuss them. Some interventions may be small (such as exempting rates from

GST), some could be targeted (local petrol taxes, visitor levies, bed taxes and so on), some could be structural and substantial (GST and income tax sharing between central and local government) and some could new and additional (local consumption and income taxes, resource use charges and so on).

The time for a national conversation leading to a basic resetting of who pays for what in our governance infrastructure has arrived. *At that time, and in that context, what commercial property owners pay for local government services* can be part of the bigger picture.

But outside of that context, fiddling around at the edges may make some local councillors feel that they are “doing something”, but all they are doing is further stressing already stressed residents.