

Local government funding and financing

November 2019



The Government has asked the Productivity Commission to undertake an inquiry into local government funding and financing. The Government wants to know whether the existing funding and financing arrangements are suitable for enabling local authorities to meet current and future cost pressures.

High-performing local government is vital for community wellbeing

Local government matters a great deal to communities and the wellbeing of New Zealanders. High-performing local government can provide greater access to housing; better protection of New Zealand's natural environment and cultural values; strong, engaged communities; and quality infrastructure at the right time in the right place.

The funding and financing framework for local government must incentivise good performance, and enable local authorities to deliver quality amenities and services that reflect the preferences and aspirations of their communities.

Significant scope exists for better use of current tools

Many councils could make better use of current funding tools. Better organisational performance and decision making would also help to relieve funding pressures. The sector should work to **improve elected members' governance and financial skills**. All local authorities should be required to establish an **Audit and Risk Committee**, with at least one independent member, to enhance governance capability.

The best way to use the current funding tools

The benefit principle says that those who benefit from, or cause the need for, a service should pay its costs. It implies that user charges or targeted rates should be used wherever it is possible and efficient to do so. Councils may legitimately consider ability to pay alongside the benefit principle and efficiency principles as its main guides to choose funding tools and allocate the costs of its services.

Legal clarity is needed in some areas, to support better use of existing tools. For example, councils should have the ability to use targeted rates on the properties benefiting from new infrastructure, to capture some of the increase in property values resulting from infrastructure investments, without fear of legal challenge.

Need for greater transparency around decisions and performance

Council decision making and broader performance need to be more transparent, so local communities can hold their council to account. The current performance

reporting framework for local government should be fundamentally reviewed and streamlined. A small set of mandatory measures should be developed. These measures would be reported to and published by a central entity. Councils should be required to provide **itemised rates assessments** to ratepayers.

The property rates-based system remains appropriate...

The current main funding tools of local government in New Zealand measure up well against the principles of a good revenue-raising system, including simplicity, efficiency and revenue stability.

The current framework provides councils with considerable flexibility in how they raise revenue, and how they spend it. This is reflected in the diversity of ways in which they do so. This autonomy is a strength of the existing system and should be retained.

Internationally, no single way of funding local government is clearly better or worse. Compared to alternatives, property taxes are simple and efficient to administer, and wholesale change to a radically different model would be costly, disruptive and uncertain. Given the modest scope of local government in New Zealand, and the benefits of a property-tax-based system, **rating land and property should continue as the main taxing power of local government.**

... but there are areas of funding pressure

At an aggregate level, average rates revenue per person has grown in line with incomes since the early 1990s. This suggests that the current funding system has been adequate and sustainable in the past. But there are some areas of funding pressure:

- adapting to the impacts of climate change;
- unfunded mandates passed to local government from central government;
- meeting the demand for infrastructure in high-growth areas; and
- coping with the growth in tourism.

The scale of some of these pressures on local government is unprecedented. They are also highly uneven across councils. Some smaller, rural, and lower-income councils are under additional strain because, to raise enough revenue, they have needed to increase rates to a high level as a percentage of incomes. And some of these small councils are already unable to comply with the cumulative burden of unfunded mandates placed on them from central government. This is clearly an unsustainable situation.

Given the advantages of a property rates-based system, the Commission favours targeted solutions to these different and uneven pressures on councils.

Payments from central to local government are justified in some circumstances, including when local government activities have national-level benefit spillovers. Central government should take a principled approach to providing funding to local government; and the Commission has outlined a framework to inform central government funding decisions. It is difficult to estimate the fiscal costs of the Commission's recommended funding streams. By far the largest item will be

co-funding for councils whose assets are threatened by climate change, which could cost central government in the order of \$150 million per year over 20 years.

Regional spatial planning will better prepare councils for the future

Regional spatial plans would better prepare councils for the future by integrating land-use and infrastructure planning across a whole region; ensuring better coordination across councils and between central and local government; and supporting more efficient use of councils' combined resources.

Adapting to climate change is a significant challenge

Future sea-level rise and more frequent and severe weather events from climate change directly threaten local government infrastructure. Councils are also responsible for planning and regulating development on at-risk land, and are currently in a no-win situation where either allowing or limiting development might result in litigation.

To help local government prepare for the impacts of climate change, **central government should take the lead** on providing high-quality and consistent science and data, standard setting and decision-making guidance, and legal frameworks. Institutional and legislative frameworks also need to move from their current focus on recovery after an event towards reducing risk before an event.

The Government should **extend the role of the New Zealand Transport Agency** in co-funding local roads to include assistance to councils whose roading infrastructure is facing significant threats from climate change. The Government should also create a **climate-resilience agency and associated fund** to help councils redesign, and possibly relocate and rebuild, other at-risk infrastructure.

Need to reset the relationship with central government

Another cause of funding pressures on local government is the accumulation of tasks and responsibilities passed from central government, without adequate funding means. The Commission sees significant value, and has previously recommended, that central and local government work together to develop a **"Partners in Regulation" protocol**. This would involve the co-design of regulatory regimes with appropriate funding provisions. **The Crown should also pay its way**, by covering the costs of council services provided to Crown-owned property, and paying development contributions on its developments.

New funding and financing tools for growth infrastructure

The failure of high-growth councils to supply enough infrastructure to support housing development has led to some serious social and economic problems. Councils currently have funding and financing tools to ensure that revenue for new property developments come from new residents, rather than existing ratepayers. However, the long time it takes to recover the costs of development, the risks involved, debt limits, and a continued perception that growth does not "pay for itself" are significant barriers.

User charging would help pay for and manage growth

The Government should give councils the **power to levy volumetric wastewater and road-congestion charges**. These tools would help give councils the means to efficiently fund the costs of growth. User charges can also help manage demand by

increasing the number of people that existing infrastructure can support and extending the useable life of these assets.

Special Purpose Vehicles could help councils nearing their debt limits

Special Purpose Vehicles (SPVs) are a financing option for new development, which involve debt sitting off a council's balance sheet. This provides a means for high-growth councils approaching their debt limits to continue to invest in development. The Commission supports the Government's current work around expanding the use of SPVs from greenfields to brownfields development.

Considering a tax on vacant land

The Commission has examined whether vacant land taxes would be a useful mechanism to improve the supply of available housing. The Commission concluded that such taxes would suffer definitional problems, have high administrative costs and be ineffective in improving the supply of available housing for New Zealanders. Other approaches to improving housing supply would be more effective and are preferable.

Funding amenities and services for tourists

Councils may face a small funding shortfall for the costs associated with local amenities and services used by tourists, such as public toilets. The Commission analysed a range of options for funding this modest shortfall, including an accommodation levy. It concluded that, because of the high set-up and administrative costs of these options, there would only be a net benefit if the shortfall was large. Councils should instead make **better use of available tools**, including more user charging, greater use of debt, raising more in rates, and strategies and tools to plan for tourism and manage peak demand. Central government funding for tourism should be distributed more efficiently and fairly to councils.

A new regulatory regime for the three waters

The performance of the three waters sector would be substantially improved through an approach that rigorously enforces minimum performance standards, but is permissive about the way councils structure and operate their three waters businesses. The Government should consider having backstop arrangements to deal with councils that fail to meet minimum health and environmental performance standards. Independent and effective economic regulation is needed to encourage fit-for-purpose investments to lift the sector's performance and assist with affordability (by minimising costs). Government should also provide **co-funding to assist small, rural and low-income councils** make the required upgrades to their three-waters infrastructure.

Read the full version of the report and other inquiry material at www.productivity.govt.nz/inquiries/local-government-funding-and-financing

The **New Zealand Productivity Commission** is an independent Crown Entity. It conducts in-depth inquiries on topics selected by the Government, carries out productivity-related research, and promotes understanding of productivity issues.

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