



# Local government funding and financing



# Local government funding and financing

Issues paper - November 2018

## The New Zealand Productivity Commission

Te Kōmihana Whai Hua o Aotearoa<sup>1</sup>

The Commission – an independent Crown Entity – completes in-depth inquiry reports on topics selected by the Government, carries out productivity-related research, and promotes understanding of productivity issues. The Commission aims to provide insightful, well-informed and accessible advice that leads to the best possible improvement in the wellbeing of New Zealanders. The New Zealand Productivity Commission Act 2010 guides and binds the Commission.

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### Inquiry contacts

**Administration** Robyn Sadlier  
T: (04) 903 5167  
E: [info@productivity.govt.nz](mailto:info@productivity.govt.nz)

**Website** [www.productivity.govt.nz](http://www.productivity.govt.nz)

**Twitter** @nzprocom

**Other matters** Steven Bailey  
Inquiry Director  
T: (04) 903 5156  
E: [steven.bailey@productivity.govt.nz](mailto:steven.bailey@productivity.govt.nz)

**Linkedin** NZ Productivity Commission

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<sup>1</sup> The Commission that pursues abundance for New Zealand

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# The issues paper

This issues paper aims to assist individuals and organisations to participate in the inquiry. It outlines the background to the inquiry, the Commission's intended approach, and the matters about which the Commission is seeking comment and information.

This paper contains specific questions to which responses are invited. These questions are not intended to limit comment. Participants should choose which (if any) questions are relevant to them. The Commission welcomes information and comment on all issues that participants consider relevant to the inquiry's terms of reference.

## Key inquiry dates

Due date for submissions on issues paper	15 February 2019
Release of draft report	June 2019
Final report to Government	30 November 2019

## Contacts

For further information about the inquiry, please contact:

### Administrative matters:

T: +64 4 903 5167  
E: [info@productivity.govt.nz](mailto:info@productivity.govt.nz)

### Other matters:

Steven Bailey  
Inquiry Director  
T: +64 4 903 5156  
E: [steven.bailey@productivity.govt.nz](mailto:steven.bailey@productivity.govt.nz)

### Postal address for submissions:

Local government funding and financing inquiry  
New Zealand Productivity Commission  
PO Box 8036  
The Terrace  
WELLINGTON 6143

### Website:

[www.productivity.govt.nz](http://www.productivity.govt.nz)

## Why you should make a submission

The Commission aims to provide insightful, well-informed and accessible advice that leads to the best possible improvement in the wellbeing of New Zealanders. Submissions help the Commission to gather ideas, opinions and information to ensure that inquiries are well-informed and relevant, and that its advice is relevant, credible and workable.

Submissions will help shape the nature and focus of this inquiry. Inquiry reports may cite or directly incorporate relevant information from submissions. There will be an opportunity to make further submissions in response to the draft report.

## How to make a submission

Anyone can make a submission. It may be in written, electronic or audio format. A submission can range from a short letter on a single issue to a more substantial document covering many issues. Please provide supporting facts, figures, data, examples and documentation where possible. Every submission is welcome; however, identical submissions will not carry any more weight than the merits of the arguments presented. Submissions may incorporate relevant material provided to other reviews or inquiries.

Submissions may be lodged at [www.productivity.govt.nz](http://www.productivity.govt.nz) or emailed to [info@productivity.govt.nz](mailto:info@productivity.govt.nz). Word or searchable PDF format is preferred. Submissions may also be posted. Please email an electronic copy as well, if possible.

Submissions should include the submitter's name and contact details, and the details of any organisation represented. The Commission will not accept submissions that, in its opinion, contain inappropriate or defamatory content.

## What the Commission will do with submissions

The Commission seeks to have as much information as possible on the public record. Submissions will become publicly available documents on the Commission's website shortly after receipt unless accompanied by a request to delay release for a short period.

The Commission is subject to the Official Information Act 1982, and can accept material in confidence only under special circumstances. Please contact the Commission before submitting such material.

## Other ways to participate

The Commission welcomes engagement on its inquiries. Please telephone or send an email, or get in touch to arrange a meeting with inquiry staff.



# 1 The inquiry

The Government has asked the Commission to undertake an inquiry into local government funding and financing and, where shortcomings in the current system are identified, to examine options and approaches for improving the system.

## Local government funding and financing

Local government plays an essential role in New Zealand's system of government as both a provider of services and a voice for local democracy, and its activities have a huge influence on the day-to-day lives of New Zealanders. Local government is responsible for providing the services (including water, transport, flood protection, waste management) that enable communities to function effectively. Importantly, local governments also provide a range of services such as community development and recreation and sport that support the wellbeing of local communities.

This inquiry is about the cost of services provided by local government and how they are paid for. It will examine the adequacy and efficiency of the current local government funding and financing framework.

- Funding tools are the sources of money available to provide for infrastructure and services over time. For example, a council may fund an infrastructure project through sources such as rates and use this revenue to recover the costs of financing (which would comprise interest and capital repayments in the case of borrowing).
- Financing refers to the way in which debt and/or equity is raised for the delivery of a project or service at the time it is needed. So, for example, a council may finance an infrastructure project through borrowing to ensure that it has the cash on hand to pay the upfront bills.

## The Commission's approach to the inquiry

The Commission will investigate the factors that drive local government costs now and in the foreseeable future. This will focus particularly on the drivers of cost and price escalation, including: changing policy and regulatory settings; growth and decline in population; the role of tourism and other temporary residents; the impacts of Treaty of Waitangi settlement arrangements; and the costs of climate change mitigation and adaptation.

The Commission is mindful of the need to consider the range of circumstances across local authorities, and to understand the underlying drivers of costs in these different situations. The inquiry will therefore seek to explore some of these situations in depth, for example through the use of case studies. The Commission will also have regard to current frameworks for capital expenditure decision-making, including cost-benefit analysis, incentives on decision makers and oversight of decision making.

Having considered the factors underpinning local government cost pressures, the inquiry will explore the range of options for funding services. This will include assessing the ability of the current funding and financing model to meet local governments' obligations, now and in the future. It will also consider alternative approaches to managing cost pressures, including the

potential for productivity improvements and innovative responses to service delivery. The Commission will base its analysis broadly on the scope of services currently delivered by local government.

To the extent that there are shortcomings with the current framework for funding and financing, the inquiry will identify and appraise new local government funding and financing tools and consider how a transition to any new funding and financing models should be managed. Important criteria against which any new funding and financing models should be assessed include efficiency, equity, effectiveness and affordability. The Commission is also interested in the wider effects that the funding and financing system can have – for example the extent to which it creates incentives for councils to facilitate population and economic growth.

The Commission will also assess whether changes are needed to the regulatory arrangements overseeing local government funding and financing.

The Commission is committed to a transparent inquiry process that provides opportunities for the wider local government sector, central government agencies, other stakeholders and the general public to participate. The Commission's inquiry model provides multiple opportunities for interested parties to make submissions and speak to the inquiry team and Commissioners.

Drawing on feedback from inquiry participants, the Commission plans to publish a draft report in mid- 2019, which will include a set of draft findings and recommendations. Further opportunity will be available for interested parties to provide feedback and input before a final report is delivered to referring Ministers in November 2019.

## What the inquiry is not about

Mechanisms for rating Māori freehold land and Crown land, the valuation system and practices and substantial privatisation are excluded from this inquiry. These issues have been well canvassed in the past<sup>2</sup> and the inquiry Terms of Reference notes that further inquiry in these areas would not assist in achieving sustainable local government financing.

The inquiry is not to make recommendations that would directly affect representation or boundary arrangements for councils.

The inquiry Terms of Reference do not call for an assessment of, or changes to, the current scope and responsibilities of local government. Were the scope and responsibilities to change significantly, a fresh look at the appropriate range of funding and financing tools would be required.

## The context of this inquiry

Some of the functions of local government have been the subject of significant analysis in recent years. In particular, the Commission assessed local government regulatory performance (*Better local regulation, 2013*), local government processes surrounding the supply of land for housing in high growth areas (*Using land for housing, 2015*) and undertook a first principles review of the

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<sup>2</sup> For example, the Commission (2015) found that the rating exemption on core Crown land does not appear to have a principled justification.

urban planning system (*Better urban planning, 2017*). These reports touched on issues relevant to this inquiry, such as local government approaches to rating and financing and funding the infrastructure needed to accommodate population growth.

In addition, existing government work programmes are relevant to this inquiry. In particular, the Ministry of Business, Innovation and Employment is leading the *Urban Growth Agenda*, which is a programme of work to improve housing affordability underpinned by affordable land. It aims to remove undue constraints to land supply, development capacity and infrastructure provision (Ministry for the Environment & Ministry of Business, Innovation and Employment, 2018).

Also, the Department of Internal Affairs (DIA) is reviewing how to improve the management of drinking water, stormwater and wastewater (three waters). The review has released an initial assessment that found evidence of performance issues and pressure points within the three waters system. Further work is being undertaken to develop options for improving the three waters system, including the management, service delivery, funding, and regulatory arrangements (DIA, 2018).

While these pieces of work provide useful context for this inquiry, they have tended to focus on specific aspects of the funding and financing system (eg, funding and financing infrastructure to support housing supply), or on specific classes of infrastructure (three waters). The last comprehensive review of local government funding and financing was the *Report of the Local Government Rates Inquiry* (the Shand Report) which was published in 2007. More than 10 years later, this inquiry presents an opportunity to take a holistic look at the funding and financing system as it applies across the range of local government functions.

## Why the inquiry is important

It is important that the funding and financing framework enables local governments to deliver quality services when and where they are needed. But equally, the range of services provided by local governments are largely paid for by local ratepayers, and it is important that services are effective, efficient and affordable.

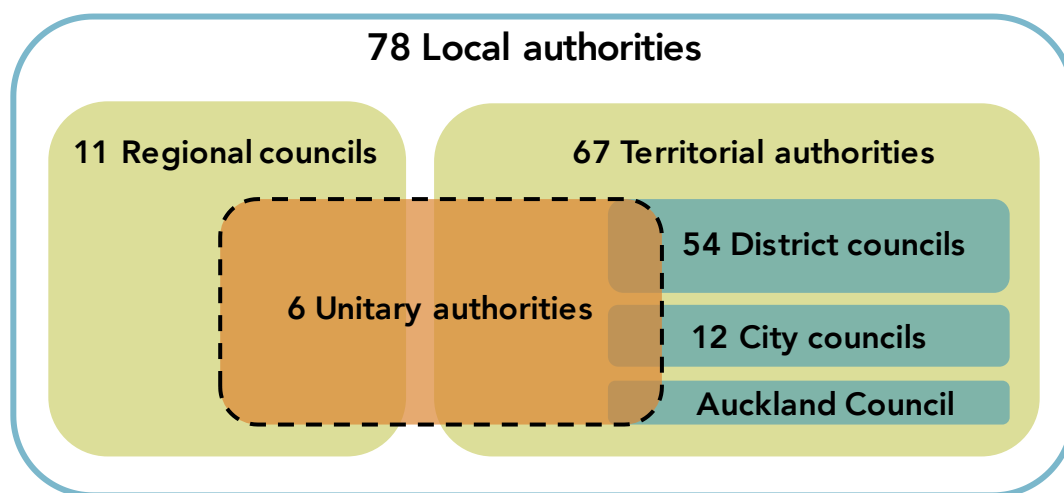
Where local government funding and financing systems do not operate efficiently or effectively it can have a deleterious effect on the performance of local government in meeting community needs and expectations. For example, the Commission has previously found instances where the costs of growth (eg, new and upgraded infrastructure) are met by existing ratepayers. This magnified ratepayers' opposition to new development, creating an environment where councils were reluctant to embrace growth which in turn contributed to a sluggish supply of land for housing and worsening housing affordability.

If councils struggle to deal with rising costs this can lead to uncomfortable compromises. For example, a recent review of New Zealand's water infrastructure identified that around 750 000 people are served by water supplies that did not meet drinking water standards in 2015/2016 (DIA, 2017a). And there are examples of ageing wastewater treatment plants that are struggling to cope with demand – in one exceptional case resulting in partly treated wastewater being discharged periodically into a nearby riverbed (Opus, 2016).

## 2 Local government in New Zealand

Local government is a term used to collectively describe New Zealand's 78 regional, district, city or unitary councils (Figure 2.1).

**Figure 2.1 Types of local government**



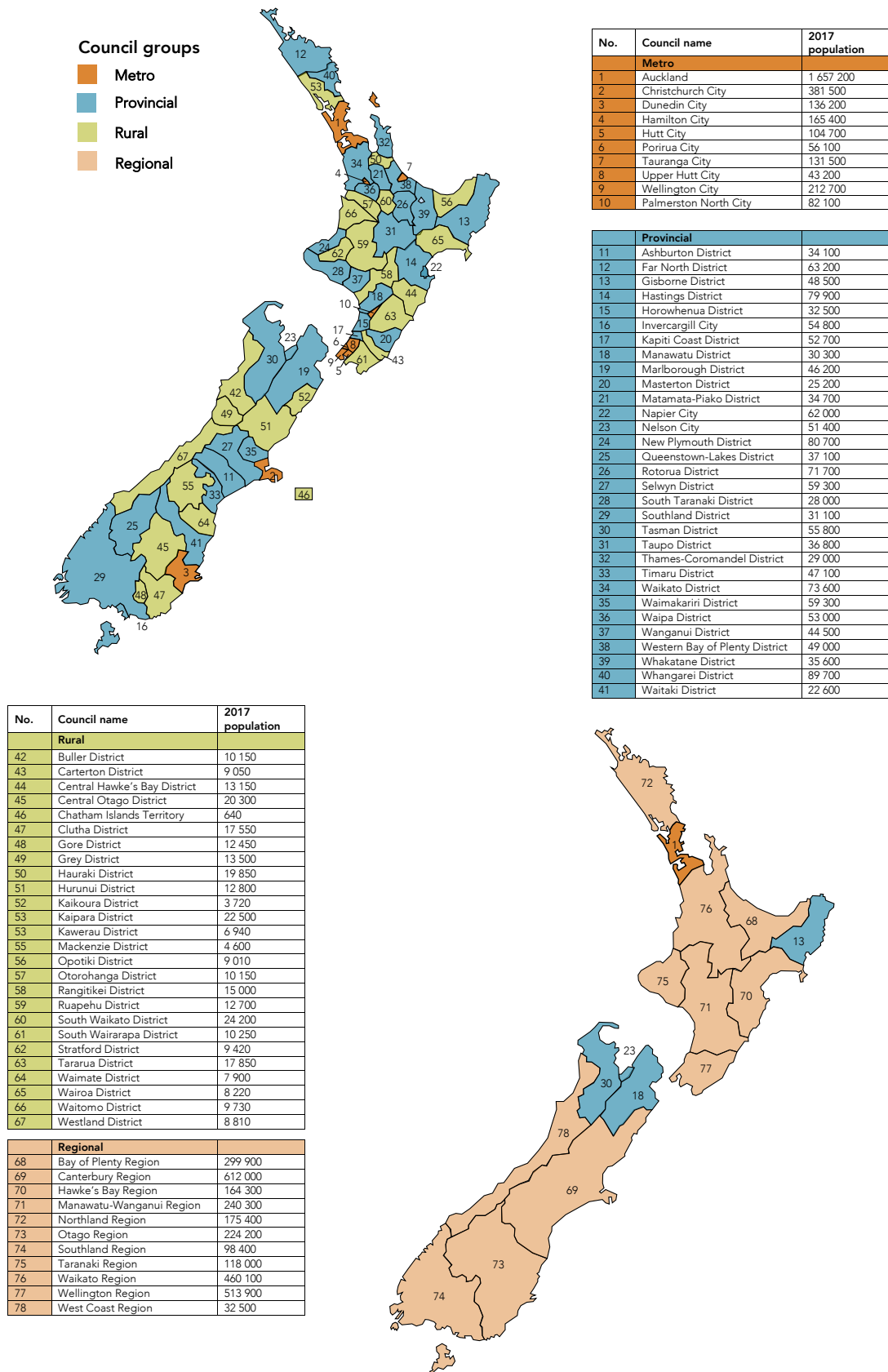
*Note:* The 67 territorial authorities include 54 district councils (four of which are unitary authorities), 12 city councils (one of which is a unitary authority) and Auckland Council (which is a unitary authority).

Regional councils are responsible for the physical environment and cross-boundary functions that require an integrated approach, which include regional land transport, flood protection, biosecurity, civil defence and some resource management. The functions of territorial authorities (city and district councils) are broader, encompassing physical infrastructure such as roads, water supply, waste water and storm water, recreation and cultural activities, land use planning, building standards and some public health and safety functions. A unitary authority is a territorial authority that also has all the responsibilities of a regional council.

The scale of local government is significant. In June 2017 local governments owned \$119 billion worth of fixed assets, employed 25 300 staff (full-time equivalent) and had annual operating expenditure of \$9.9 billion and operating income of \$9.4 billion (DIA, nd-a).

Figure 2.2 shows the location and population of local authorities. It also groups local authorities into sector groups: metropolitan; provincial; rural; and regional. These sector groups are based on Local Government New Zealand (LGNZ) membership.

Figure 2.2 New Zealand local authorities: population and sector group



Note: Unitary authorities appear on the map of territorial authorities and the map of regional councils, and are colour coded based on whether they are metro, provincial or rural.

## The purpose and powers of local government

The Local Government Act 2002 (LGA) states that the dual roles for local government in New Zealand are:

- to enable democratic local decision making and action by, and on behalf of, communities; and
- to meet the current and future needs of communities for good-quality local infrastructure, local public services, and performance of regulatory functions in a way that is most cost effective for households and businesses.

### The powers of local government

Local government is a creature of statute – it is established and empowered by legislation. The main laws that currently govern and empower local government are set out below.

- The LGA provides local authorities with the power of general competence (the ability to choose the activities they undertake and how they should undertake them, subject to public consultation). It sets out the powers of councils, including the power to make local bylaws, and councils' planning and accountability requirements.
- The Local Government (Rating) Act 2002 (LGRA) sets out the methods by which councils raise revenue through rates.
- The Local Government Act 2002 Amendment Act 2010 prescribes rules for council performance standards for core services of the LGA.
- The Local Electoral Act 2001 sets out the process for council elections.
- The Local Government (Auckland Council) Act 2009 sets out the governance structure for the Auckland Council.
- Local government activities (especially regulatory functions) are also governed by a number of statutes, such as the Resource Management Act 1991 (RMA) and the Building Act 2004.

The functions and roles of local government have been frequently restructured and reshaped over the years by central government through legislative change. For example, the Local Government Amendment Act 2012 changed the second of the two purposes of local government (noted above). Previously, the purpose was to promote the four well-beings of communities (social, economic, environmental and cultural). At the time of writing, the Local Government (Community Well-being) Amendment Bill – which restores the four wellbeings as a core purpose of local government – had progressed to the select committee stage.

### Constitutional relationships with central government

Local authorities are accountable to and funded by their own communities.

While local government is a creature of statute, it operates as a largely autonomous provider of services, funded separately by property taxation and held accountable by voters. In the absence of well-defined constitutional or fiscal relationships, local and central government are most accurately regarded as two spheres of a system of collective decision-making, each with revenue-collection powers to fund the implementation of its particular policies and programmes. (Local Futures Research Project, 2006, pp. 13-14)

Local authorities are sometimes characterised as an agent of central government, required to implement national priorities and central government's directions, and accountable to central government. However, in reality, the nature and extent of local authorities' relationship with central government is context-specific, depending on the particular regulatory framework.

Some regulatory frameworks (such as for building) specifically provide that a local authority is accountable to the relevant minister or government department. However, in the absence of explicit statutory recognition of a line of accountability, a local authority is not accountable to the relevant minister or government department for the exercise of its statutory powers.

## Constitutional relationships with Māori

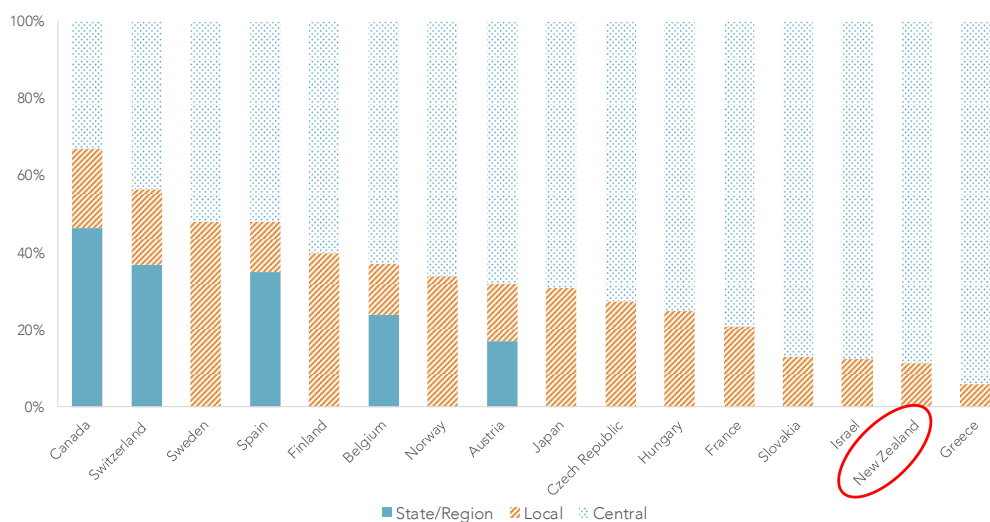
The Local Government Act (2002) includes a specific Treaty of Waitangi clause, which provides that the Crown's obligations under the Treaty are recognised and respected by placing obligations on local authorities to facilitate participation by Māori in local authority decision-making processes (s 4).

Local iwi have a strong interest in local authority functions. This is especially so for resource management decisions under the RMA. Section 6 of the RMA recognises "the relationship of Māori and their culture and traditions to their ancestral lands, water, sites, waahi tapu, and other taonga" as a matter of national importance. Section 7(a) requires persons exercising functions and powers under the Act to have particular regard to kaitiakitanga, while section 8 requires them to take into account the principles of the Treaty of Waitangi. "[K]aitiakitanga means the exercise of guardianship by the tangata whenua of an area in accordance with tikanga Maori in relation to natural and physical resources; and includes the ethnic of stewardship" (s. 2).

## The scope of local government

Local government in New Zealand currently has a smaller scope of responsibilities than local governments in many other countries, and this is reflected in local government accounting for a small share of total government spending (Figure 2.3). This is in part because many of the functions undertaken at the local level in other countries, such as health services and education, are funded centrally in New Zealand and provided through Crown entities.

**Figure 2.3 Spending by level of government, selected OECD countries (2010)**



Source: OECD/Korea Institute of Public Finance (2012).

## Differing circumstances across local authorities

### Local authorities vary considerably in size

Local authorities vary considerably in population size. Auckland Council, the largest authority, has a population of about 1.6 million, while the smallest authority, Kaikōura District Council, has a population of just under 4 000. All councils are responsible for the same core services, such as local roading and the three waters, but the share of expenditure allocated to different services can vary significantly between councils (Chapter 3).

### Population growth and decline across local authorities

New Zealand has experienced significant population growth since the 1990s. Accordingly, the populations of most local authorities have grown over recent decades; some have grown considerably (Figure 2.4). For instance, Queenstown-Lakes District more than doubled in size, partly because of strong growth in its tourism industry. Selwyn District's population also doubled.

In absolute terms, a high proportion of recent population growth has occurred in large urban councils, particularly Auckland, Hamilton and Tauranga – commonly referred to as the Golden Triangle (NZPC, 2015). The scale of Auckland's population growth is unique (Box 1).

#### Box 1 The unique case of Auckland

About 35% of New Zealanders live in Auckland. Over the past two decades Auckland has grown rapidly and its population is projected to increase by another 550 000 people over the next 20 years. That increase is more than three times Hamilton's total population. The size of Auckland combined with its rapid growth brings about unique challenges.

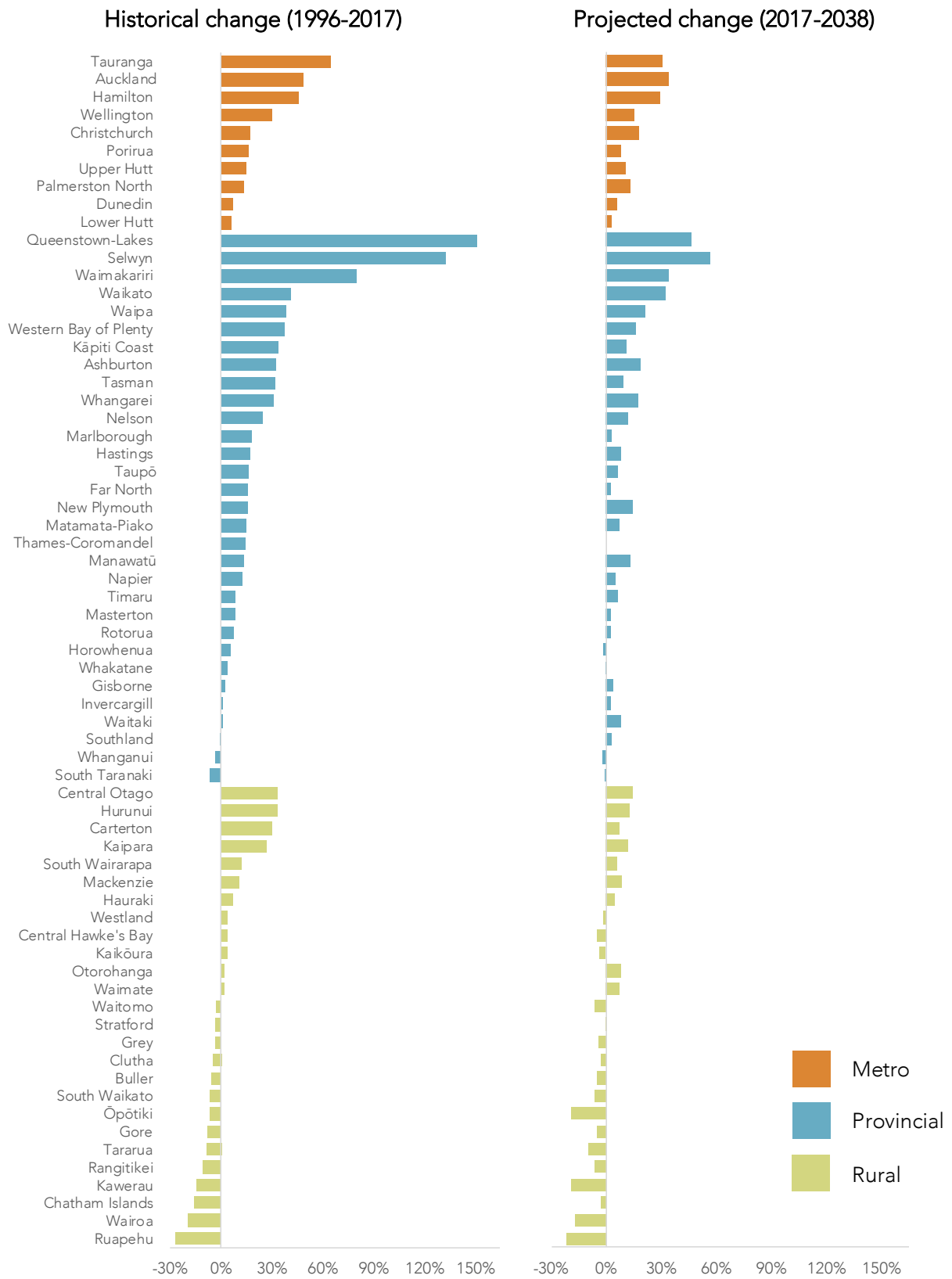
- The Council needs financing and funding in place to deliver significant additional infrastructure to service new developments associated with population growth.
- Population growth has put substantial pressure on the transport network, resulting in increased traffic congestion, particularly at peak periods. It has also demanded large investment in roading infrastructure and public transport (eg, the CityRail link).

Given Auckland's size, failing to effectively address these challenges has indirect (and material) effects on the prosperity of the wider New Zealand economy. Accordingly, central government is working with Auckland Council to address some growth-related issues; for example, through the Auckland Transport Alignment Project and the Congestion Question project. Also, a recent legislative change enables Auckland Council to implement a regional fuel tax as a new tool to fund transport projects (Chapter 3).

Yet, not all local authorities have seen growth – several faced a decline in population between 1996 and 2017. With the exception of Whanganui, declining councils are smaller provincial and rural councils. For example, the population of Ruapehu District reduced by roughly a quarter, from 17 300 to 12 700, between 1996 and 2017. Wairoa District reduced in size by about 20% (Figure 2.4).



**Figure 2.4 Historical and projected population change across local authorities**



Source: Stats NZ (2018a,2018b).

Note: Population projections based on 2013 population estimates.

These recent trends reflect a general trend of urbanisation as people move from smaller centres to larger towns and cities. While predicting future population changes is inherently difficult, projections from Stats NZ suggest these trends may continue (Figure 2.4). Specifically, cities within the Golden Triangle, along with Queenstown and Selwyn, are projected to grow the fastest, while 20 provincial and rural local authorities are projected to decline at varying rates.

## **Age structure**

The average age of populations in towns and cities has been increasing as a result of historic reductions in birth rates and increasing life expectancy. Across New Zealand as a whole, the median age is projected to increase from 37.5 years to 42.9 years between 2013 and 2043. Projections vary across councils – for example, the median age in Ashburton District is projected to increase from 39 to 40 in the years to 2043. By contrast, the median age in Porirua City is projected to increase from 35 to 45 (Stats NZ, 2018b).

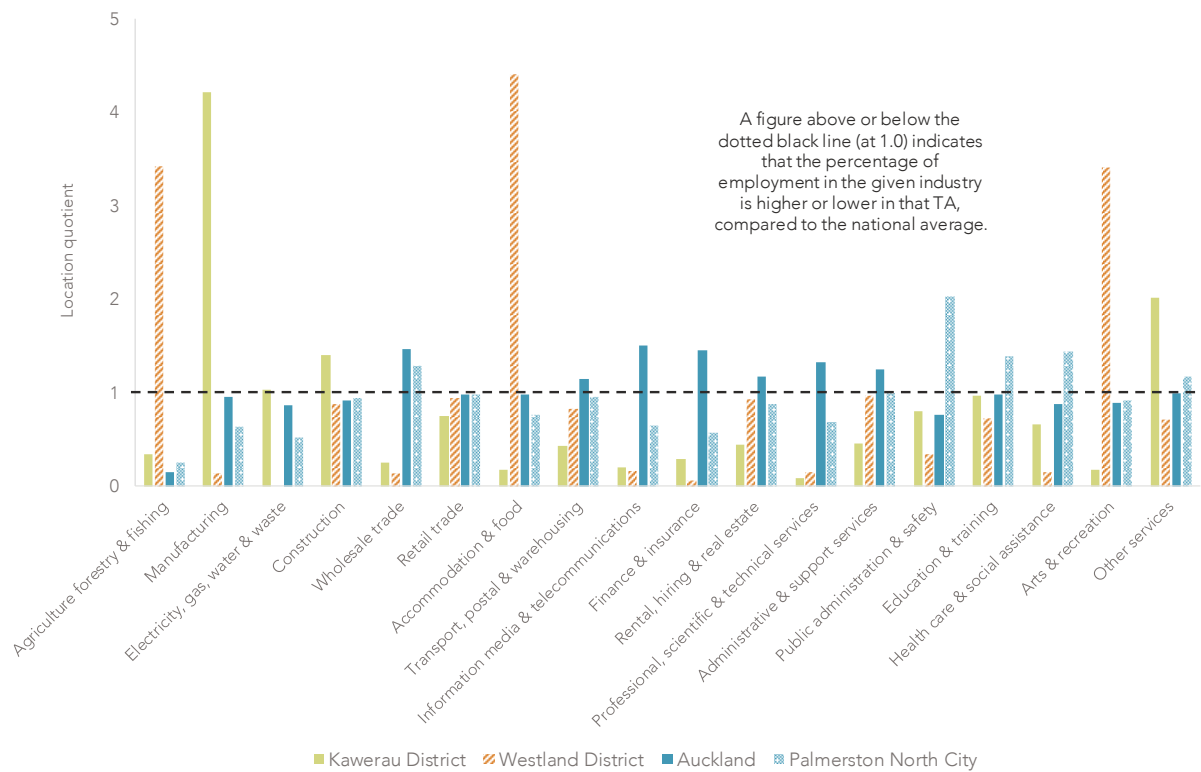
High-growth areas tend to have a younger population than slow-growth areas (NZPC, 2015), although areas attractive for retirees, such as Kāpiti Coast and Tauranga, are exceptions where population growth among older residents has been fast. In towns and cities facing decline, the younger demographic is often the first to leave. This in turn reduces the share of people at reproductive age, thus slowing the rate of natural increase in population and leading to further slow growth (or decline) over time. The factors driving population decline can be highly challenging (and in some cases impossible) to reverse (NZPC, 2017).

## **Physical resources and industry structure**

Physical resources and industry structure vary across the country, driving different infrastructure requirements and local regulatory needs in different areas. Employment data indicate a pattern of larger 'hub' territorial authorities where employment is distributed across a range of industries, while industrial specialisation is greater in smaller territorial authorities (Figure 2.5).

Some areas have very specialised industries. For example, employment in the Kawerau District is heavily concentrated in manufacturing, reflecting the importance of the nearby Norske Skog newsprint mill in the local economy. In the Westland District, employment is most concentrated in accommodation and food, followed by agriculture, forestry, and fishing. Palmerston North has a similar industry structure to the national average, reflecting its position as a regional hub providing goods and services for a wide area. A similar industrial structure can be seen in Auckland (Figure 2.5).

**Figure 2.5 Industry structure in selected territorial authorities compared to the national average, 2017**



Source: Productivity Commission estimates using Stats NZ Business Demography Statistics.

**Notes:**

1. The percentage of employment in each industry is compared to the percentage of employment in that industry across the country as a whole.
2. Mining, which accounts for a very small share of employment in the selected TAs, is not included.

## Other relevant issues

Other differing circumstances relevant to funding and financing local government services include:

- some local authorities (eg, Queenstown-Lakes District Council) experience much higher tourism levels than others, placing additional pressure on their local infrastructure network;
- the potential impacts of climate change and other environmental issues (eg, deteriorating water quality) differ across councils; and
- a small number of councils, including Christchurch City Council and Kaikōura District Council, face particular funding challenges due to the impacts of severe earthquakes.

**Q1**

**What other differing circumstances across councils are relevant for understanding local government funding and financing issues?**

# 3 How funding and financing currently works

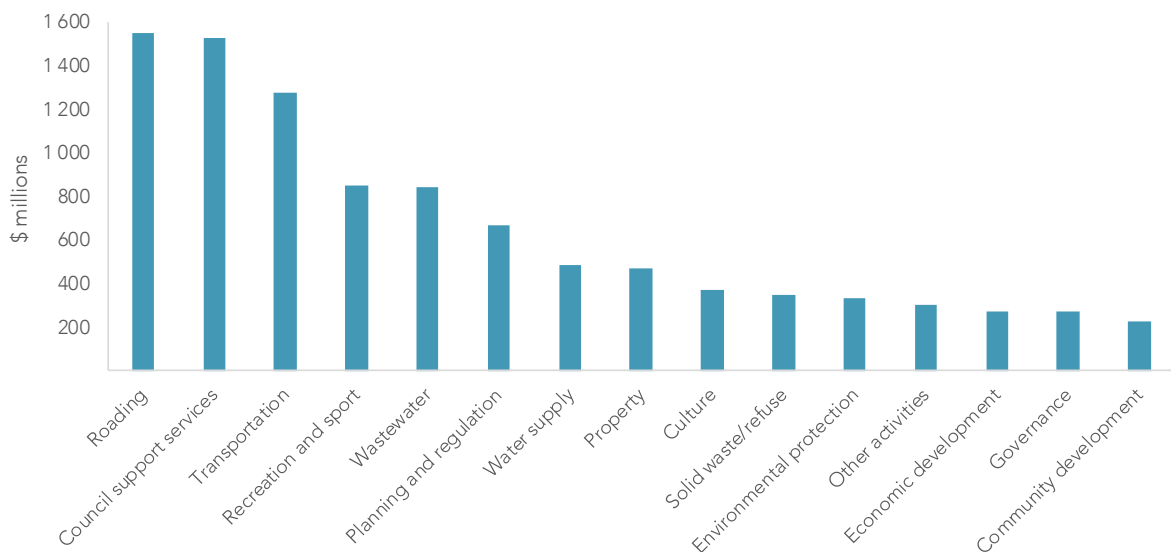
## What do councils need to pay for?

### Operating expenditure

Councils had a total operating expenditure of nearly \$10 billion in 2017. Operating expenditure is the ongoing cost of providing day-to-day council services. The five largest sources of expenditure account for around two thirds of the total (Figure 3.1).

- *Roading* (maintenance of gravel and tar-sealed roadways, bridges, cycle lanes, verges, and footpaths) is the largest expenditure area accounting for about 16% of total expenditure.
- *Council support services* (which include overheads for local authority administration, finance, IT, and HR functions as well as preparation of reports such as Long-Term Plans) is the second largest expense (15.5%).
- *Transportation* (bus and all other forms of passenger transport such as rail, trams and ferries, parking, airports, and transport planning) accounts for 13% of expenditure.
- *Recreation and sport* (which includes swimming pools, sports facilities, reserves, playgrounds, and bike and walking tracks) accounts for about 9% of expenditure.
- *Wastewater* accounts for 8.5% of expenditure.

**Figure 3.1 Total operating expenditure for all councils by activity (2017)**

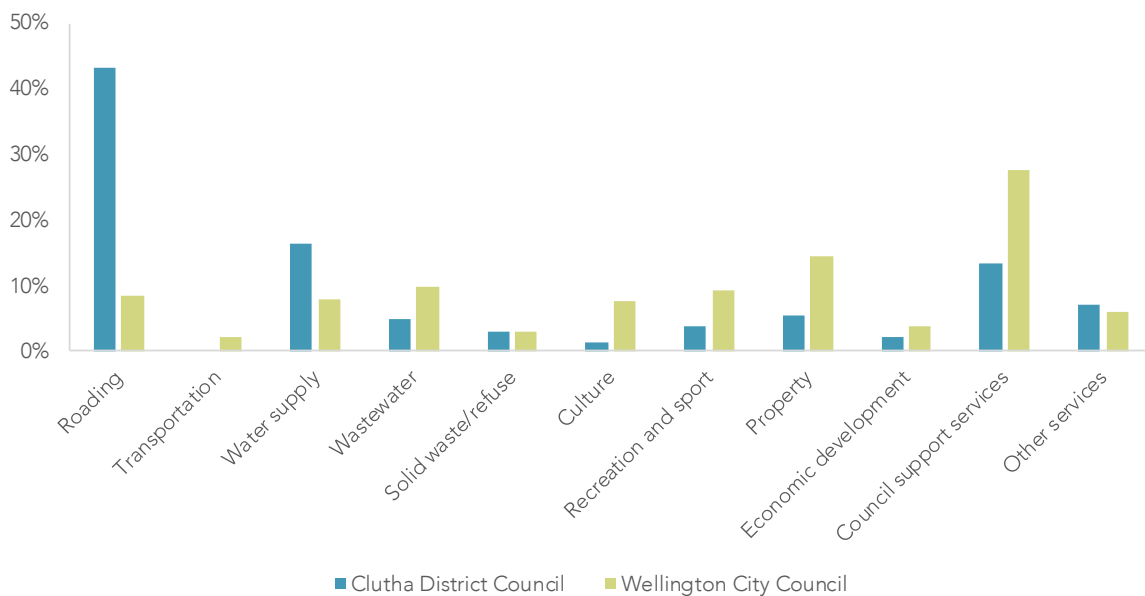


Source: Stats NZ (2018c).

Note: All figures in this chapter show data for the year ended June 2017.

There is significant variation in the demands faced by councils. As an example, Figure 3.2 shows expenditure on different activities as a share of total operating expenditure for Wellington City Council and Clutha District Council. Clutha is a rural local authority with a population of 17 550 and a large road network covering nearly 6 400 square kilometres (LGNZ, 2015a; Stats NZ, 2018d). It spends 43% of total expenditure on roading, while culture and recreation and sport accounted for just 5%. Wellington City Council has a population 12 times that of Clutha and less than 5% of the land area (LGNZ, 2015a). Wellington spent 9% of its budget on roading, while culture and sport and recreation accounted for 17%.

**Figure 3.2 Operating expenditure by activity for Wellington City and Clutha District (2017)**



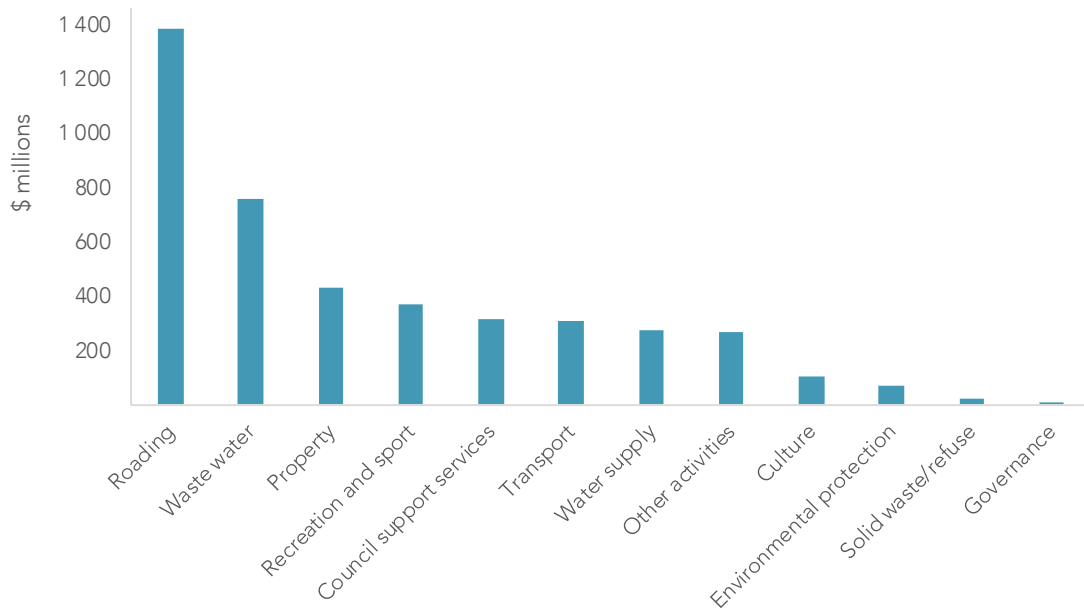
Source: Stats NZ (2018c).

Note: Other services include environmental protection, governance, emergency management, planning and regulation, community development and other activities.

### Capital expenditure

Local government capital expenditure in 2017 was \$4.31 billion, up from \$3.35 billion in 2007 – a real increase of 7% (Stats NZ, 2018c). Capital expenditure pays for building or buying new assets to meet additional demand, replacing existing assets, and improving assets to deliver better levels of service. Roading and wastewater were the two largest areas of capital spending in 2017 (Figure 3.3).

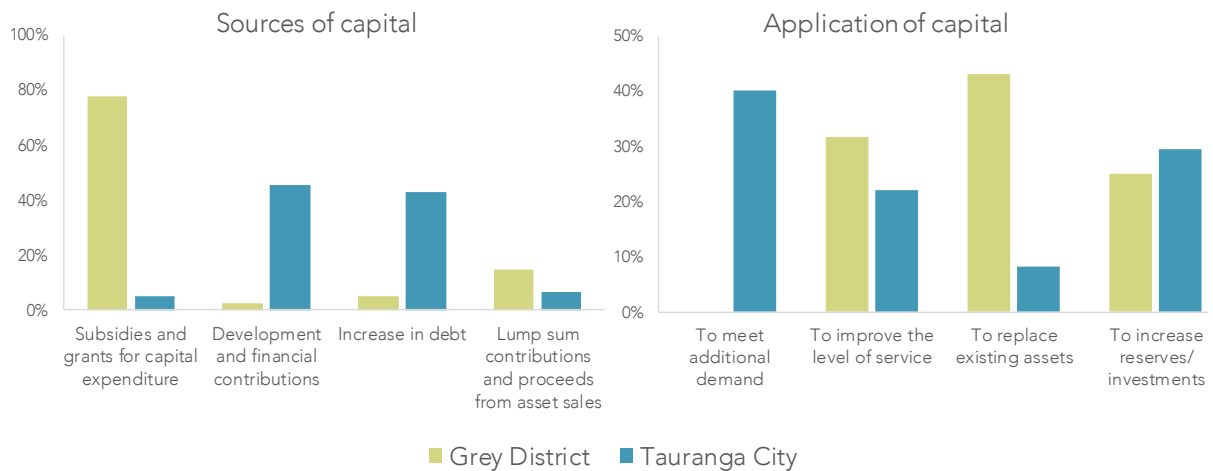
**Figure 3.3 Total capital expenditure by activity, all councils (2017)**



Source: DIA (nd-b).

As with operating expenditure, there is significant variability across councils in where capital spending is directed, and how they raise funds for capital projects. For example, Figure 3.4 shows the sources and application of capital expenditure for Tauranga City Council and Grey District Council. Tauranga is a fast-growing city. A relatively large share of its capital comes from development and financial contributions, and a large share is directed toward new investments to meet additional demand. Grey District has a relatively small and stable population. A large share of its capital came from subsidies and grants — largely New Zealand Transport Agency (NZTA) contributions — and was directed toward replacing existing assets and improving levels of service.

**Figure 3.4 Capital expenditure, Grey District and Tauranga City (2017)**

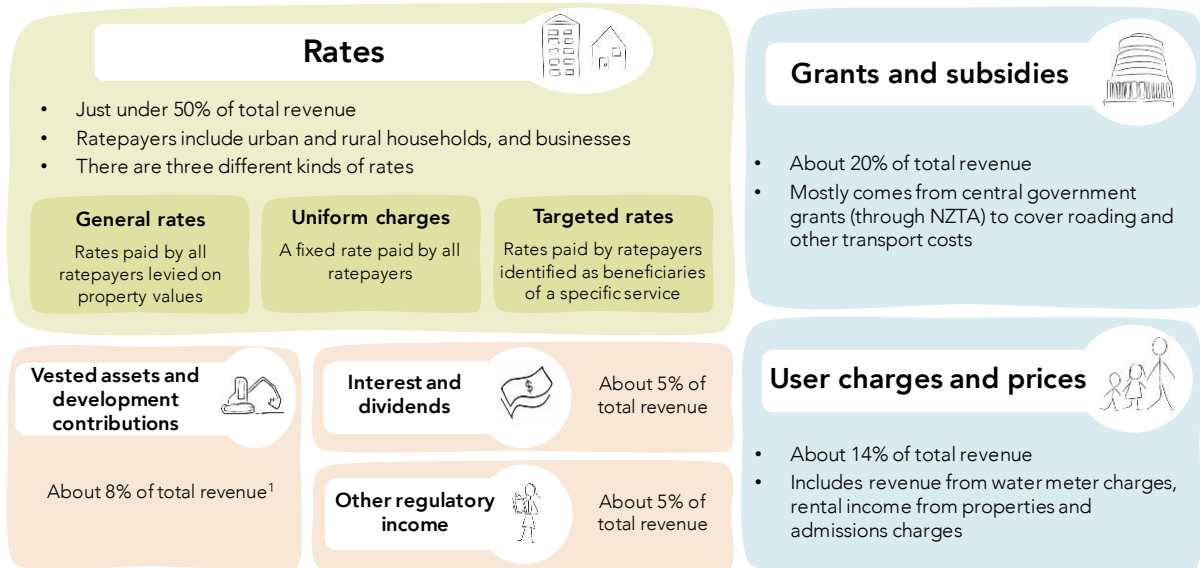


Source: Grey District Council (2017); Tauranga City Council (2017).

## What funding sources are available to local government?

Councils can access a variety of sources of revenue to fund infrastructure and other services. These can pay for both operating costs and the costs of any debt attached to infrastructure assets. Total revenue across all local authorities in 2017 was about \$11.6 billion. This does not include \$5.6 billion in revenue generated by valuation changes and other non-operating income.

**Figure 3.5 Main funding tools available to local authorities**



Notes:

1. Includes financial contributions.
2. Estimates exclude income from valuation changes and other non-operating income.

### Rates

Under the LGRA, local authorities may set a general rate for all rateable land within a district. Rates are councils' major revenue source making up 48% of total revenue in 2017. Rates revenue is used mainly to fund operating expenditure, but it can be used in a variety of other ways, including funding new infrastructure assets or the interest costs on debt incurred to finance them.

The relationship between property values and rates is frequently misunderstood, with many assuming that increasing property values translate to increased rates. However, it is council expenditures that drive rates. By law, councils must decide how much they will spend in the coming year and then set rates to cover those expenses. Property values are used to allocate the burden of rates, and the share of general rates paid by an individual household or business depends on the value of their property relative to the value of other ratepayers' properties in the council area. Where property values change differently (for example if property values in a certain suburb are assessed to have increased more than another suburb) then the rating burden will change, with those property owners in the higher-value suburb facing a greater proportion of total rates. The total amount of revenue raised does not change as property values change.

Many councils apply a rating differential to groups of ratepayers, which adjusts the proportion of rates paid by different groups of ratepayers. Differentials are usually expressed as multipliers of

the residential rate – if the residential rate is \$1.00 per \$1 000 of property value and the business rate is \$2.50, the business differential is 2.5 (Covec, 2007).

### **Targeted rates and uniform annual general charges**

The LGRA allows councils to set targeted rates to fund infrastructure and services that benefit identifiable taxpayers. Christchurch City Council, for example, has targeted rates for properties near new cycleway projects, those that benefit from land drainage and some that are connected to specific water and sewerage schemes.

Local authorities are also able to set a uniform annual general charge, which is a fixed charge per rating unit.

### **Prices, user charges and other regulatory income**

Under the LGRA, councils can set volumetric charges for drinking water. They may be calculated as either a constant price per unit of water supplied and consumed, or according to a scale of charges. Councils can also charge for services such as solid waste collection, swimming pools, facilities hire, regulatory services (eg, building consent and liquor licensing fees), and other council-provided services. Such charges help recover operating costs and may contribute to capital costs.

Fuel taxes are also a source of income for local authorities, and recent legislation allows for the collection of regional fuel taxes (Box 2).

#### **Box 2 Fuel taxes**

Local authority fuel tax is levied on petrol and other fuels, at between 0.33 and 0.66 cents per litre, and distributed to local authorities by central government (MBIE, 2018a).

The Land Transport Management (Regional Fuel Tax) Amendment Act (enacted 26 June 2018) provides a funding tool for Auckland Council to raise revenue to fund transport projects that would otherwise be delayed or not funded. A regional fuel tax of 10 cents per litre (plus GST) applies from 1 July 2018 within the Auckland region. From January 2021 other councils will be able to apply to establish a regional fuel tax. Applications will be subject to a Ministerial approval process (Ministry of Transport, 2018).

### **Grants or subsidies**

Central government provides grants to support council operations, particularly transport (via the NZTA). National roads are fully funded by central government, while local roads are jointly funded by local and central government. Overall, central government covers 53% of the cost of local transport programmes (NZTA, 2018).

### **Interest and dividends**

Many local authorities own (or part own) business enterprises such as ports, airports, forests, and farms, or have investments in financial assets such as bonds and shares. Income from these sources amounted to 6% of local authorities' total operating income in 2017.



## Development and financial contributions

Development contributions are charges levied on developers under the LGA to recover the portion of new infrastructure that is related to growth. They can be charged for the capital costs of connections to trunk infrastructure (water, wastewater, stormwater, roads and other transport), and community infrastructure (such as neighbourhood halls, reserves, playgrounds and public toilets). They can be charged when a resource consent, building consent or service connection is granted. Councils are required to set out a development contributions policy that explains how contributions are calculated.

Financial contributions are charges set under the RMA that provide councils with resources to avoid, remedy or mitigate adverse environmental effects. Contributions can take the form of money or land and must promote the sustainable management of natural and physical resources. They may be applied to fund capital expenditure on similar assets to development contributions but cannot be used to fund the same expenditure for the same purpose, or to fund operating spending.

Parliament recently legislated the phase-out of financial contributions by 2022. The purpose of the phase-out, according to the previous Government, was to avoid overcharging (on top of development contributions) and simplify the process of recovering infrastructure costs (New Zealand Government, 2015).

## Vested assets

As an alternative to councils providing infrastructure and recovering costs through development contributions, developers sometimes directly provide infrastructure through development agreements (a form of contract with local authorities). Once completed, the infrastructure is vested in the council. In this case, the council does not bear any capital costs for the infrastructure, but needs to meet ongoing operational, maintenance and depreciation costs.

## Sources of finance

Financing refers to the way in which debt and/or equity is raised for the delivery of a project or service at the time it is needed. Local authorities can finance projects on a pay-as-you-go basis (eg, through current revenue, grants or accumulated savings) or through borrowing.

With pay-as-you-go financing, councils purchase or construct only those capital assets made possible by financial resources currently at their disposal, such as cash in the capital budget, savings and reserve funds, or other cash on hand. Pay-as-you-go financing essentially takes current revenues – taxes, user charges, and grants collected in the current fiscal year – and applies them directly to current capital expenditures for the same year.

Proponents of pay-as-you-go financing argue that it avoids interest costs, supports local government's fiscal flexibility, and maintains borrowing capacity. However, because pay-as-you-go limits investment essentially to what can be funded from cash in hand, it is likely to lead to large projects being delayed. Accordingly, it may not effectively or efficiently fund the infrastructure needed to support a growing population. The approach is also inconsistent with intergenerational equity. If pay-as-you-go is employed for assets with a long lifespan, the current generation of users bear all the costs. Future generations pay nothing and yet still enjoy the benefits (although future generations may be required to pay for the next investments in infrastructure that will primarily benefit subsequent generations).

Borrowing enables the cost of assets to be matched with their benefits over their life. This promotes intergenerational equity, since those who benefit from the infrastructure contribute to its cost. Other benefits of debt finance include:

- councils can deliver infrastructure earlier than they otherwise could have;
- there is less need to divert funds from internally generated renewal and maintenance budgets to capital expenditure;
- local governments' steady and secure income from rates can be used to meet debt-servicing obligations and to secure debt facilities; and
- it can facilitate institutional investment, such as from superannuation funds, which brings with it additional rigour and discipline (Ernst & Young, 2012).

### Options for raising debt

Local authorities have three main options for raising finance.

- *Banks and other financial institutions* – Since 1996, local authorities have been able to borrow directly from banks (previously, councils could only borrow from the Local Government Loans Board).
- *Local bonds* – Local authorities may issue local bonds. For example, Auckland Council has issued fixed-rate retail bonds that are listed on the NZX Limited Debt Market (Auckland Council, 2018a).
- *The New Zealand Local Government Funding Agency (LGFA)* – The LGFA was established in 2011 to raise debt on behalf of local authorities on more favourable terms to them than if they raised the debt directly (LGFA, 2018). The LGFA is a council-controlled organisation (CCO) and is jointly owned by central government (20% shareholding) and 30 councils (80% shareholding). Other than central government, each shareholder must be a guarantor.

Since its establishment, the LGFA has been the largest lender to local government, accounting for between approximately 60% and 85% of all lending to local government. Fifty-six councils are borrowers from the LGFA, with total borrowing at just under \$8 billion. LGFA lent councils just over \$1 billion in the 2017/18 financial year (LGFA, 2018).

## Laws and regulations for funding and financing

### Local Government Act

The LGA (and its various amendments) establishes processes to shape the provision of infrastructure and other local government spending. The Act also sets out a range of planning requirements relating to the provision of infrastructure (Table 3.1).

**Table 3.1 Local Government Act 2002 planning processes**

Requirement	Main purpose
Long-Term Plan	To plan activities and service provision over a timeframe of at least 10 years. As part of Long-Term Plans, local authorities must prepare and adopt a financial strategy. The strategy's purpose is to facilitate prudent

Requirement	Main purpose
	financial management, and to provide transparency about the effect of funding and expenditure proposals on rates, debt and investments.
Infrastructure strategy	To set, over at least 30 years, the local authority's approach to the development of new assets and the management of existing assets.
Asset management plans	To manage infrastructure assets in a way that meets required levels of service for current and future users.
Annual Plan and Annual Report	To set out and report on planned activities, revenue and expenditure for a financial year.

Source: NZPC (2015); Local Government Act (2002).

### Financial reporting requirements

Regulations introduced under the LGA in 2014 require every local authority to report in its Annual Plan, Annual Report and Long-Term Plan on its planned and actual performance against a number of financial prudence benchmarks (Table 3.2). The regulations were introduced to help identify local authorities where further inquiry is needed into their financial management; and to promote prudent financial management by local authorities (DIA, nd-c).

**Table 3.2 Local authority financial prudence benchmarks**

Benchmark	A local authority meets the benchmark if:
Rates affordability	<ul style="list-style-type: none"> <li>Actual or planned rates income for the year <math>\leq</math> quantified limits on rates income set by the authority in its financial strategy</li> <li>Actual or planned rates increases for the year <math>\leq</math> quantified limits on rates increases set by the authority in its financial strategy</li> </ul>
Debt affordability	Actual or planned borrowing for the year is within the quantified limits on borrowing set by the authority in its financial strategy
Balanced budget	Revenue for the year exceeds operating expenses
Essential services	Capital expenditure on network services for the year $\geq$ depreciation on network services
Debt servicing	Yearly borrowing costs $\leq$ 10% of its revenue (15% for high-growth councils)
Debt control	Actual net debt at the end of the year is $\leq$ planned net debt
Operations control	Actual net cashflow from operations for the year $\geq$ planned net cashflow from operations

Source: Local Government (Financial Reporting and Prudence) Regulations 2014.

Local authorities are also required to disclose in their Annual Report certain information about core infrastructure assets (water, wastewater, stormwater, flood protection and roading). The information includes the closing book value, the value of acquisitions made during the financial year, and estimates of replacement costs.

## Local Government (Rating) Act 2002

The purpose of the LGRA is to promote the purpose of local government set out in the LGA by

- providing local authorities with flexible powers to set, assess and collect rates to fund local government activities;
- ensuring that rates are set in accordance with decisions that are made in a transparent and consultative manner; and
- providing for processes and information to enable ratepayers to identify their liability for rates (LGRA, s 3).

In particular, Part 1 of the LGRA sets out who is liable to pay rates, what land is rateable, what kinds of rates may be set, and how rates are set. Other parts contain administrative provisions and liability for rates on Māori freehold land.

## Land Transport Management Act 2003

The Land Transport Management Act 2003 governs the funding of major transport projects and services, including road policing, public transport, and maintaining and developing the state highway network and local roads.

Through its Government Policy Statement (GPS) on Land Transport, central government sets the overall objectives and long-term results sought over a 10-year period, and expenditure ranges for each class of transport activity. NZTA then develops a three-year National Land Transport Programme (NLTP), which gives effect to the GPS and outlines the activities that will receive funding from the National Land Transport Fund.

Once the NLTP is confirmed, local authorities can seek funding for activities carried out in their area. They are required to develop a 10-year Regional Land Transport Plan that sets out the region's land transport objectives, policies, and activities where NZTA funding is sought.

The National Land Transport Fund typically does not cover the full cost of these activities. It meets an average of 53% of costs across the country. Local authorities contribute the rest, from sources such as rates, development contributions and passenger fares. The exact funding rate varies between 51% and 75% depending on the ability of local authorities to deliver transport outcomes.

# 4 Key funding and financing trends

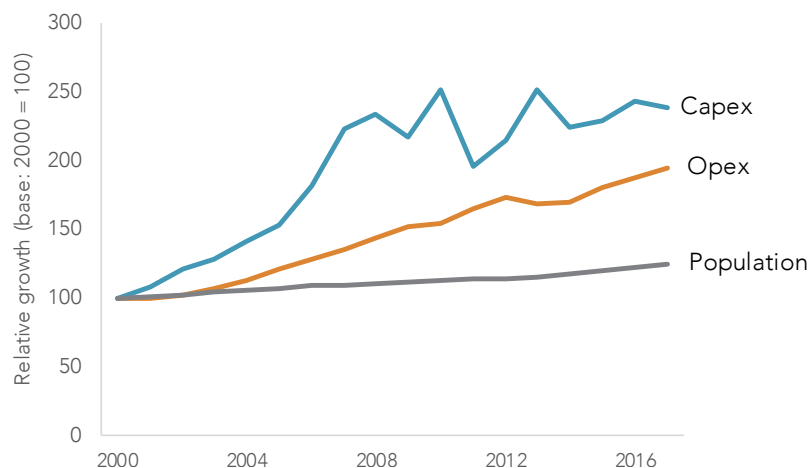
This chapter identifies key funding and financing trends for local authorities over recent decades. The chapter often distinguishes between high-growth, medium-growth, and low growth (and declining) councils<sup>3</sup>, based on population data between 1996 and 2017. All data are in real terms (in 2017 dollars) unless stated otherwise.

## Past trends in costs, funding and finance

### Growth in operating and capital expenditure

Both operating and capital expenditure by local authorities have grown significantly since 2000. Total expenditure increased from \$6.9 billion to \$14.2 billion between 2000 and 2017. Growth in spending was much faster than population growth, on average, over this period (Figure 4.1).

**Figure 4.1 Relative growth in local authority spending and population, 2000–2017**



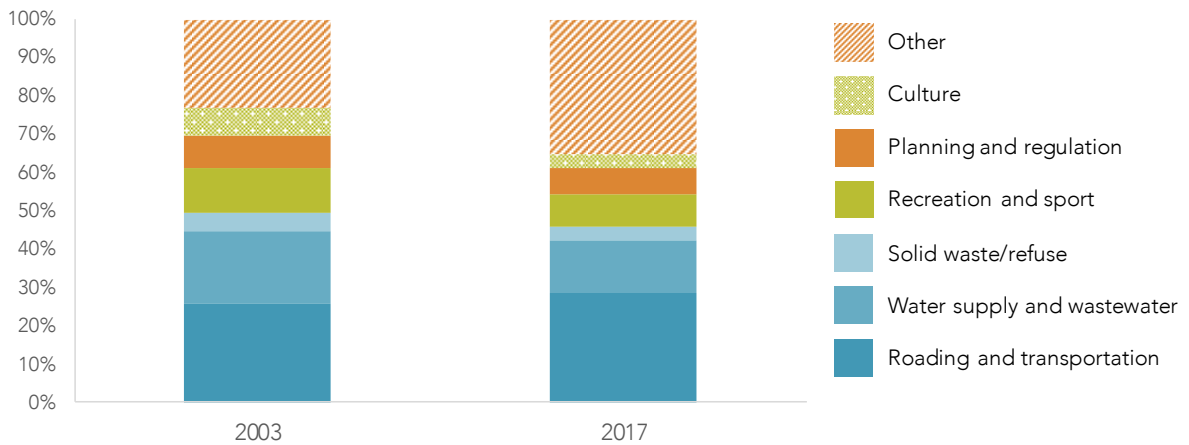
Source: Stats NZ (2018a, 2018c).

Note: Capital expenditure is estimated as “additions to fixed assets” from council financial statements.

Total operating expenditure increased by 95% between 2000 and 2017 at a relatively steady rate. Infrastructure is a large component of council operating costs and infrastructure costs have risen significantly. However, their relative contribution to expenditure fell slightly between 2003 and 2017, highlighting that other non-infrastructure activities (eg, council support services and economic development) collectively play a key role in driving rising costs (Figure 4.2).

<sup>3</sup> High-growth councils are defined as those with population growth of 30% or greater between 1996 and 2017. Medium-growth councils are defined as those with growth between 5% and 29.9% between 1996 and 2017. Low-growth (and declining) councils are defined as those with growth less than 5% between 1996 and 2017.

**Figure 4.2 Total operating expenditure across cost activities, 2003 and 2017**

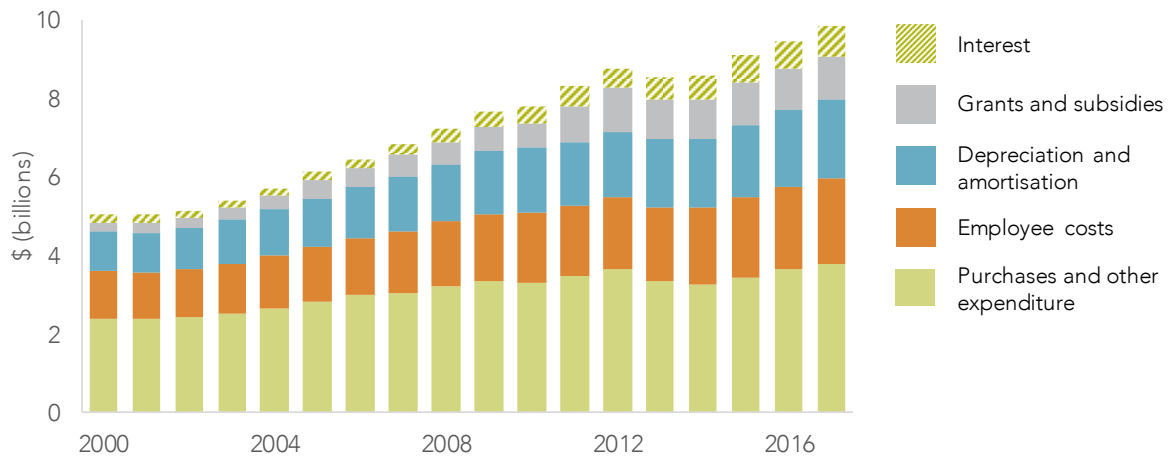


Source: Stats NZ (2018c).

Figure 4.3 breaks down council operating expenditure by specific cost sources (rather than cost activities). It shows that three significant drivers of operating expenditure are the depreciation and amortisation of assets, council grants, and interest payments. The contribution of these three costs to operating expenditure has increased from about 30% to 40% since 2003. Box 3 specifically discusses the impact of accounting for depreciation on local government spending.

Capital expenditure grew rapidly, by 133%, between 2000 and 2008. But growth has tapered off since then. An absence of historical data that breaks down capital expenditure by activity makes it difficult to determine the specific drivers of growth in spending during the earlier period.

**Figure 4.3 Total operating expenditure across cost sources, 2000-2017**



Source: Stats NZ (2018c).

**Box 3 The impact of depreciation on local authority costs**

Local authorities account for depreciation as an expense each year, to provide funds for future renewals of their assets. Depreciation calculations are based on the cost of replacing

an asset and this cost is spread over the asset's life. In 2017, depreciation made up about one fifth of total operating expenditure by local authorities. Therefore, the way in which depreciation is calculated can make a big difference to the required level of council rates.

Over time, the total amount of depreciation accumulated should roughly equal the total cost of replacing a council's assets. However, the Office of the Auditor-General (2018a) identified that over the past five years, asset reinvestment for most local authorities has been less than 100% of depreciation. In 2016/17 there was 28 local authorities whose renewals expenditure was less than 60% of depreciation. This may suggest that either: councils are opting to defer the replacement of assets; depreciation is too high; or funds accumulated from depreciation are being spent on other items.

Over-accounting for depreciation has implications for inter-generational equity because it means current generations pay more for future renewals. The Shand Report (2007) noted that there is "scope for reducing the extent to which depreciation is funded" (p. 3).

Q2

**What explains the difference between the amount that councils account for depreciation and the amount spent on renewing assets? Are changes needed to the methods councils use to estimate depreciation? If so, what changes are needed?**

## Both low-growth and high-growth councils saw rising expenditure

On average, between 2000 and 2017 high-growth councils saw a larger increase in operating and capital expenditure than low-growth councils. But spending from low-growth councils still grew significantly and, interestingly, their per-person operating expenditure rose faster than for high-growth councils. LGNZ (2015a) noted that smaller rural areas tend to face higher per-person costs for renewing infrastructure assets, since each part of the network serves fewer people.

**Table 4.1 Growth in expenditure, 2000-2017**

Type of local authority	Annual growth in opex	Annual growth in opex per capita	Total growth in capex
High growth	4.6%	2.5%	132%
Medium growth	3.1%	2.35%	69%
Low growth	3%	3%	74%

Source: Stats NZ (2018c).

Notes:

1. Each statistic is the average across all local authorities in each growth category. The total growth in capex refers to the percentage increase in total capital expenditure in 2012-2017, compared with 2000-2005. This is more useful than comparing capital expenditure between two single points in time since capital expenditure can be highly volatile (as a result of the lumpy nature of infrastructure investments).
2. Regional councils are excluded.

### Debt, especially for high-growth councils, has risen substantially from a low base

Between 2000 and 2017, total local authority debt increased from a low base of \$2.7 billion to \$15.2 billion. Most local authorities saw a significant increase in per capita debt, although the greatest increases in debt mostly occurred in high-growth councils (Figure 4.4). For instance, Auckland’s per capita debt increased from \$615 to \$4 955. Interestingly, the debt of Waitomo District and South Taranaki District also increased by 280% and 233% respectively, despite both councils experiencing population decline. Christchurch experienced the greatest increase in debt, because of the 2010/11 earthquakes.

**Figure 4.4 Debt per capita across selected high-growth councils, 2000 and 2017**

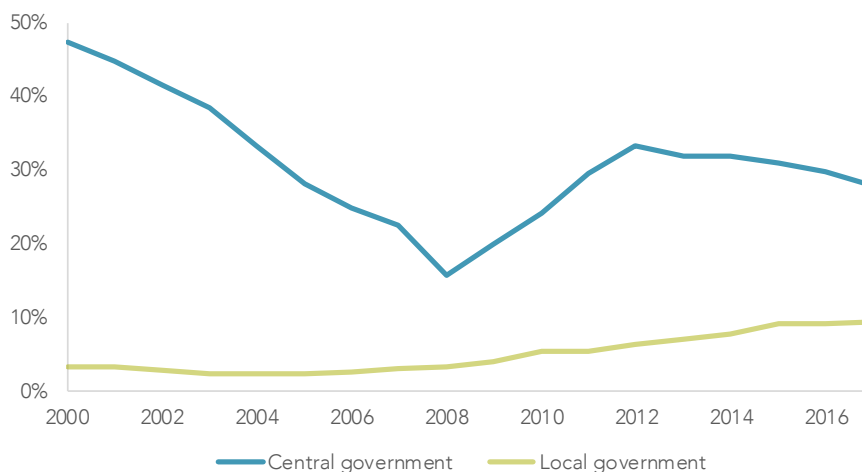


Source: Stats NZ (2018c).

Note: Auckland’s debt includes debt from Auckland Transport.

Despite increases in debt, recent assessments have not identified serious concerns about levels of council debt (NZPC, 2015). Gearing ratios (debt as a share of total assets) of local authorities have been much lower than for central government (Figure 4.5) and large companies in the private sector.

**Figure 4.5 Local and central government gearing ratios**



Source: Stats NZ (2018c); The Treasury (2017).

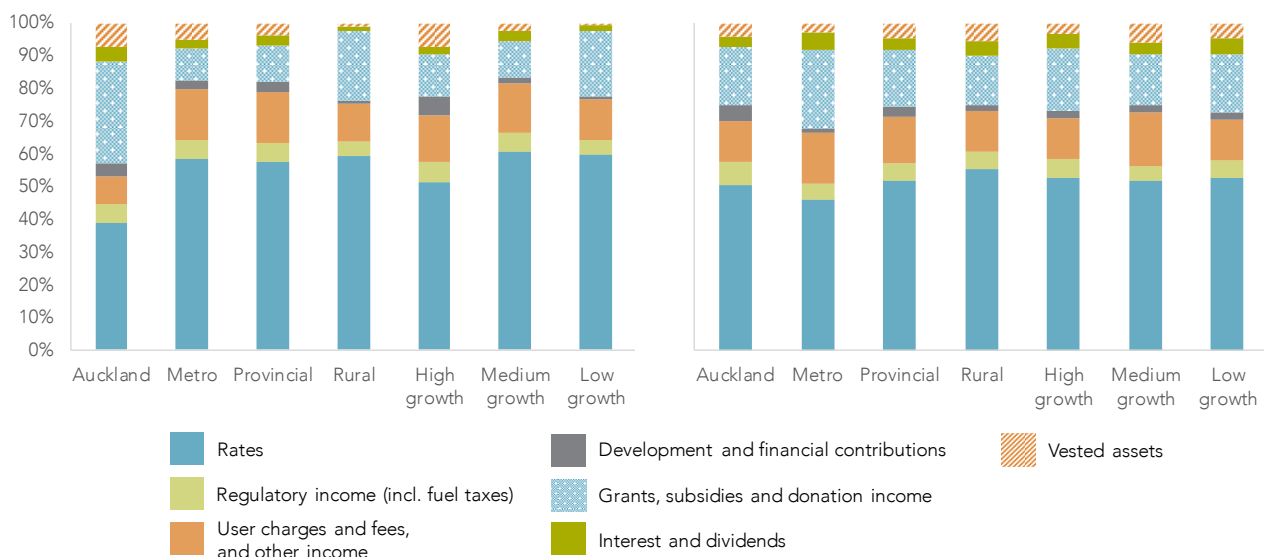


A Grant Thornton (2014) study developed a proxy for council financial health using a range of metrics (including debt per head, and debt as a proportion of assets). The study concluded that the overall financial health of all but four councils was “sound” or higher. More recently, the Office of the Auditor-General (2018a) concluded that “overall, local authorities continue to manage their debt prudently” (p. 14).

## The composition of council revenue

Rates have remained the dominant source of revenue for local authorities over the last two decades. On average, the contribution of rates to total revenue has remained relatively stable over recent decades. High-growth councils tend to be less reliant on rates than slower-growing councils (Figure 4.6). Low-growth and rural councils tend to be more reliant on central government grants and subsidies, though Auckland is an exception (nearly a third of Auckland’s total revenue in 2017 came from grants and subsidies).

**Figure 4.6 Average composition of revenue across different councils, 2007/2017**



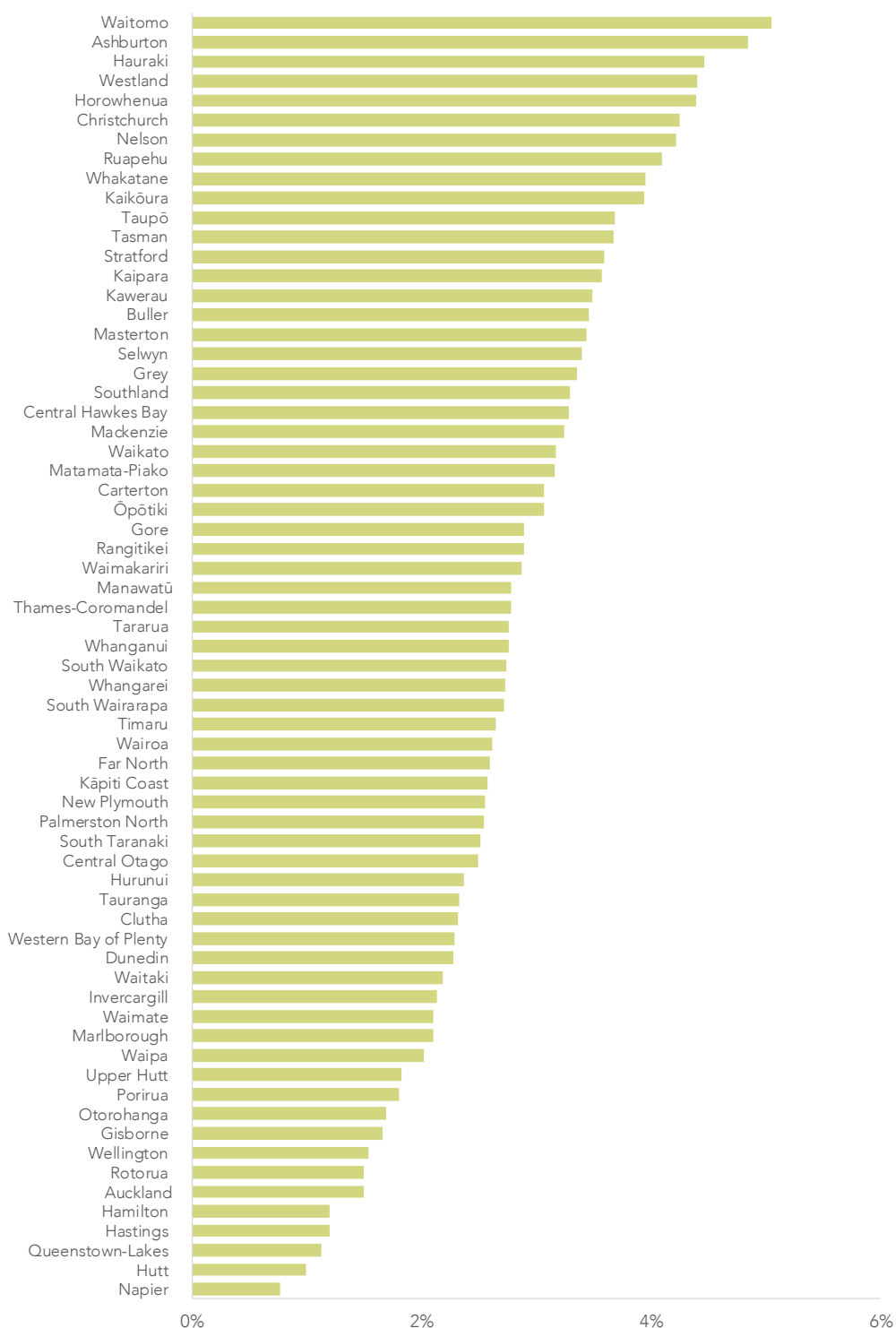
Source: Stats NZ (2018c).

One important change to the composition of revenue since the early 2000s has been the introduction of development contributions and vested assets (Chapter 3). Relative to other revenue sources, development contributions are small for most councils (and some councils do not apply them), but they are a key funding source for some high-growth councils. This helps explain why fast-growing councils are less reliant on rates. In 2017, development contributions made up about 15% of Selwyn District Council’s total revenue, 14% of Waimakariri District Council’s revenue, and 13% of Tauranga City Council’s revenue.

## Rates trends vary greatly across local authorities

Growth in rates per capita over the past 20 years has varied greatly across councils. The largest growth was about 5% per year for Waitomo District Council, and the slowest growth was about 0.8% per year for Napier City Council (Figure 4.7).

**Figure 4.7 Average annual growth in rates per capita across territorial authorities, 1996–2017**



Source: Stats NZ (2018a, 2018c).

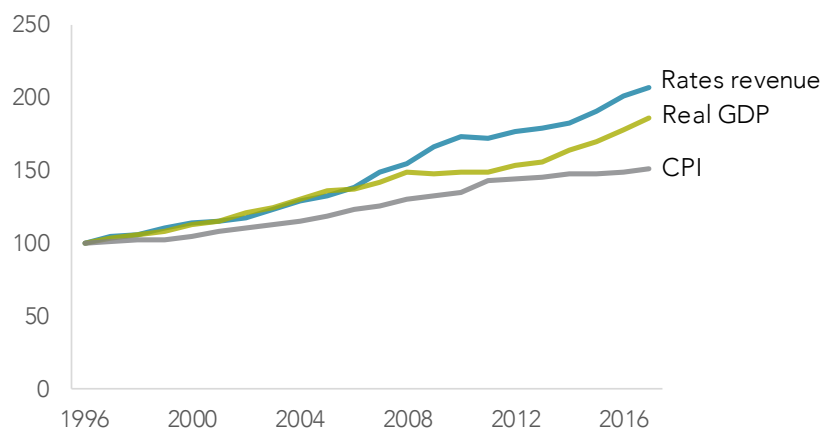
Note: Analysing changes in rates per capita over time is useful for comparing trends in rates across councils. However, comparing rates per capita in a single year across councils is less useful since rates per capita is a poor proxy for the average rates bill.

The average high-growth council had a smaller increase in per-person rates compared to low-growth (or declining) councils, although growth in per-person rates does not appear to have a strong connection to population growth. For example, among the councils with the slowest increase in per person rates were Queenstown-Lakes and Hamilton (both high-growth councils) as well as Rotorua and Gisborne (both low-growth councils). Notably, several councils with comparatively lower average household incomes, including Hauraki District, Horowhenua District and Ruapehu District, had among the largest increase in per-person rates.

### How has the affordability of rates changed over time?

Comparing the growth in rates revenue with growth in gross domestic product (GDP) is a simple, albeit blunt, method for measuring aggregate changes in the affordability of rates over time (Figure 4.8). Between 1996 and the late 2000s, rates increased in line with GDP. However, income growth stalled between 2008 and 2012, due to the global financial crisis, while rates continued to rise. This suggests that, broadly, rates became less affordable to some extent over this period. It also highlights that rates revenue is less susceptible to economic downturns than central government tax revenue because rates are effectively a cost allocation system. More recently, rates and GDP have been increasing at a similar rate.

**Figure 4.8 Relative change in rates revenue, GDP and CPI, 1996-2017**



Source: Stats NZ (2018c, 2018d); RBNZ data.

However, as shown above, rate trends of different local authorities have been varied, while income growth has not been evenly distributed across the country. Comparing the change in rates per capita with median incomes, Figure 4.9 suggests that, between 2001 and 2013, over half of territorial authorities' rates became more affordable for a median household.

Even so, comparing rates with income (or GDP) increases is just one way of considering rates affordability that focuses on changes for the average household. Rates affordability may still be an issue for many lower-income households and households on fixed incomes (eg, for people reliant on superannuation). Figure 4.8 above shows that rates have been rising much faster than the Consumer Price Index (CPI). Also, non-residential ratepayers, including businesses and farms, may face distinct affordability issues.

Also, households contribute to local authority expenditure in ways other than rates. For example, some councils, including Auckland, use volumetric charging for drinking water to help recover costs related to supplying water. Because these charges substitute for rates, rate levels for these

councils can be lower (compared to having no volumetric charging), but the actual cost borne by households is not substantially different. Charges for using public transport and other council services also impose additional costs on some households.

**Figure 4.9 Growth in rates per capita and median household incomes across councils, 2001–2013**



Source: Stats NZ (2014, 2018c).

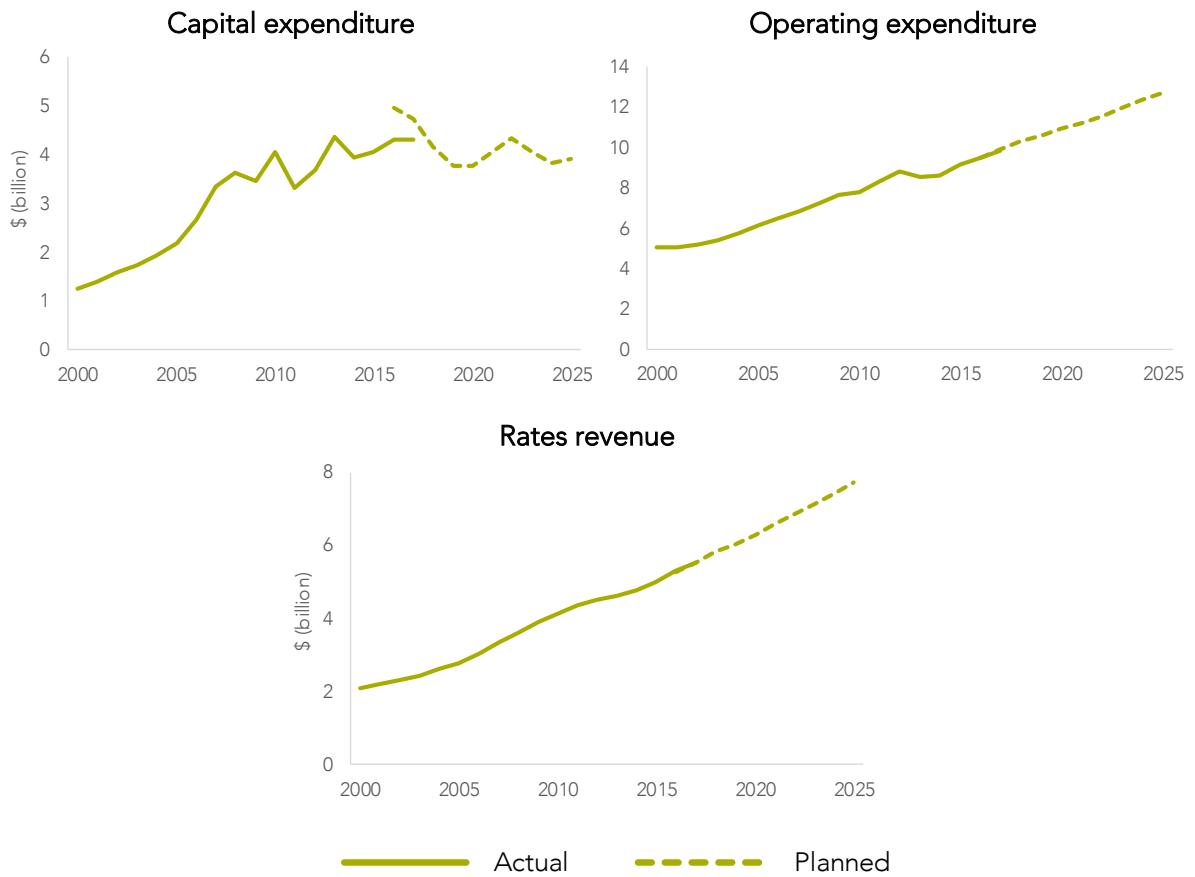
## Projected future trends

Every three years, local authorities (including regional councils) prepare a Long-Term Plan that forecasts its revenue and expenditure over the coming decade. These forecasts can be a useful indicator of likely future financial trends. Figure 4.10 shows the actual capital and operating expenditure as well as rates across all councils for 2000 to 2015, and the forecast figures from 2016 to 2025, based on Long-Term Plan data.

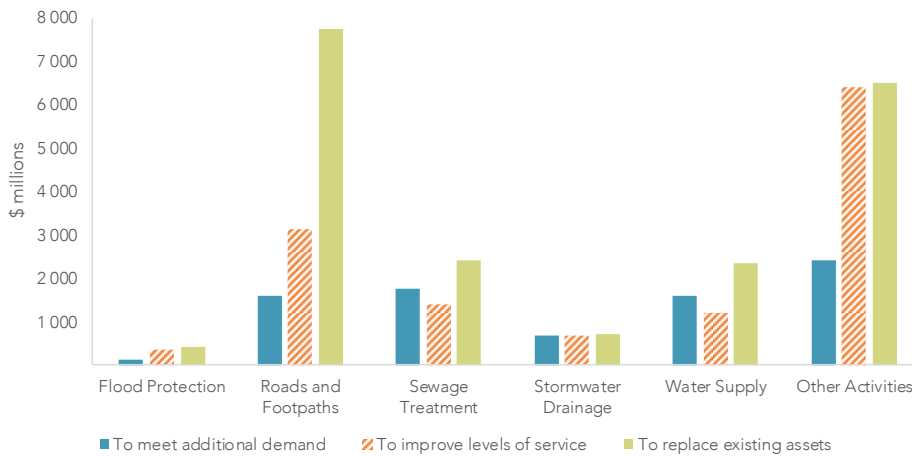
Because of the projected rise in operating costs, total rates revenue across all councils is projected to continue to rise at an annual average of around 4–5% (in nominal terms). This growth in rates is similar to recent trends. Depreciation and interest are projected to be the fastest growing sources of costs for councils – both are forecast to rise by just over 40% between 2016 and 2025. Rising interest costs is unsurprising given the recent growth in debt.

On the other hand, capital expenditure is projected to decrease slightly from current levels. This could signify that investment demands for councils are expected to reduce or reflect the lumpy nature of infrastructure investment. Alternatively, it may indicate that funding/financial pressures on councils are causing them to scale back investment in important capital projects. Of the roughly \$40 billion forecasted capital expenditure over the next 10 years, just under half is designated for replacing existing assets (Figure 4.11). Replacing roads and pathways is the biggest item of capital expenditure for councils.

**Figure 4.10 Actual and planned revenue and expenditure by councils, 2000–2025**



**Figure 4.11 Forecast capital expenditure by purpose and activity, 2016–2025**



Source: Stats NZ (2018c); DIA data based on Council Long-Term Plans.

**Notes:**

1. Data is in nominal terms
2. The actual and forecast capital expenditure for 2016/2017 materially differ because the estimates for actual expenditure are based on figures for “additions to fixed assets” in council financial statements, whereas forecast expenditure is based on explicit forecasts for capital expenditure in LTPs.

# 5 Where are the pressure points?

A key part of this inquiry is to identify the factors driving local government costs now and into the future. This chapter provides some background on issues that LGNZ and other commentators have put forward as drivers of local government costs. The Commission is interested in feedback from inquiry participants regarding the materiality of these factors in driving current and future local government costs and prices, and their implications for the funding and financing framework.

## Population growth and decline

Funding and financing requirements are very different for fast-growing councils compared to councils facing slow growth or decline. Fast population growth places pressure on existing infrastructure (eg, roading networks) and also demands large investments in new infrastructure to accommodate a growing population. For example, councils are responsible for servicing new subdivisions with three waters, roading, and social and community infrastructure (eg, parks, libraries), as well as providing ongoing services such as waste management. In cities and larger towns, expanding other services, including the public transport network, can be needed to support growth.

Investments in renewing, upgrading and expanding these services typically involve significant upfront expenditure. The Commission's previous inquiries have found that fast-growing councils often struggle to finance and fund the infrastructure needed to accommodate growth. Unresponsive provision of infrastructure slows down development and in turn can contribute to rising land prices and worsening housing affordability.

On the other hand, declining councils face the challenge of maintaining service levels and funding the maintenance and replacement of infrastructure assets with a declining rating base. Despite New Zealand's growing population, 16 territorial authorities saw their population decline over the past 20 years. LGNZ (2015a) notes that a small and shrinking population results in a smaller base to pay for fixed costs, which makes it particularly difficult when infrastructure needs to be renewed.

Q3

**In what ways are population growth and decline affecting funding pressures for local government? How significant are these population trends compared to other funding pressures?**

## Other demographic changes

In addition to population growth and decline, other demographic changes such as ageing populations and changes in household composition are occurring across local governments.

LGNZ (2015a) has argued that an ageing population structure has implications for the affordability of local services as the elderly are more likely to be on fixed incomes. A changing local age structure might also have implications for the types of services demanded. For example, there may be less demand for some types of sporting facilities in locations with declining numbers of young people (DIA, 2013).

**Q4**

**What are the implications of demographic changes such as population ageing for the costs faced by local government?**

## Tourism

The growth of tourism, particularly international tourism, has been identified as a source of funding pressure for some local authorities. In particular, influxes in visitor numbers, which are often concentrated in just a few months of the year, can put significant pressure on infrastructure networks. For example, during peak times 58 600 people, of which 38 300 are visitors and 21 300 are residents, are using Queenstown's infrastructure (Martin Jenkins, 2018).

Several tourism-specific revenue streams are available to meet local tourism expenditure.

- User charges – for example, for car parks, information site services, and council-owned commercially run services such as museums.
- Revenue captured indirectly – for example, from commercial rates for accommodation, retail, hospitality, and other tourism-oriented businesses, and dividends from investments in companies such as airports that derive some of their profits from international tourists (Deloitte Access Economics, 2018).
- Tourism Infrastructure Fund – this central government fund provides financial support (up to \$25 million per year), primarily to local governments, to support local tourism-related infrastructure. The fund aims to support local areas where tourism growth is placing pressure on existing infrastructure and the local community is unable to respond in a timely way without assistance (MBIE, 2018b).
- Targeted rates – for example, in June 2017 Auckland Council adopted a targeted rate on commercial accommodation providers with proceeds funding Auckland Tourism, Events and Economic Development's budgeted expenditure on visitor attraction and major events (O'Reilly, 2017).
- Visitor levies – although local authorities can set targeted rates to fund specified activities, the LGRA does not allow local authorities to introduce levies on visitors (O'Reilly, 2017). Specific legislation is required to introduce such a levy. Currently there is only one example of such legislation – the Southland District Council (Stewart Island/Rakiura Visitor Levy) Empowering Act, which took effect in October 2013. This enabled Southland District Council to establish a visitor levy, which is collected by tourism operators when visitors travel to Stewart Island/Rakiura. Queenstown-Lakes District Council has expressed a desire to be able to implement a local levy to support tourism infrastructure in Queenstown (Nicoll, 2018).

Although tourism can produce revenue for local governments, some evidence suggests that this is outweighed by the costs local governments face in accommodating international tourists. Deloitte Access Economics (2018) conducted three case studies examining local government

revenue and expenditure associated with international tourism (Table 5.1). Their results for Southland and Nelson indicate that international tourism expenditure only marginally exceeds revenue, while in Auckland expenditure exceeded revenue by a more significant margin.

**Table 5.1 Revenue and expenditure attributable to international tourists**

Local government agency	Annual revenue attributable to international tourists	Annual expenditure attributable to international tourists
Southland District Council	\$14.2 – \$15.5 million	\$15.4 – 17.0 million
Nelson City Council	\$5.7 – 6.5 million	\$6.3 – 7.2 million
Auckland Council	\$93 – 103 million	\$133 – 137 million

Source: Deloitte Access Economics (2018).

Note: Data is for the year ending June 2017. Deloitte Access Economics (2018) note limitations including difficulty in apportioning revenue and expenditure specifically to international tourists at the local level and suggest that their analysis should be seen as an indicative rather than a definitive measure.

Q5

**To what extent is tourism growth resulting in funding pressures for local government? Which councils are experiencing the greatest pressure, and how is this manifesting?**

## An expansion of local government responsibilities

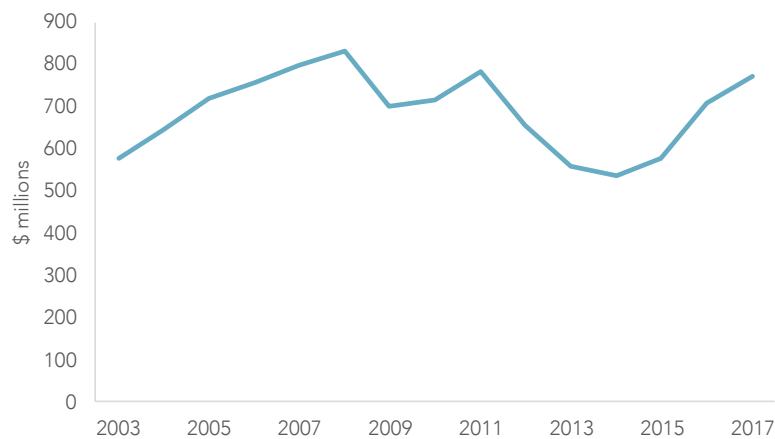
Local government has expressed concern that the shifting of costs and responsibilities from central government to local government is placing cost pressure on local government. LGNZ (2012a) notes that this takes three broad forms.

- *Cost shifting* – the transfer of responsibilities without funding to local government and/or the reduction of funding for a local government activity requiring a greater contribution from rates.
- *Raising the bar* – a requirement on councils (usually through changes to regulatory standards) to raise the level of service of particular services, beyond that which local citizens themselves are prepared to pay for.
- *Regulatory creep* – expanding the scope of regulations and processes and so increasing councils' administrative costs.

### Cost shifting

Shifting costs and responsibilities from higher levels of government can place pressure on councils' ability to provide basic services. LGNZ (2012a) has previously pointed to reductions in funding provided by NZTA for local road maintenance and renewals as an example of cost shifting. At an aggregate level, the total value of 'current grants, subsidies and donations' for roading and transportation expenditure (which is comprised largely of NZTA contributions) fell between 2008 and 2014, before climbing in the last three years (Figure 5.1).



**Figure 5.1 Current grants for roading and transport, 2003-2017 (2017 dollars)**

Source: Stats NZ (2018c).

Note: Current grants exclude grants that go towards capital investments.

## Rising standards

LGNZ has also raised concerns about the cost impacts associated with higher mandatory standards imposed by central government. One example is the 2007 amendment to the Health Act 1956 which required councils to take all practicable steps to comply with (previously voluntary) drinking-water standards and to implement a public health management plan for drinking-water supply (LGNZ, 2015a).

Other examples are requirements on councils set by national policy statements and national environmental standards under the RMA. For instance, the Government is currently considering recommendations on a National Policy Statement on Indigenous Biodiversity. This could require both regional and territorial local authorities to undertake work on identifying, monitoring reporting, researching and setting standards for biodiversity (MfE, 2018).

In some cases, community expectations of local government are also increasing. Councils report pressure from communities for better local services, and some communities increasingly expect councils to deal with social issues such as alcohol abuse and associated crime (NZPC, 2013).

## Regulatory creep

The Commission has previously reviewed the amount of legislation passed by Parliament that affects local authority regulatory functions. This showed that local authority regulatory responsibilities were increasing, with a steady stream of new or modified responsibilities over the last decade. However, the review found that it is difficult to categorise the new statutes into those that created significant new workloads and those that required little change to existing regulatory processes. In addition, no significant increase in regulatory expenditure within local authorities was apparent in the previous 10 years (NZPC, 2013, p. 54).

**Q6**

**Is an expansion of local government responsibilities affecting cost pressures for local government? If so, which additional responsibilities are causing the most significant cost pressures and what is the nature of these increased costs? To what extent do these vary across local authorities?**

## Treaty of Waitangi settlements

LGNZ (2018b) note that it is increasingly common for Treaty of Waitangi settlements to include some form of 'co-governance' or 'co-management' arrangements over significant natural resources and reserve lands. Local authorities are part of these arrangements, both as the regulatory authority for the natural resource or land, and as the co-governance and co-management partner with Treaty settling groups. LGNZ (2018b) acknowledges that Treaty settlement arrangements provide valuable connectivity between iwi and local government, but also suggests that arrangements impose costs on local authorities that are over and above business-as-usual costs.

Examples of additional costs include:

- administrative support and other council staff services required for the provision of the exercise of powers and functions for the co-governance entities, boards or committees;
- RMA policy development activities that are not planned or anticipated but are required by a Treaty settlement within a specified timeframe;
- specialist technical staff time on the development and implementation of co-governance entity plans, documents, and joint management agreements or other agreements; and
- assistance with building iwi capacity to participate in the Treaty settlement arrangements. (LGNZ, 2018b, p. 8)

Central government sometimes provides one-off financial contributions to local government for the implementation of Treaty settlement outcomes. However, LGNZ notes that council implementation costs far exceed Crown contributions. Table 5.2 sets out some examples of Treaty settlements, associated costs to councils and Crown contributions.

**Table 5.2 Examples of Crown and council Treaty settlement costs**

Council	Settlement	Crown contribution	Actual or estimated costs to councils
Horizons Regional Council	Rangitāne o Manawatū Claims Settlement Act 2016	Nil	Estimated costs of establishing the Manawatū River Catchment Advisory Board, \$240 000  Estimated ongoing administration costs, \$37 000 per year
Bay of Plenty Regional Council	Ngāti Whare Claims Settlement Act 2012 and Ngāti Manawa Claims Settlement Act 2012	Nil	Estimated development costs for the Rangitāiki River Document, \$164 000  Ongoing costs are unknown
Hawke's Bay Regional Council	Hawke's Bay Regional Planning Committee Act 2015	\$100 000	Establishing and maintaining the Hawke's Bay Regional Planning committee has cost \$787 627  Estimated ongoing costs, \$163 000 per year

Source: LGNZ (2018b).

Q7

**How is the implementation of Treaty of Waitangi settlements, including the establishment of 'co-governance' and 'co-management' arrangements for natural resources, affecting cost pressures for local government? How widespread is this issue?**

## Climate change and other natural hazards

Local governments face significant, and likely growing, costs associated with responding and adapting to climate change and other natural hazards such as earthquakes and extreme weather events. Initial results from a study commissioned by LGNZ show that billions of dollars of local government infrastructure and assets are at risk from sea level rise, and that the impacts will be most significant for water infrastructure and roads (LGNZ, 2018a). Rising costs may also be driven by higher insurance premiums and underwriters exiting areas that have recently suffered from earthquakes or other natural disasters.

Boston and Lawrence (2018) note that the impacts of climate change and their related costs can be reduced by preventing further housing development in risky areas, and through prudent investment in more resilient infrastructure. However, local governments can struggle to get community support for expenditure on risk reduction, as many voters are more likely to reward governments that spend money on disaster relief rather than those investing in prevention. This dynamic can also be seen in central government's approach – "the national civil defence plan provides for central government to contribute up to 60% of the costs of repairing underground water and sewerage services after a catastrophic event, but there are no similar guaranteed contributions for future-proofing infrastructure" (Boston & Lawrence, 2018, pp. 42-43).

In addition to the post-event focus of much disaster-related funding, Boston and Lawrence (2018) identify several other issues with existing funding arrangements for adaptation.

- There is a mismatch between the resources and capabilities available to local authorities and the scale of their adaptation challenges. Communities such as Dunedin, and the eastern Bay of Plenty lack the capacity (via their rating base and borrowing limits) to fund large-scale relocation of affected infrastructure assets and communities. More generally, many local authorities – and especially those with ageing populations – will struggle to raise the capital necessary for futureproofing their infrastructure.
- The central government approach to providing financial assistance to communities affected by natural disasters tends to be ad hoc and inconsistent.
- No consistent and centrally managed mechanism for funding the costs of managed retreat exists. As a result, local authorities are attempting to develop their own approaches. But these will generate inconsistencies and inequities across New Zealand.
- No mechanisms are in place to ensure the costs of climate change adaptation are shared equitably across the existing population, and intergenerationally.

Q8

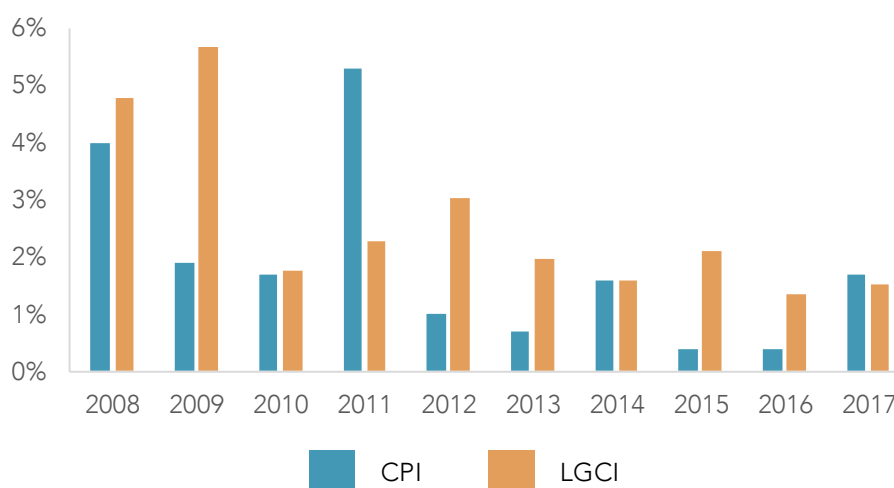
**How are local authorities factoring in response and adaptation to climate change and other natural hazards (such as earthquakes) to their infrastructure and financial strategies? What are the cost and funding implications of these requirements?**

## Rising prices

Rising prices for inputs can contribute to growth in local authority spending. The Local Government Cost Index (LGCI) is a price index, developed by BERL, that seeks to monitor changes in the cost of goods and services most relevant for local authorities including capital expenditure on pipelines, earthmoving and site works, and operating expenditure such as local government sector salary and wage rates.<sup>4</sup> Some changes in the index are driven by factors over which local government has little control (like the price of raw materials such as cement), while others, such as salary and wage rates, are driven largely by local government decisions.

The LGCI rose by 29% between 2007 and 2017, nine percentage points more than the CPI over that period. Figure 5.2 shows annual changes in these indices over the same period. The overall change was similar for operating and capital expenditure items (BERL, 2017).

**Figure 5.2 Annual change in the LGCI and CPI between 2008 and 2017**



Source: BERL (2017); RBNZ data.

Q9

**Why is the price of goods and services purchased by local government rising faster than the consumer price index? To what extent is this contributing to cost pressures for local government?**

The LGCI is a national price index, reflecting average prices across the country. Different local authorities may face significant variations in input prices.

Q10

**Do the prices of goods and services purchased by local government vary across councils? If so, what are the reasons for these differences?**

<sup>4</sup> In estimating the overall LGCI, BERL uses a range of price indices constructed by Stats NZ, such as the Capital Goods Index (CGI) and Producers Price Index (PPI) to estimate the price of individual expenditure items (BERL, 2010). For example, to estimate the price of capital expenditure on roading, BERL uses a mix of the CGI price estimate for "transport ways" and the PPI price estimate for inputs into road transports. The overall LGCI is a weighted average of these different indices, based on the relative expenditure of local authorities (at an aggregate level) on different items.

## 'Non-core' expenditure

While local government has raised concerns about central government shifting costs and responsibilities to lower levels of government, other commentators have expressed concerns that increasing council expenditure on 'non-core' functions is a driver of local cost pressure.

The Local Government Business Forum (2018) notes that although a broadening scope is not the main driver of increasing costs, it is significant and ongoing.

There has been a broadening of scope and a shift away from traditional core business in recent years with spending on economic development, sport and recreation and community development increasing as well as new, previously uncategorised, items of expenditure. This is despite 2012 legislative changes intended to narrow the scope. (p. 6)

The Local Government Business Forum (2018) argues for councils to limit their spending to core business and suggests central government or the private sector is better placed to provide many of the non-core services that local government is increasingly providing.

Table 5.3 sets out some broad categories of local government operating expenditure, based on the activity areas included in Stats NZ's local government financial data. Activities that might be considered 'non-core' accounted for 17% of total operating expenditure in 2017, and expenditure on these activities has grown less than other groups of activities. 'Other activities' has grown significantly, but from a very small base.

The breadth of activity areas in Stats NZ's local government financial data, along with the absence of clear definitions of 'core' and 'non-core' activities, mean that it is difficult to gauge the veracity of claims about increasing non-core spending. For example, supposedly 'non-core' activity areas include many activities and services that local government has provided for many decades, such as parks, recreational facilities and libraries (LGNZ, 2012b).

**Table 5.3 Local government operating expenditure categories**

Category <sup>1</sup>	Activities included	% of total opex, 2017	% growth, 2009 – 2017 (nominal)
Core infrastructure	Roading, transport, water supply, wastewater, solid waste/refuse	46%	45%
Core services	Environmental protection, property, emergency management, planning and regulation, governance	18%	40%
'Non-core'	Culture, recreation and sport, community development, economic development	17%	35%
Council support	Council support services	16%	48%
Other	Other activities	3%	470%

Source: Stats NZ (2018c).

Notes:

1. Expenditure categories were established subjectively.

**Q11**

**Is local government expenditure shifting away from traditional core business into activities such as economic development, sport and recreation and community development? If so, what is the rationale for this shift, and could these activities be better provided by other parties?**

**Q12**

**Does the scope of activities funded by local government have implications for cost pressures? If so, in what ways?**

## Other factors

Other factors could contribute to local government cost pressures, now and in the future. Technological change, including disruptive new technologies, could place pressures on councils to respond. A current example is the provision of infrastructure and systems to accommodate (and encourage) the use of electric vehicles. Changes to the nature and composition of economic activity, and associated changes in land use, may also impact on both costs and revenues for local government.

As well as seeking feedback on the nature and materiality of the factors discussed in this chapter, the Commission is also interested in views regarding any other drivers of local government cost pressure.

**Q13**

**What other factors are currently generating local government cost pressures? What will be the most significant factors into the future?**

**Q14**

**How will future trends, for example technological advances and changes in the composition of economic activity, affect local government cost pressures?**

# 6 Managing cost pressures

The main focus of this inquiry is the funding and financing tools that local government needs to carry out its role in providing services for local residents and businesses. The previous chapter outlined some pressures that are making funding and financing challenging. Yet councils can also manage cost pressures through efficiency gains. This chapter explores these opportunities. It also looks at tools to manage affordability of services for particular groups such as low-income households or those reliant on fixed incomes, and, more generally, the allocation of costs across local communities, and between generations.

## Managing cost pressures through efficiency gains

When considering possible new sources of local government funding, the Shand Report (2007, p. 11) noted that “there is no ‘pot of gold’ sitting out there that is readily available. Somebody must pay, whatever the taxation source that is used”. While the statement remains true, improvements in local government productivity offer an avenue for councils to maintain or increase the quality or volume of services that they provide without increasing costs for ratepayers.

Councils can respond to cost pressures (within current revenues) by:

- changing the mix and quantity of services they produce to better match the preferences of ratepayers and purchasers of those services at given prices (allocative efficiency); and
- using input resources more efficiently so they can produce the same mix and quantity of services at a lower cost (productive efficiency).

As discussed below, councils can put in place service planning and asset management practices, and they can adopt new technologies and business models to improve allocative and productive efficiency over time (dynamic efficiency).

## Decision making about capital investments and levels of ongoing service

Council decisions about the level of service they provide, and regarding capital investments, can have an important bearing on managing cost pressures. Decisions to invest in large new capital assets (for example transport infrastructure or sports stadiums) have potential to add significant costs that ultimately must be recovered – largely from local residents and businesses.

Accordingly, it is important that council plans are broadly aligned with the expectations of ratepayers, and that ratepayers are able to contribute to the cost of new investments. A major challenge in assessing this is that preferences and ability and willingness to pay are likely to vary significantly within council jurisdictions.

In areas facing funding pressures, some councils might choose to maintain affordability through lower levels of service. Rangitikei District Council is an example of a district council that has focused on shrinking its built infrastructure and adjusting service levels in response to funding challenges and its declining population. For example, by 2046 the council anticipates more variance in the condition of its road network, and a smaller number of Council-managed community facilities (NZPC, 2017).

As set out in Chapter 3, every three years, councils are required to prepare a Long-Term Plan that sets out planned activities and service provision over a 10-year timeframe. In considering the funding sources for delivering these activities, councils must take into consideration the costs and benefits, and the distribution of benefits, for each activity.

As part of Long-Term Plans, councils must prepare and adopt a financial strategy that documents the effect of funding and expenditure proposals on rates, debt and investments, in a manner that promotes the current and future interests of the community. The strategy must cover the factors expected to have a significant impact on the council's ability to maintain existing levels of service and meet additional demands for services, including expected changes in population and land use.

The Local Government Act (2002) requires that, before adopting a Long-Term Plan, councils must prepare a consultation document. The Act states that the purpose of a consultation document is to provide an effective basis for public participation in local decision-making processes about the content of a Long-Term Plan. The Act requires that consultation documents should do this by:

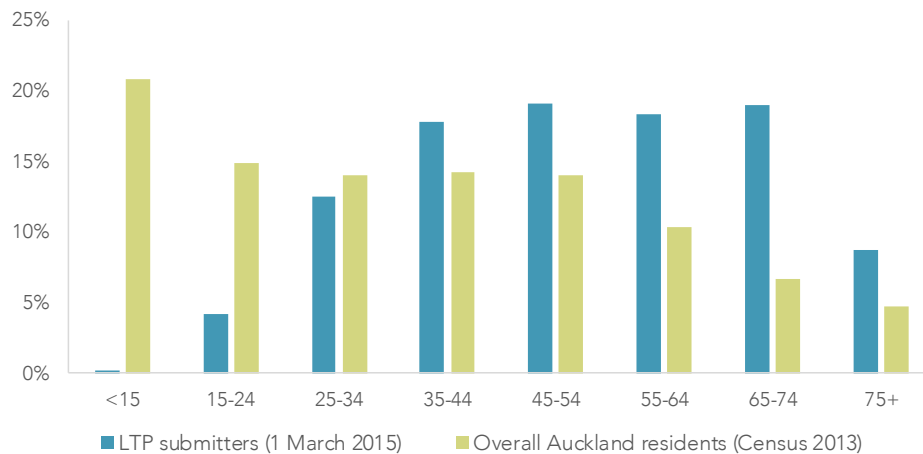
- (a) providing a fair representation of the matters that are proposed for inclusion in the long-term plan, and presenting these in a way that—
  - (i) explains the overall objectives of the proposals, and how rates, debt, and levels of service might be affected; and
  - (ii) can be readily understood by interested or affected people; and
- (b) identifying and explaining to the people of the district or region, significant and other important issues and choices facing the local authority and district or region, and the consequences of those choices; and
- (c) informing discussions between the local authority and its communities about the matters in paragraphs (a) and (b).

Accordingly, consultation processes and how councils respond play an important role in aligning council plans for investments and levels of service with the expectations of their local community. Councils must ensure the contents of their consultation documents are presented "in a form and manner that provides an effective basis for public participation in local authority decision-making" (Office of the Auditor-General, 2018b).

The Office of the Auditor-General (2018b, p. 10) reviewed council consultation documents in 2018 and concluded that "many councils ... missed the opportunity to engage effectively with their communities" and that "there is still room for improvement overall in how consultation documents are presented".

In addition to concerns about the consultation documents, concerns have also been raised about the effectiveness of council consultation processes in capturing feedback from a reasonably representative cross-section of the community. In an analysis of feedback on Auckland Council's 2015 Long-Term Plan, Nunns (2015) showed that the age profile of people who submitted was roughly inversely proportional to the age profile of Auckland's population as a whole (Figure 6.1). And Māori, Pasifika and Asian people were all significantly underrepresented.



**Figure 6.1 The age of submitters on Auckland Council's 2015 Long-Term Plan**

Source: Nunns (2015).

**Q15**

**How effective is the Long-term Plan process in addressing cost pressures and keeping council services affordable for residents and businesses?**

**Q16**

**How effective are councils' Long-term Plan consultation processes in aligning decisions about capital investments and service levels with the preferences, and willingness and ability to pay, of residents, businesses and other local organisations?**

**Q17**

**Is there scope to improve the effectiveness of Long-term Plan processes? If so, what, if any, changes would this require to the current framework for capital expenditure decision making?**

## Improving efficiency in providing services

Across the economy, productivity improves as a result of firms successfully adopting new business processes, new business models and new technology. The same opportunities for productivity improvements arise for local government organisations.

For example, better asset management planning can reduce the cost of infrastructure maintenance and renewals. According to LGNZ (2015a), Wellington City Council projected savings of \$60 million over 10 years as a result of improved data about the status and capacity of its infrastructure. In its 2015–25 Long-term Plan, Wellington City Council outlined its implementation of regional shared services in water, IT and procurement. It expects these initiatives to deliver savings in excess of \$50 million over 10 years (Wellington City Council, 2015).

Effective risk management is also an important element of managing cost pressures over time. Stobo (2013) argues that “access to skills and expertise to think about and manage risk” is a bigger issue for local authorities than purchasing insurance to cover risk “which tends to be the last risk mitigation option” (p. 5).

The inquiry Terms of Reference exclude substantial privatisation from scope. Yet business arrangements such as Council-controlled organisations (CCOs), may offer opportunities for more efficient and effective management of particular assets held on council balance sheets. Auckland Council, for instance, has six substantive CCOs, including Auckland Transport, Panuku Development Auckland, and Watercare (Auckland Council, 2018b).

New Zealand councils are also using or experimenting with new technologies that help them manage infrastructure and deliver services more efficiently. For instance:

- South Taranaki District Council used drones to check the seismic safety of its water tower in Hawera (SOLGM & ALGIM, 2015);
- Christchurch City Council has trialled using electronic sensors to detect when public rubbish bins need to be emptied. This will help it optimise collection times and routes (Christchurch City Council, 2018);
- Wellington Water uses real-time monitoring and control technology to increase their understanding of the water system and how it responds to different situations. This increases demand management opportunities and enhances the capacity to make long term predictions on the costs of different investment options (Hutt City Council, 2018b);
- Wellington City Council has experimented using cameras to count people at different choke points in the city. This helps to understand the economic return on public events (Lepla, 2017); and
- Auckland Transport has piloted connecting school zone safety signs electronically to the internet, making it easy to see if the signs are working or not.

**Q18**

**How much scope is there for local government to manage cost pressures by managing assets and delivering services more efficiently?**

**Q19**

**What practices and business models do councils use to improve the way they manage their infrastructure assets and the efficiency of their services over time? How effective are these practices and business models in managing cost pressures? Do councils have adequate capacity and skills to use these practices and business models effectively?**

**Q20**

**How do councils identify and employ new technologies to manage their infrastructure assets and produce services more efficiently? How effective are councils in using new technologies to manage cost pressures? Please provide specific examples of the use of new technologies to manage cost pressures.**

**Q21**

**What incentives do councils face to improve productivity as a means to deal with cost pressures? How could these incentives be strengthened?**

The Commission's inquiry into state sector productivity (NZPC, 2018) identified barriers to achieving higher productivity. These include:

- closed, risk-averse cultures in government agencies;
- poor policy and commissioning practice;
- restrictive rules and funding models; and
- patchy monitoring, evaluation and data use.

These may also be barriers to improving local government productivity.

**Q22**

**What are the most important barriers to local government achieving higher productivity?**

### **Is there enough focus on productivity measurement and improvement?**

The Productivity Commission's inquiry into measuring and improving state sector productivity (2018) identified that there appears to be little demand for, and little inclination to supply, productivity-related performance information on core public services. The Commission is interested in how local government measures productivity performance.

**Q23**

**How does local government measure productivity performance? Are these metrics useful? If not, what metrics would be better?**

**Q24**

**To what extent and how do councils use measures of productivity performance in their decision-making processes?**

**Q25**

**Do councils dedicate sufficient resources and effort toward measuring and improving productivity performance? If not, why not, and how could effort toward measuring and improving productivity performance be increased?**

## **Measures to improve affordability for specific groups**

While this inquiry is primarily about local government cost drivers and the funding and financing framework, an overarching consideration is affordability, particularly the affordability of rates. Concerns about the affordability of rates and other local government services are not new. In 2007, "concerns about the impacts of rates increases for low-income groups and other sectors of society and the economy" were important factors leading to the establishment of the Shand Inquiry (Shand Report, 2007, p. 22).

The previous section discussed the important role that increases in efficiency can play in managing local government cost pressures. In addition, the Commission is interested in the use

and effectiveness of any dedicated measures to reduce the costs faced by specific groups of ratepayers – such as the Rates Rebate Scheme and the Accommodation Supplement.

### **Rates Rebate Scheme**

The Rates Rebate Scheme was introduced in 1973 to assist low-income and older ratepayers facing affordability pressures who wished to stay in their own homes. Under the scheme, ratepayers are currently eligible for a rebate of up to \$630 depending on a person's income, rates bill and number of dependants. As an example, a single person whose sole income was from New Zealand Super would be eligible for the full rebate if their total yearly rates were \$1105 or higher (the lowest average yearly rate in 2017 was \$1 593 in Mackenzie District Council). In 2017, just under 98 000 rebates were paid, with a total value of \$55 million (DIA, 2017b).

Ratepayers must apply to their council to receive the rebate and, provided they are eligible, the rebate is deducted from their rates bill. Although ratepayers apply to their local council, the rebate is actually provided by central government – the Department of Internal Affairs transfers funds to the council to meet the cost of the rebate. The Rates Rebate Scheme has suffered from low take-up since its inception. According to LGNZ (2015a, p. 61), this is generally understood to be because of “a combination of insufficient promotion, complex administrative processes and a sense that it is a state hand-out”.

In addition to the Rates Rebate Scheme, social supports exist to assist with accommodation costs. The most significant is the Accommodation Supplement, a weekly payment that helps people with their rent, board or the cost of owning a home. Eligibility depends on factors such as accommodation costs, location, income and assets, and family circumstances.

### **Rates remission or postponement**

Under section 102(5) of the Local Government Act 2002, local authorities have the option to develop a rates remission policy and/or a rates postponement policy.

- Rates postponement occurs when a local authority agrees to delay the due date of rates payment until a specified time or a specific event occurs, such as the sale of the property.
- Rates remission occurs when a local authority agrees to reduce or eliminate the amount of rates payable on a property.

The Shand Report (2007) found that rates postponement can be helpful for those who are asset rich and cash poor, but found that the level of rates remitted or postponed was usually very small, at between 0.3% and 0.7% of total rates revenue. The report also found that remission policies tended not to focus on addressing financial affordability problems – the most common remission policy provisions dealt with the waiver of penalties for late or non-payment of rates.

The Commission is not aware of any more recent reviews or assessments of rates postponement, rates remission, or other affordability measures and is interested in feedback from inquiry participants on what measures councils use to address financial affordability problems and how effective any measures are.

**Q26**

**What measures do councils use to keep services affordable for specific groups, and how effective are they?**

## Allocation of costs across local communities

The approach that councils take to levying rates and other charges has a significant impact on the affordability of local government services for different households, businesses and other organisations. Councils typically seek to achieve a 'fair' allocation of costs – fairness can refer to either (1) the 'benefit principle' – rates and other charges should be levied in rough proportion to the benefit that a property owner receives from council-provided services, or (2) the 'ability to pay' principle – collect tax in relation to some measure of income or wealth of the property owner (NZPC, 2017).

Councils have a range of approaches to recover costs based on the beneficiary pays principle. One approach is through the use of user charges. LGNZ (2015a) notes two main advantages of user charges:

First, a price allows consumers to decide what they want to buy. Consumers choose to buy or not to buy a given product or service at a given price. This gives individuals the greatest control over their economic lives... The second major advantage of using prices is that prices allocate resources efficiently. Prices send strong signals about what is wanted and what is not. (p. 42)

Many councils also apply targeted rates as a way of creating a match between those who benefit from a service and those who pay. The next chapter asks for feedback on whether there is a good case for local governments to make greater use of user charges and targeted rates.

The main approach that councils use to adjust charges in response to ability to pay is to levy rates based on the value of property, meaning that those with higher-value properties pay more. LGNZ (2015a) notes that rates are roughly progressive, but also notes that property taxes are by definition based on property wealth, rather than on income or total wealth, and so are not always a good indication of ability to pay.

Council choices about how rates are calculated have an important influence on how progressive they are. For example, use of uniform annual general charges is regressive, as it applies a fixed charge on all ratepayers, irrespective of the value of their property. To limit the regressive impacts of fixed charges on low-income households, the LGRA specifies that revenue from uniform annual general charges must not exceed 30% of the total revenue from all rates sought by a local authority in a given year.

Other council funding tools can also be designed in a way that takes account of ability to pay. For example, many councils apply different user charges for services such as public transport, including discounted rates for children or tertiary students.

The LGRA provides for some types of Māori land to be exempt from rates and, in addition, some councils may decide to remit or postpone collection of rates for Māori land. Review of mechanisms for rating Māori freehold land is excluded by the inquiry Terms of Reference.

**Q27**

**How do councils manage trade-offs between the ability to pay and beneficiary pays principles? What changes might support a better balance?**

## Rating differentials

Rating differentials are another tool used to adjust the allocation of costs across the community. For example, Table 6.1 shows the differentials used by Hutt City Council and Hamilton City Council along with the proportion of total rates collected from each differential group.

**Table 6.1 Hutt City Council and Hamilton City Council rating differentials for 2018/19**

Hutt City Council			Hamilton City Council		
Category	Differential	% of total rates	Category	Differential	% of total rates
Residential	1.0	70.3%	Residential	1	59.90%
Business <sup>1</sup>	2.58, 2.74 or 2.86	24.4%	Commercial	2.2938	30.96%
Community facilities <sup>1</sup>	0.5, 1.0 or 2.38	1.1%	BID Commercial	2.1791	7.75%
Rural	0.74	0.6%	Other	0.7420	1.39%
Utility networks	2.38	3.6%			

Source: Hutt City Council (2018a); Hamilton City Council (2018).

### Notes:

1. Hutt City Council applies differentials for three groups of business and three types of community facilities.
2. BID Commercial refers to commercial properties located within Hamilton City Council's business improvement district.

In a 2007 analysis of the use of rating differentials, Covec found that 40 territorial authorities set business differentials on general rates. All business differentials were greater than one, indicating that they are used to increase the incidence of rates on business (the average business differential was 3.2). Covec suggests that this may reflect greater ability to pay, given that in most cases businesses receive the same level of service as other ratepayers, and at a similar cost: "Indeed, even in the presence of differentials, business rates are a relatively small fraction of operating revenue (compared to residential rates as a fraction of disposable incomes)" (Covec, 2007, p. 40).

The same analysis showed that 39 Territorial Authorities set rural differentials on general rates. In all but three cases these differentials were less than one, showing that rural differentials are generally used to ease the burden of rates on rural ratepayers. Covec (2007, pp. 42-43) noted that rural differentials can be justified because rural properties often receive lower levels of service:

... most rural properties are distant from council facilities (such as parks, libraries and swimming pools) and thus use them less than other ratepayers. Rural properties are often also more self-sufficient than urban properties. e.g. many rural properties supply their own water and stormwater services. Both justify a lower rate for rural properties.

Where councils elect to set a rate differentially, the different rating categories along with the objectives for the differentiation must be clearly explained in their funding impact statement (part of a council's annual plan) (SOLGM, 2013). However, LGNZ (2015a, p. 56) found that the "rationale behind rating differentials is not always transparent". The Shand Report (2007, p. 131) also raised concerns about the use of rating differentials:

The Panel considers that business differentials have been set in an arbitrary fashion historically and are not related well to the benefits received. These are generally fixed by a subjective and essentially political decision.

**Q28**

**Do councils currently distribute costs fairly across different groups of ratepayers? If not, what changes to funding and financing practices would achieve a fairer distribution of costs across ratepayers?**

### **Inter-generational equity**

A further factor in considering how councils allocate costs is the question of how costs are shared over time. Inter-generational equity refers broadly to a fair distribution of costs and benefits between present and future generations. Inter-generational equity is relevant when local governments invest in costly long-lived infrastructure that will serve both current and future generations of residents. The achievement of intergenerational equity depends on how councils use debt and any other long-term funding mechanisms to match the period of funding with the perceived period of benefit. Use of debt is discussed in the next chapter.

**Q29**

**Do councils currently distribute the costs of long-lived infrastructure investments fairly across present and future generations? If not, what changes to funding and financing practices would achieve a fairer distribution of costs across generations?**

# 7 Future funding and financing

The various cost drivers discussed in Chapter 5 place pressure on councils to obtain sufficient revenues to pay for their spending needs. The choice of how funds are collected to pay for council spending (and the range of funding tools a council has access to) is important. For instance, it determines how the costs of local services are distributed across communities (in other words, who pays what). This, in turn, affects the affordability of services for individual households and businesses and the relative cost burden imposed on different types of land owners, and on different generations. How funds are collected also affects the cost of administering the funding and financing system, and the incentives of households, businesses and local authorities.

This chapter sets out a range of questions and issues regarding the future of the local government funding and financing framework on which the Commission is seeking feedback.

## Desirable characteristics for a funding and financing framework

The key task of this inquiry is to examine the adequacy and efficiency of the local government funding and financing framework. The terms of reference specify that suitable principles be applied in this appraisal, including efficiency, equity, affordability and effectiveness. These principles are broadly compatible with the established principles for assessing tax systems and reforms, which typically include the following dimensions (Tax Working Group, 2018; Victoria University of Wellington Tax Working Group, 2010).

- Efficiency – considering the incentive effects imposed by taxes and the likely responses to these incentives. For local government funding this includes the impacts on decisions by households and businesses about investing in, developing and using property, and about using services.
- Equity and fairness – including the concepts of treating similar individuals in a similar manner (horizontal equity) and treating unlike individuals in a similarly unlike way (vertical equity), as well as the distribution of costs across present and future generations (inter-generational equity).
- Revenue integrity – providing a sustainable revenue base over time and minimising avoidance.
- Compliance and administration costs – considering the cost and ease of administering and complying with taxes.
- Fiscal adequacy – the ability of the system to raise ‘just enough’ revenue to meet expenditure needs.
- Coherence with the broader (national-level) tax system.

None of these principles are absolutes and consideration of any changes to the current framework will require nuanced judgements about how they are applied. Trade-offs will need to



be made across individual principles: for example, administrative simplicity may need to be balanced against the potential revenue generated.

It may also be appropriate to adjust these principles, or the way they are applied, for assessing the funding model for local government. For instance, the current framework includes user charges, targeted rates, rating differentials and development contributions, which reflect the beneficiary pays principle. Some other potential tools such as visitor levies (discussed below) seek to account for negative spillovers.<sup>5</sup> Transparency is also an important principle in the context of councils' accountability to their local ratepayers.

The Commission will assess whether and how the design and use of the current framework is resulting in pressures against these principles, and the extent to which any such pressures could be relieved by potential changes, such as the introduction of new funding and financing tools.

The Commission is interested in receiving feedback on the most suitable principles for assessing the current and potential new or improved approaches to the local government funding and financing framework.

**Q30**

**What principles should be used to appraise current and potential new approaches to local government funding and financing, and how should these be applied? What are appropriate trade-offs across these principles?**

## Existing funding tools

### Effective use of existing funding tools

Chapter 3 set out the range of funding tools available to local government. The Commission is interested in whether the existing set of funding tools is being used effectively, and whether certain funding tools are under-utilised.

In particular, the Commission has previously found that councils have considerable scope to increase their use of targeted rates to recoup the upfront costs of growth-related infrastructure over a longer timeframe. This is particularly suitable for community infrastructure that benefits a wider group than just those in new developments and that cannot be funded through development contributions. Targeted rates allow for the cost of infrastructure to be attributed to those that benefit from the investment and to be spread over the life of the asset.

The Commission has also argued that councils should make more use of user charges such as volumetric water pricing. User charges are an effective approach to managing demand and have substantial potential to reduce the operating expenditure of councils, and delay or avoid capital investments in new infrastructure. For example, Tauranga City Council's introduction of water meters and volumetric charges has resulted in a significant reduction in demand for water. This,

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<sup>5</sup> Negative spillovers are when activities impose costs that are not fully borne by those responsible. When these costs are instead placed on those responsible, the negative spillover (or externality) is said to be internalised. This principle is referred to as 'exacerbator pays' (sometimes 'polluter pays', in the context of environmental externalities).

in turn, has generated significant savings, primarily because upgrades to water infrastructure can be delayed (NZPC, 2015).

Rates are by far the largest single source of funding for local government, and the Commission previously examined the approach local authorities use to calculate rates. Under the LGRA, councils are able to choose the basis on which they levy general rates. They can choose from:

- capital value, being the value of land and improvements;
- annual value, which is the greater of either the estimated gross yearly rental less 20% (or 10% no buildings are on the land) or 5% of the property's capital value; or
- land value, which is essentially a locally applied land value tax.

A trend in recent decades has been for councils to abandon land value rating in favour of capital value rating. Underpinning this shift was a view that capital value is more equitable owing to a better fit between capital value and a person's ability to pay. However, available evidence at a national level suggests that a system based on land values may be more progressive, and therefore more equitable (NZPC, 2015, 2017). Additionally, a land value rating system encourages land to flow to its highest value use and, at the margin, discourages holding undeveloped land. Yet, switching to a land value system may disadvantage particular landowners (eg, farms and other households with large pieces of land) and involve large administration costs.

The Commission is interested in further information regarding councils' approach to levying rates, and the costs and benefits of adopting a land value rating system.

**Q31**

**How effectively is the existing range of local government funding tools being used?**

**Q32**

**Is there a case for greater use of certain funding tools such as targeted rates and user charges? If so, what factors are inhibiting the use of these approaches?**

**Q33**

**What is the rationale underlying councils' approach to levying rates? What are the costs and benefits of shifting from a capital value system to a land value system?**

## Limitations on the use of existing tools

The Commission has previously recommended that the scope of some existing funding tools should be broadened. For example, under the LGRA, councils are unable to impose targeted rates based on changes in property value. This prevents councils from introducing funding tools that capture some of the uplift in property values generated by infrastructure investment (Box 4).

#### Box 4 Value capture

Investment in infrastructure frequently delivers benefits to residents, including better connection to employment opportunities, reduced congestion, improved amenities, and basic services such as drinking water. Therefore, it is not surprising that these benefits are usually reflected in rising land and property values.

Increases in land values generated by public action such as investments in infrastructure directly benefit private landowners. Currently, councils can use targeted rates to indirectly capture this benefit. These are usually levied through a fixed charge or on a proportion of a property's value. Yet neither of these approaches strongly reflects the windfall gains that a private owner receives. Directly taxing the uplift in land values would better capture the windfall gains afforded to landowners, but current legislation does not allow this approach.

The Commission (2015, 2017) previously concluded that there is considerable scope for value capture to be used in New Zealand to help fund the infrastructure needed to support growth, and recommended legislative change to enable this.

Source: NZPC (2015, 2017).

The use of user charges is also restricted. Councils (or their subsidiary infrastructure providers) are not permitted to charge volumetrically for wastewater. Auckland (where water services are delivered through the CCO Watercare) is the only area where volumetric charges are used for wastewater. Current legislation also provides only limited opportunities to apply user charges for roads (eg, tolls and congestion fees). Under the Land Transport Management Act 2003, tolls may only be established with the approval of the Minister of Transport and applied only to new roads.

The Commission (2015, 2017) has recommended that councils should be allowed to set volumetric charges for both water and wastewater; and to price the use of existing local roads where it would enable more efficient use of the road network.

**Q34**

**In addition to restrictions on how targeted rates are applied and the types of services where user charges can be levied, do any other restrictions on existing funding tools unduly limit their uptake or usefulness?**

### Addressing funding risks

Even with more comprehensive use of funding tools currently available to councils, funding risks may still cause councils to be cautious about making key, long-term investments, especially for growing councils. For example, councils must pay upfront for the early infrastructure that service new subdivisions. But, most funding streams (eg, development contributions) are only paid when (or after) the development occurs. Because of this timing gap, initially councils may need to use debt or general rates to pay for infrastructure, both of which come with political risk (Krupp & Wilkinson, 2015). Councils also bear the risk of overestimating future demand (NZPC, 2017).

**Q35**

**How does the timing and risk associated with future funding streams influence local authority decision making about long-term investments? What changes to the current funding and financing system (if any) are needed to address these factors?**

## Are new funding tools needed?

Various commentators have suggested that local government would benefit from additional funding tools. For example, the Commission found that the local government funding toolkit should be expanded to improve councils' ability to provide infrastructure, and the land needed for future infrastructure and public open spaces, adequately and more efficiently (NZPC, 2017).

LGNZ (2015a, p. 76) has also raised concerns about the funding tools available to local government noting that New Zealand has an unusual reliance on property rates, which creates difficulties including;

- ... some communities struggling to afford services and infrastructure that others take for granted;
- a lack of resilience, given that comparable local government systems tend to have access to at least two different types of taxes providing additional protection against risk should a tax base fail;
- affordability, with some households, particularly those on fixed incomes, facing economic hardship as a result of the share of household expenditure spent on rates; and
- failure of the local tax system to adequately reward councils for investing in growth.

**Q36**

**What are the pros and cons of a funding system where property rates are the dominant source of funding? Does the local government funding system rely too heavily on rates?**

## Increased Crown investment in infrastructure

Central government makes a significant contribution to local roads and transport. But for other infrastructure and services local government receives little funding from central government. This is in keeping with the principle of beneficiary pays. It also aligns with the concept of subsidiarity, where responsibility (including responsibility for funding) is allocated to the level of government closest to those affected by the policies made or the actions taken.

There are, however, situations where central funding for local infrastructure and services may be justified. One is where the benefits of certain investment are not captured entirely within the jurisdiction funding the activity. In these cases, investment is likely to be at a suboptimal level. As an example, Queenstown-Lakes District Council has argued a case for central government to invest in improving Queenstown's infrastructure because of significant spillovers from tourists visiting Queenstown that benefit other parts of the country (Box 5).

### Box 5 Possible spillover benefits from Queenstown's tourism industry

Queenstown-Lakes District Council notes that greater infrastructure investment is needed to maintain Queenstown's international visitor experience. A paper commissioned by the council argues that investments to maintain or enhance the town's tourism experience would buy significant regional and national benefits. One reason for this is that visitors who come to New Zealand because of Queenstown spend a further \$157–\$254 million per annum in the rest of the South Island (excluding Queenstown).

The paper also argues that there is potential for negative spillovers if insufficient infrastructure investment resulted in a significant deterioration of the tourism experience in Queenstown:

Queenstown's position as New Zealand's most popular tourist destination (after Auckland), and the strong association between the Queenstown and New Zealand brands also means that New Zealand's tourism brand could be damaged from a diminished Queenstown experience.

Source: Martin Jenkins (2018, p. 1).

Another situation where central government funding may be justified is when centrally determined standards are different from what a local government would choose. New Zealand has adopted a number of national standards in the national interest; for example, for drinking water. In some areas the standard will be above what the local community would choose, either because the opportunity cost is very high (there are other more important competing local preferences or priorities), or because the absolute cost of meeting the standard is very high. In the latter case, central government may choose to assist the local authority meet the standard. This conclusion is reinforced if the health care costs of poor drinking water are borne nationally.

Assistance with funding achieves the objective of the regulation which is for people to be able to enjoy the same standard of air quality or drinking water regardless of where they live. It is essentially a redistributive policy, allowing every locality to enjoy the same standard regardless of the local ability to fund meeting the standard. There are examples of such funding in the New Zealand context. For example, national drinking water standards that were developed by the Ministry of Health came into effect in December 2008. The new standards forced many councils to upgrade their water treatment plants – in some cases at significant cost (Krupp, 2016).

To help councils meet the standards, central government established a Drinking Water Assistance Programme that provided a fund for both technical assistance to drinking water suppliers and a capital assistance programme to fund capital works where necessary. Central government funding of \$150 million was set aside for this assistance programme, however, the costs of compliance were estimated at between \$309 million and \$527 million (Krupp, 2016).

**Q37**

**Under what circumstances (if any) could there be a case for greater central government funding transfers to local government? What are the trade-offs involved?**

## Funding tools to encourage growth

A frequent concern about the local government funding and financing framework is that it creates few incentives for councils to pursue economic growth and accommodate population growth. The Commission (2015) has previously found that although councils welcome population growth and want to accommodate it, they find it costly to do so. Accommodating population growth is not seen as financially beneficial to local government, but as a drain on resources.

LGNZ has also found that the funding arrangements of local government mean that it can be less than welcoming of economic opportunities and facilitating development of new housing. They have recommended that

Councils should be able to retain a share of any value uplift arising from additional economic activity related to local intervention and investment: we need to provide additional incentives that will encourage councils to invest in growth, whether through investment in new infrastructure and amenities or different planning rules. (LGNZ, 2015b, p. 5)

Infrastructure New Zealand (2018, p. 5) also notes that councils require greater incentives to increase housing supply:

Councils need to be rewarded for increasing housing and development supply by:

- Enabling councils to share in taxes that the Government receives from growth through city or regional deals.
- Greater use of competitive grants and transfers to councils, like the Provincial Growth Fund, to encourage city-regions to compete for growth and invest in their future.

Similar proposals have also been put forward by the New Zealand Initiative, who recommend introducing financial incentives to encourage alignment between local and central government priorities. For example, Krupp (2016) suggests that central government should pay local councils for every new house constructed in a specified period, and that councils should be allowed to share in the economic growth that occurs in their region via a tax-sharing arrangement should growth exceed central government projections.

**Q38**

**Do local authorities have sufficient financial incentives to accommodate economic and population growth? If not, how could the current funding and financing framework be changed to improve incentives?**

## Funding tools to support areas with declining population

Funding challenges can also arise from lack of growth. As noted in Chapter 2, a number of New Zealand towns face population decline. In some cases, population numbers and incomes may be too low realistically to fund the replacement of ageing assets such as water and wastewater treatment plants and distribution networks.

A common strategy to address decline and associated funding pressures has been to develop plans and strategies to revitalise the local economy (Hollander, Popper, Schwarz, & Pallagst, 2009). Most declining councils prepare economic development strategies that outline initiatives aimed at stimulating population and economic growth. Examples of initiatives include removing

development contributions to encourage commercial and housing development (Whanganui District), redeveloping the CBD (Grey District) and collaborating between districts to promote local business (Kawerau District, Whakatane District and Ōpōtiki District) (NZPC, 2017).

Yet, evidence on the success of these policies is mixed. Neumark and Simpson (2014) reviewed relevant literature and found that policies aimed at boosting the economic performance of underperforming areas are often ineffective. McMillan (2015) argues that attempting to combat decline is increasingly challenging in New Zealand as demographic and economic trends encourage outmigration. Similarly, Hollander et al. (2009) contend that

aiming for economic growth in order to regain population growth – an uneasy compromise – is the most typical response of planners and politicians, a strategy that rarely leads to success anywhere. (p. 12)

Having identified that the underlying factors driving decline are usually very difficult to counter, the Commission's *Better urban planning* inquiry recommended central government should consider providing funding and advice to councils in areas with declining populations to help meet infrastructure needs. The Commission recommended that any support should be conditional on councils taking sensible steps to adapt to demographic change (rather than trying to reverse the decline). Steps could include, for instance, the use of distributed infrastructure options that can efficiently adjust to changes in the local population. The Commission is interested in views on this, and any other funding and delivery strategies, such as regionally shared services, for local governments in areas with declining population.

**Q39**

**What funding and financing options would help councils to manage cost pressures associated with population decline? What are the pros and cons of these options?**

**Q40**

**Are other options available, such as new delivery models, that could help councils respond to funding pressures associated with a declining population? What conditions or oversight would be required to make these tools most effective?**

## Local income and expenditure taxes

Local income and expenditure taxes are sometimes used internationally as a revenue source for local governments. For example, about 70% of local government revenue in Sweden comes from personal income taxes – although the scope of local government roles and responsibilities is usually larger in jurisdictions that apply local taxes. As with some of the examples discussed above, providing councils with local income and expenditure taxes would ensure that they benefit more directly from growth. For example, councils would receive greater revenues as a result of the spending and income of an increased population as well as from the spending and income earned from investing in the infrastructure to serve the larger population.

However, there are several reasons to be cautious about the introduction of local income and expenditure taxes (NZPC, 2017):

- linking council revenue sources more closely with economic activity would risk more volatility in council finances;
- declining councils would face an even greater funding shortfall than they currently do; and
- local income or expenditure taxes would also be costly to implement – LGNZ (2015a, p. 68) notes that a locally determined and collected tax “would require local authorities to replicate IRD resources and hence would be prohibitively expensive”.

Q41

### What are the pros and cons of local income and expenditure taxes?

## Local property taxes

As discussed in chapter 3, council rates are set to cover a council’s annual budget, and property values are used to allocate the burden of rates across the community. Local property taxes are an alternative approach, where property is taxed according to its value – if the value of a property increases or decreases, the amount of tax paid adjusts accordingly. Internationally, many cities use local property taxes to provide revenue, rather than rates.

Infrastructure New Zealand (2018) notes:

Increasing property values, in general, increase the amount of revenue taxing authorities receive and property owners pay. Various tax provisions ensure taxing authorities can raise at least the same amount of revenue if property values fall. (p. 28)

Infrastructure New Zealand notes that cities that use property taxes of this sort have fewer financial concerns than other cities they studied, that use the equivalent of New Zealand’s rating approach. Also

...property owners pay more if property values increase. Higher tax bills reduce the benefits of increasing property values to property owners. Public feedback over increasing taxes to elected representatives provides a strong political incentive to manage costs down to facilitate supply [of housing]. (Infrastructure New Zealand, 2018, p. 28).

A potential problem with local property taxes is that they increase the volatility and reduce the predictability of council revenue streams and the tax faced by property owners. On the other hand, as discussed below, the use of property taxes supports tax increment financing (discussed below) as an additional financing tool.

Q42

### What are the advantages and disadvantages of a local property tax as an alternative to rates?

## Other funding tools

The preceding section set out an overview of various arguments regarding the need for additional local government funding tools, and set out some potential additional funding tools. In addition to seeking feedback on the merits of these tools, the Commission is also interested in other potential funding tools that would improve the local government funding framework.



Environmental taxes are one example of potential additional funding tools. The Tax Working Group is considering the role of the tax system in delivering positive environmental and ecological outcomes. The Group has developed a draft framework for considering environmental taxes and resource rents, including locally-variable tax instruments (Tax Working Group, 2018).

**Q43**

**Are there any other changes to the current local government funding and financing framework, such as new funding tools, that would be beneficial?**

**Q44**

**How can the transition to any new funding models be best managed?**

As noted throughout this paper, councils vary considerably in terms of demographic and economic circumstances, and in the cost pressures that they face. Accordingly, the sufficiency of existing funding tools is unlikely to be uniform across all councils. Locally specific pressures (such as tourism growth in some locations) may be best met by particular funding and financing tools (such as a bed tax that is only levied in some areas). The Commission is interested in further information on the circumstances under which additional funding tools may be required, and how the need for particular funding tools may vary across councils.

**Q45**

**To what extent does the need for particular funding tools vary across local authorities?**

## Financing barriers

To meet the costs of infrastructure investments, councils have a choice between pay-as-you-go financing, and borrowing – between paying up front, and spreading payments over the life of the asset. The Commission explored this choice in its *Land for Housing* report. For long-lived assets not specific to a new development, it saw borrowing as the way to go because of intergenerational equity concerns, the ability to bring forward needed investments, and the ability to service debt from rates income (NZPC, 2015).

However, local governments may be reluctant to make use of debt-financing for several reasons.

### Credit-rating risk

Twenty-four of New Zealand's councils are rated by one of the three main credit-rating agencies, Standard & Poor's (S&P), Moody's and Fitch. These agencies have their own methodologies for making credit-rating assessments of local authorities, which include factors such as debt-to-revenue ratios. S&P has warned Auckland Council of a rating downgrade if its debt-to-revenue ratio exceeds 270% (New Zealand Herald, 2016). Auckland Council recently forecasted that its debt to revenue ratio revenue would be close to hitting this threshold by 2019 (Norman, 2017).

If Auckland Council were to suffer a credit downgrade it would likely lead to an increase in the interest cost of new debt of 0.1% to 0.15% (10 to 15 basis points) or \$1 million to \$1.5 million a year on a loan of \$1 billion. This may not seem large, yet the Council's reputation in the eyes of credit-rating agencies and investors would take a serious hit if it made a deliberate choice to exceed a limit knowing that it would cause a downgrade. Also, a two-notch downgrade of

Auckland would very likely cause a downgrade of the LGFA's credit rating, leading to a rise in the cost of borrowing for all councils in New Zealand.

## Debt benchmark regulations

Central government has increased its scrutiny of local authority debt levels. Regulations introduced in 2014 require councils to report their actual and planned performance against a number of financial prudence benchmarks (Table 3.2). One of these benchmarks is the debt-servicing capacity of local authorities. It is met if the costs of servicing loans for the year are no greater than 10% of revenue. For local authorities defined as high-growth under the regulations, this threshold is set at 15%. Several councils are close to or exceeding their threshold (Figure 7.1).

**Figure 7.1 Interest expenditure as a share of total operating revenue across selected councils, 2017**



Source: Councils' 2016/17 annual reports.

### Notes:

1. The Local Government (Financial Reporting and Prudence) Regulations 2014 defines a "high-growth" council as a local authority "whose population is expected to grow at or above the national population growth rate" according to the most recent Stats NZ projections.
2. Auckland Council's ratio is calculated for the full Auckland Council Group (including Auckland Transport and Ports of Auckland) with the exception of Watercare, because Watercare is not reliant on council funding.

The regulations focus on financial plans and are not "hard" limits. They require councils to prepare disclosure statements about compliance and related information. Central government has graduated intervention powers. Any council acting "imprudently" is likely to be noted in the Office of the Auditor General's report to Parliament; the council could be subject to a request to report to the Minister, the appointment of a Crown Observer, a Crown Manager or, in an extreme case, replacement by Commissioners or an early election (Minister of Local Government, 2012).

## Local Government Funding Agency rules

The Local Government Funding Agency (Chapter 3) undertakes its own internal credit assessment and rating process for all council borrowers. The primary criteria are:

- debt levels relative to population;
- debt levels relative to asset base;
- ability to repay debt;
- ability to service debt (interest cover); and
- population trends.

The LGFA imposes lending covenants on council borrowers. Local authorities with a long-term credit rating of 'A' equivalent or higher (currently all rated councils) are subject to slightly less restrictive financial covenants.

**Table 7.1 LGFA financial covenants**

For councils with an external credit rating equivalent to 'A' or better	For councils without an external credit rating
Net debt/total revenue is less than 250%	Net debt/total revenue is less than 175%
Net interest/total revenue is less than 20%	Net interest/total revenue is less than 20%
Net interest/rates is less than 30%	Net interest/rates is less than 25%

Source: NZPC (2017).

Unlike the benchmark regulations these are 'hard' limits. Non-compliance will preclude a council from borrowing and trigger a review. Default will occur if a council fails to meet an interest or principal payment and after 30 days the LGFA can seek repayment of all loans. As at 30 June 2015 all member councils were compliant with these ratios. A further LGFA rule limits its exposure to its largest single borrower – Auckland Council – to no more than 40% of LGFA total funding (currently it sits at 33%).

## Political pressures

In addition to commercial constraints, community attitudes and perceptions can also constrain councils' borrowing. Councils often face strong political pressures from ratepayers not to increase their debt levels. Often this is due to concerns that future repayment obligations will result in rates increases. Central government also has an interest in the finances of local government to the extent that their financial position could affect New Zealand's overall standing with rating agencies. And central government would be likely to come under pressure to support councils that were at risk of defaulting – however, no local authorities have defaulted since at least World War Two (DIA, 2014).

**Q46**

**To what extent are financing barriers an impediment to the effective delivery of local infrastructure and services? What changes are needed to address any financing barriers?**

## Other financing approaches

### Private financing

Private sources could finance local government infrastructure and development investments. Even so, ultimate responsibility for debt may still lie with councils, and so such arrangements may not overcome the financing barriers discussed in the previous section. For example, public-private partnerships (PPPs) can introduce private sources of finance for a project. Under a PPP, the local authority contracts a private entity to supply new or refurbished infrastructure. This could involve the private party designing, building, financing, owning, maintaining and, in some cases, operating all or part of the facility over an extended period (NZPC, 2017). Yet the obligation on the council to pay back the PPP entity by some means over time counts as council debt.

A way to get non-council capital to take the strain may be to allow and encourage private developers to finance large new subdivisions, service them with infrastructure, and have the ability to recoup costs from new residents. This would put the additional debt on the balance sheets of households purchasing new properties through their mortgages. The debt would not lie with the relevant council.

The Commission explored this option in its inquiry on better urban planning (NZPC, 2017). Several options exist to address the ownership, funding, financing and succession issues of such subdivisions. Legal clarity and policy support would be needed for developers, investors and prospective residents to have the confidence to proceed. Desirably, the higher upfront costs of infrastructure for homeowners could be offset with lower land prices through making markets for urban land more competitive.

Another proposal is for central government to take on the debt for local government infrastructure investments, in turn funding this by issuing 50-year infrastructure bonds to private investors. The bonds would be backed by an income stream from targeted rates and, in effect, guaranteed by central government (Twyford, 2017).

**Q47**

**What role could private investors play in financing local government infrastructure and how could this help address financing barriers faced by local governments? What central government policies are needed to support private investment in infrastructure?**

### Tax increment financing

A number of commentators have proposed tax increment financing for growth-related infrastructure investments (NZPC, 2015; Infrastructure New Zealand, 2018). The idea behind TIF is that a local authority forecasts the increase in tax revenue that will result from an infrastructure investment, and borrows against that future income. This is commonly done in the United States by issuing bonds, with future tax revenue hypothecated for a timeframe to repay the debt.

Yet tax increment financing will only work if councils' revenue is derived from a property tax rather than rates (Infrastructure New Zealand, 2018). As described in Chapter 3, rates are currently calculated using a top-down method; with a council first agreeing a Long-Term Plan and a financial impact statement, then allocating the financial burden between ratepayers. Where an infrastructure investment increases the rateable value of newly serviced land, this only

causes the total rating burden to be re-allocated among ratepayers. No new revenue is actually generated unless a council also increases its forecast expenditure. Nor is it possible to forecast what the rate take from a new development will be in the future, because it depends entirely on the council's expenditure plan (which is subject to change).

**Q48**

**If New Zealand replaces rates on property with a local property tax, should it also adopt tax increment financing as a way to finance growth-related infrastructure investments? What are the advantages and disadvantages of tax increment financing?**

## Oversight of local government funding and financing

Local authorities have a number of accountabilities and requirements in relation to their revenue raising and expenditure. As discussed in Chapter 6, under the LGA local authorities are required to prepare a financial strategy as part of their long-term planning, and their funding and expenditure plans are subject to public consultation. Long-Term Plans, as well as Annual Plans and Annual Reports must be provided to the Auditor General, who is responsible for financial and performance review of local authorities.

As noted in Chapter 2, local authorities are subject to statute. DIA administers the main acts governing local government, while the Ministry for the Environment administers others, such as the RMA. Legislation requires local authorities to maintain a balanced budget, and mandates how they set rates and development contributions. For example, s230 of the LGA specifies how local authorities should set the maximum development contributions for different types of development. Under Part 10 of the LGA, central government has a range of powers to intervene in certain situations, including where there is significant or persistent failure in performance of statutory functions or duties, or failure in financial management. And as explained earlier in this chapter, there are a number of restrictions and reporting requirements around financing and debt.

There are alternative models for regulating local government funding and financing. In Australia, state governments impose a range of legislative and regulatory restrictions on the use of revenue-raising instruments available to local governments, including limits on rate-setting and development contributions. For example, the Independent Pricing and Regulatory Tribunal in New South Wales sets the maximum amount councils can collect in general revenue through an annual "rate peg". The Essential Services Commission in Victoria also sets caps on council rates.

**Q49**

**How effective are the current oversight arrangements for local government funding and financing? Are any changes required, and if so, what is needed and why?**

# Summary of questions

**Q1**

**What other differing circumstances across councils are relevant for understanding local government funding and financing issues?**

**Q2**

**What explains the difference between the amount that councils account for depreciation and the amount spent on renewing assets? Are changes needed to the methods councils use to estimate depreciation? If so, what changes are needed?**

**Q3**

**In what ways are population growth and decline affecting funding pressures for local government? How significant are these population trends compared to other funding pressures?**

**Q4**

**What are the implications of demographic changes such as population ageing for the costs faced by local government?**

**Q5**

**To what extent is tourism growth resulting in funding pressures for local government? Which councils are experiencing the greatest pressure, and how is this manifesting?**

**Q6**

**Is an expansion of local government responsibilities affecting cost pressures for local government? If so, which additional responsibilities are causing the most significant cost pressures and what is the nature of these increased costs? To what extent do these vary across local authorities?**

**Q7**

**How is the implementation of Treaty of Waitangi settlements, including the establishment of 'co-governance' and 'co-management' arrangements for natural resources, affecting cost pressures for local government? How widespread is this issue?**

**Q8**

**How are local authorities factoring in response and adaptation to climate change and other natural hazards (such as earthquakes) to their infrastructure and financial strategies? What are the cost and funding implications of these requirements?**

**Q9**

Why is the price of goods and services purchased by local government rising faster than the consumer price index? To what extent is this contributing to cost pressures for local government?

**Q10**

Do the prices of goods and services purchased by local government vary across councils? If so, what are the reasons for these differences?

**Q11**

Is local government expenditure shifting away from traditional core business into activities such as economic development, sport and recreation and community development? If so, what is the rationale for this shift, and could these activities be better provided by other parties?

**Q12**

Does the scope of activities funded by local government have implications for cost pressures? If so, in what ways?

**Q13**

What other factors are currently generating local government cost pressures? What will be the most significant factors into the future?

**Q14**

How will future trends, for example technological advances and changes in the composition of economic activity, affect local government cost pressures?

**Q15**

How effective is the Long-term Plan process in addressing cost pressures and keeping council services affordable for residents and businesses?

**Q16**

How effective are councils' Long-term Plan consultation processes in aligning decisions about capital investments and service levels with the preferences, and willingness and ability to pay, of residents, businesses and other local organisations?

**Q17**

Is there scope to improve the effectiveness of Long-term Plan processes? If so, what, if any, changes would this require to the current framework for capital expenditure decision making?

**Q18**

How much scope is there for local government to manage cost pressures by managing assets and delivering services more efficiently?

**Q19**

What practices and business models do councils use to improve the way they manage their infrastructure assets and the efficiency of their services over time? How effective are these practices and business models in managing cost pressures? Do councils have adequate capacity and skills to use these practices and business models effectively?

**Q20**

How do councils identify and employ new technologies to manage their infrastructure assets and produce services more efficiently? How effective are councils in using new technologies to manage cost pressures? Please provide specific examples of the use of new technologies to manage cost pressures.

**Q21**

What incentives do councils face to improve productivity as a means to deal with cost pressures? How could these incentives be strengthened?

**Q22**

What are the most important barriers to local government achieving higher productivity?

**Q23**

How does local government measure productivity performance? Are these metrics useful? If not, what metrics would be better?

**Q24**

To what extent and how do councils use measures of productivity performance in their decision-making processes?

**Q25**

Do councils dedicate sufficient resources and effort toward measuring and improving productivity performance? If not, why not, and how could effort toward measuring and improving productivity performance be increased?

**Q26**

What measures do councils use to keep services affordable for specific groups, and how effective are they?

**Q27**

How do councils manage trade-offs between the ability to pay and beneficiary pays principles? What changes might support a better balance?

**Q28**

Do councils currently distribute costs fairly across different groups of ratepayers? If not, what changes to funding and financing practices would achieve a fairer distribution of costs across ratepayers?



**Q29**

Do councils currently distribute the costs of long-lived infrastructure investments fairly across present and future generations? If not, what changes to funding and financing practices would achieve a fairer distribution of costs across generations?

**Q30**

What principles should be used to appraise current and potential new approaches to local government funding and financing, and how should these be applied? What are appropriate trade-offs across these principles?

**Q31**

How effectively is the existing range of local government funding tools being used?

**Q32**

Is there a case for greater use of certain funding tools such as targeted rates and user charges? If so, what factors are inhibiting the use of these approaches?

**Q33**

What is the rationale underlying councils' approach to levying rates? What are the costs and benefits of shifting from a capital value system to a land value system?

**Q34**

In addition to restrictions on how targeted rates are applied and the types of services where user charges can be levied, do any other restrictions on existing funding tools unduly limit their uptake or usefulness?

**Q35**

How does the timing and risk associated with future funding streams influence local authority decision making about long-term investments? What changes to the current funding and financing system (if any) are needed to address these factors?

**Q36**

What are the pros and cons of a funding system where property rates are the dominant source of funding? Does the local government funding system rely too heavily on rates?

**Q37**

Under what circumstances (if any) could there be a case for greater central government funding transfers to local government? What are the trade-offs involved?

**Q38**

Do local authorities have sufficient financial incentives to accommodate economic and population growth? If not, how could the current funding and financing framework be changed to improve incentives?

**Q39**

What funding and financing options would help councils to manage cost pressures associated with population decline? What are the pros and cons of these options?

**Q40**

Are other options available, such as new delivery models, that could help councils respond to funding pressures associated with a declining population? What conditions or oversight would be required to make these tools most effective?

**Q41**

What are the pros and cons of local income and expenditure taxes?

**Q42**

What are the advantages and disadvantages of a local property tax as an alternative to rates?

**Q43**

Are there any other changes to the current local government funding and financing framework, such as new funding tools, that would be beneficial?

**Q44**

How can the transition to any new funding models be best managed?

**Q45**

To what extent does the need for particular funding tools vary across local authorities?

**Q46**

To what extent are financing barriers an impediment to the effective delivery of local infrastructure and services? What changes are needed to address any financing barriers?

**Q47**

If New Zealand replaces rates on property with a local property tax, should it also adopt tax increment financing as a way to finance growth-related infrastructure investments? What are the advantages and disadvantages of tax increment financing?

**Q48**

**What role could private investors play in financing local government infrastructure and how could this help address financing barriers faced by local governments? What central government policies are needed to support private investment in infrastructure?**

**Q49**

**How effective are the current oversight arrangements for local government funding and financing? Are any changes required, and if so, what is needed and why?**

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# Terms of reference

## New Zealand Productivity Commission Inquiry into Local Government Funding and Financing

Issued by the Minister of Finance and the Minister for Local Government (the “referring Ministers”). Pursuant to sections 9 and 11 of the New Zealand Productivity Commission Act 2010, we hereby request that the New Zealand Productivity Commission (“the Commission”) undertake an inquiry into local government funding and financing.

### Context

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In 2007, the results of the Local Government Rates Inquiry (the *Shand* Inquiry) were reported to the Government. Local Government cost pressures have grown significantly since the *Shand* Inquiry, and local authority rates and payments increases have outpaced increases in the local government cost index.

Local Government plays important roles in New Zealand society. These place-shaping roles enhance and promote local community wellbeing across physical and financial, social, human and environmental capitals. In pursuit of these wellbeing outcomes, Local Government provides essential services, including transport, water and flood protection services, social and community infrastructure services, refuse collection, local planning, regulatory services that assist with public safety, health, environmental protection, biosecurity and economic development and a range of other essential services.

Local Government makes a considerable direct impact on the economy. In June 2016, councils owned \$112 billion worth of fixed assets, employed over 25,000 full-time equivalent staff and had annual operating expenditure of \$9.3 billion and operating income of \$8.9 billion.

The costs and pressures facing local government have increased in recent years, though the circumstances of individual councils vary (e.g. urban and rural communities face differing challenges). Local authority rates increases have outpaced increases in other indices measuring average costs and incomes. In particular, local authority rates and payments increases have significantly outpaced increases in the consumer price index and the independently prepared local government costs index.

Local authorities are capital-intensive businesses. Expenditure on fixed assets has grown significantly in recent years and demand for ongoing capital expenditure is unabated or increasing due to the development, maintenance and replacement of the infrastructure required to support New Zealand’s rapidly growing population (including international visitors) and support economic growth.

As a whole, local authority debt has grown steadily since 2006. Some high growth councils are experiencing constraints in their ability to finance further infrastructure investment because they are coming close to covenanted debt limits. At the same time, some local authorities take on very little debt at all.

Major factors that are influencing local authority costs include:



- for fast-growing areas, the need for local authorities to increase the supply of development capacity to address declining housing affordability
- maintaining services in areas with declining populations
- requirements for higher performance, including potentially from fresh water, wastewater, stormwater and flood protection systems to meet environmental and public health standards
- costs of adapting communities and infrastructure to mitigate risks and hazards associated with climate change
- supporting regional development (e.g. growing demand pressures from the tourism industry which may be disproportionate to the number of local residents)
- the need to replace existing infrastructure coming to the end of its useful life.

This mix of factors – rates increases, limits on borrowing, and increased expenditure demands, particularly for infrastructure – creates the need for an independent inquiry into cost pressures, decision making and affordability. Following an objective inquiry into these issues, the Commission is requested to provide an assessment and recommendations of current and alternative funding and financing options for local authorities to maintain and deliver services to their communities into the future.

#### **Scope and aims:**

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In light of the pressures discussed above, and in the context of a decade after the conclusion of the Shand Inquiry, the Government has selected this inquiry topic to examine and report on local government funding and financing arrangements.

Where shortcomings in the current system are identified, the inquiry is to examine options and approaches for improving the system of local authority funding and financing.

#### **Approach to the inquiry**

The Inquiry should:

- Have regard to previous reports, inquiries and reviews, but should also look to bring new and innovative thinking to these issues.
- Complement and receive existing work, (e.g. three waters review, and the Urban Growth Agenda) rather than duplicating it.
- Consult with key interest groups and affected parties including (but not limited to) ratepayer organisations, local business and community groups.
- Work closely with Local Government New Zealand, the Local Government Funding Agency, the New Zealand Society of Local Government Managers and the wider local government sector and relevant central government agencies to ensure its findings provide practical ways to improve the funding and financing of local authorities.

## Scope

The inquiry would examine the adequacy and efficiency of the existing local government funding and financing framework. Specifically, the inquiry will investigate:

### *Cost pressures*

- The factors (including the mix of services and investment) that drive local authority costs now and in the foreseeable future. This is to include an investigation of the drivers of cost and price escalation, in particular:
  - Whether this is a result of policy, and/or regulatory settings.
  - The role of growth/decline in population (including visitors and other temporary residents).
  - The impacts of Treaty settlement arrangements and costs of climate change on local authorities.
- In addition, the Commission should have regard to current frameworks for capital expenditure decision making, including cost-benefit analysis, incentives and oversight of decision making.

### *Funding and Financing models*

- The ability of the current funding and financing model to deliver on community expectations and local authority obligations, now and into the future.
- Rates affordability now and into the future.
- Options for new local authority funding and financing tools to serve demand for investment and services.
- Appraise both current and new or improved approaches considering suitable principles including efficiency, equity, affordability and effectiveness.
- How the transition to any new funding and financing models could be managed.

### *Regulatory system*

- Any constitutional and regulatory issues that may underpin new project financing entities with broader funding powers.
- Whether changes are needed to the regulatory arrangements overseeing local authority funding and financing.

## Out of scope

The Government considers that some aspects of local government finance have been well canvassed and further inquiry into them would not assist in achieving sustainable local government financing. Therefore, the following matters are out of scope of the inquiry:

- The particular mechanisms for rating of Maori freehold land and Crown land.
- The valuation system and practices.
- Substantial privatisation.

The Inquiry is not to make recommendations that would directly affect representation or boundary arrangements for Councils.

### **Report and Recommendations**

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The report should build on previous relevant inquiries undertaken by the Productivity Commission, and use the Shand Inquiry report as context.

The final report should provide findings and recommendations directed at central and local government regarding how to improve funding and financing arrangements.

### **Consultation**

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The Commission should engage with a broad range of stakeholders, including industry and non-governmental groups, Iwi, and the public.

### **Timeframe**

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The Commission should present the final report to referring Ministers by 30 November 2019.





NEW ZEALAND  
PRODUCTIVITY COMMISSION  
Te Kōmihana Whai Hua o Aotearoa

