SUBMISSION

Review of local government funding and financing

LGNZ's submission to the Productivity Commission

February 2019

Introduction

Local government funding is an issue that has been at the forefront of LGNZ's concerns for much of the organisation's history, as the challenge of providing communities with the services they needed to flourish often confronted real financial constraints. The result has been a number of local government funding reviews extending back at least to the mid-1940s. Unfortunately, despite the recommendations of these reviews, all of which identified problems with local government's dependence on property taxes, no fundamental changes to the way councils are funded have been made.

LGNZ considers that local government is handicapped by the comparative narrowness of the taxation base and, more particularly, its dependence on rating as the major source of revenue (Local Authority Finance in NZ 1973).

More recently, in 2014, LGNZ undertook its own review of local government funding and recommended a broad range of changes. These findings can be found in the report of that funding review at http://www.lgnz.co.nz/assets/Uploads/Our-work/Local-Government-Funding-Review.pdf. Those findings underpin the responses to the 49 questions in this issues paper.

LGNZ is pleased that the Productivity Commission has been asked to undertake this review and is committed to work with the Commission to ensure that the issues of funding and financing local government are fully understood, and practicable solutions identified.

Issues paper

LGNZ's responses to the questions set out below are based on its experience as the national organisation of local authorities and the findings of our 2014 review of local government funding. In relation to questions concerned with technical and operational matters, such as those concerned with the process of rating and budgeting, LGNZ would also refer the Commission to the submission prepared by the Society of Local Government Managers (SOLGM).

The response below is focused on the questions posed by the Commission and, for the most part, keeps within the scope set out in the issues paper. However, at the onset it is necessary to discuss some broader issues, as well as those ruled outside of the scope, to inform our response. Specifically, the relationship between central and local government, the incentives (positive and negative) created by different funding streams, and the future role of local government.

Speaking to the relationship, as has been well-covered in the Commission's Towards Better Local Regulation report, central government can (and does) pass on roles and duties for local councils to perform, and also sets regulatory standards across a range of measures that must be met. However, when Parliament does so, too often it gives little consideration to the costs it imposes in the process, and most mandates are unfunded or underfunded, to the degree that it could be described as a "free regulatory lunch". It is LGNZ's view that this relationship needs to be addressed in the funding review, especially if transparency and accountability are to be increased in this murky area. To do otherwise is to perpetuate the status quo, where central government bemoans rates increases while, at the same time, being a meaningful contributor to these cost pressures.

With regard to incentives, LGNZ would note that in the many reviews of New Zealand's property-rates-dependent funding model, too often the various reviewers have only taken a one dimensional look at the sector; the analysis has focused too heavily on first order considerations (can councils cover their costs? Is the tax base appropriate?), and have generally paid too little attention on second order considerations (what incentive does this create?).

As a result, there are a number of reports praising the technical efficiency of rates as a means of collecting revenue, but which give little or no regard to the anti-growth attitude that this kind of tax can foster. As LGNZ sees it, by decoupling local government revenues from the economic cycle, the property-tax-dependent local government funding structure has made ratepayers and councils reluctant to embrace economic growth. If this is to be reversed, a more a direct link between council revenues and the economy, such that ratepayers will welcome measures that promote growth (such as opening land for development) will need to be created.

On funding, the role of local government must, and will, change as the country does. Like many developed world countries, New Zealand is facing a number significant challenges, including climate change, an aging population, and a rapidly changing global economy, to name but a few. As the tier of government closest to the people, councils can increasingly play an important role in helping manage the complex local issues that arise as a result of our response to these challenges. The shape of this role is unclear, which is why LGNZ would urge the Commission to focus on establishing institutional funding arrangements that are sufficiently flexible to accommodate this change, without the need to significantly revisit the settings. To tailor the funding tools too tightly to the specific roles and responsibilities that councils undertake today would be to lock in problems that a future funding review would have to consider. As these reviews, and the political will to enact their recommendations, is infrequent, this could perpetuate the status quo, where local government has had to make do with the toolset that is only marginally fit for purpose.

LGNZ would note that the Minister of Local Government is proposing to review the roles and responsibilities as set out in the “Local governance for community well-being” Cabinet paper. Similarly, the “Future state of the three waters system: regulation and service delivery” proposes restructuring the service delivery, ownership and funding arrangements for drinking, waste and stormwater services, which could significantly change the scope of local government activities in the near-term. These processes are being run in parallel to the Commission’s inquiry, and there is a risk that they could undermine any recommendations from this inquiry should they be too narrowly focussed and specific. As such, LGNZ would urge the Commission to consider looking at the merits of a funding framework, with various funding tools that can be applied as best fits specific circumstances.

Question 1

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

LGNZ’s response

In addition to the factors identified in Chapter Two, greater recognition could be given to the relation of funding and financing pressures and the type of local authority. For example:

- The funding pressures on regional councils, which tend to be related to changing/higher environmental standards and extreme weather events, are broadly different to those of territorial councils, which are more directly related to community expectations, changes in population and the cost of capital works;
- Rural councils will be more affected than urban councils by changes in the cost of infrastructure provision, especially roading, due the size and slow rate of population growth (or decline in some cases);
- Urban councils face not only the costs of upgrading traditional infrastructure in response to higher standards, but also demands from citizens to address social issues, such as homelessness, and the need to invest in smart city technology as they compete with cities across the world for investment.

Question 2

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?

LGNZ's response

It is to be expected that the amount accounted for depreciation will differ from the amount spent, since depreciation is accounted for annually but expenditure can be extremely "lumpy". The more important question for the Commission's inquiry is to examine how the concept of depreciation is understood by councils and whether there is a need for guidance.

An important outcome of this review could be to provide clarity on how "depreciation" should be approached. On this point, LGNZ has questions about the depreciation discussion in box 3 on pages 22 and 23. This section makes reference to "providing funds for future renewals" and the amount of depreciation over time having "accumulated" to roughly equal the total cost of replacing a council's assets. In LGNZ's view, the latter comment, in particular, is simply wrong if it implies the creation of a "replacement fund". While councils may choose to build up reserve funds for specific purposes, depreciation does not require them to accumulate a replacement fund.

An optimal approach to investing in long life infrastructure that meets inter-generational objectives would be to raise the initial capital cost through some form of long term borrowing and pay it off over the life of the asset. Consequently, depreciation is the operational cost of renewals and maintenance to preserve levels of service.

Another factor to consider is the nature of the long term planning (LTP) process. In the first instance it must be noted that LPTs are a plan, not a script. As such, the three year planning and local political cycle means that councils tend to have higher confidence over the first three years of their 10 year plans, rather than those later on in the period. This may explain some of the variance between depreciation and renewals.

Overall, this is a complex area and one in need of further investigation. LGNZ notes that the Office of the Auditor General, in its annual review of long term plans, regularly raises the discrepancy between depreciation and renewals funding, but has failed to attribute a specific cause to the problem. LGNZ has suggested that this is a topic worthy of deeper investigation.

Question 3

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?

LGNZ's response

LGNZ suspects, that the issue is less about growth or decline, and more about the rate of growth.

Since its establishment, local government has experienced periods of both significant population growth and decline, and has had to make difficult trade-offs between the needs of current and future generations; this is simply the nature of government. It is business as usual. Councils that suffer significant population decline will eventually become unsustainable compared to a neighbouring municipality. Consider, for example, the case of Naseby Borough whose population had fallen to 109 residents prior to amalgamation in 1989.

Periods of rapid population growth, however, force councils to make politically and financially challenging choices between maintaining investments in existing services and investing in the infrastructure and services needed for new communities. This tension plays out in cities like Auckland, as noted in previous reports by the Commission, and is reflected in political sentiments that tend not to be encouraging to growth.

The critical issue is primarily one of financing as, in situations of extremely fast growth (New Zealand is growing faster than any other OECD country except Luxembourg), the current range of funding and financing tools available to councils appears to result in existing residents and businesses carrying the cost of new development to a level that is not sustainable.

Financing growth has resulted in some "growth councils" having reached central government imposed debt thresholds and, as such, are facing constraints that can undermine their ability to borrow for asset replacement and/or new infrastructure provision.

Such constraints can result in existing service level declines, such as traffic congestion, increased demand for library services, and coastal pollution due to delays in upgrading three waters infrastructure. This balance sheet constraint can also spill over into other sectors of the economy, such as housing, as councils may restrict opening up new land for development, which constrains supply and pushes up land prices.

Under the current funding arrangements, there are significantly more political disincentives associated with growth than there are incentives. To be explicit on this point, this is a case where the financial benefits of a growing population, such as a bigger rating base, accrue indirectly in the long-term, whereas the costs, which are borne by existing residents in the form of higher rates charges, accrue directly in the short-term.

The only way to avoid situations where councils face making trade-offs between maintaining and enhancing existing service levels, or investing to provide for the needs of future residents is to provide better funding and financing tools; ones which are more responsive to population changes.

One means of doing this is to ensure that the beneficiaries of new infrastructure pay for it through the provision of new financing tools that are better able to align the costs of growth with the beneficiaries of that growth. While development contributions go some way to achieving this, they have significant limitations:

- Since 2012 central government has imposed limitations on what development contributions can be used for. As such, developers cannot be charged for the cost of the community amenities, such as recreational and cultural facilities, that are essential for new subdivisions (this is expected to be addressed with the enactment of the Local Government (Community Well-being) Amendment Bill 2018);
- Development contributions are not easily used to fund the impact of new developments on existing infrastructure, such as roading and water services, which may need to be upgraded to cope with extra demand; and
- The fact that income from development is not considered "revenue" for the purpose of determining prudent levels of debt.

Question 4

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

LGNZ's response

This is another question where local variation will be significant. Some general points for consideration are:

- As populations age, councils will be required to change the way in which services are delivered and, in some cases, the services themselves. For example, there will be less demand for organised sport facilities, such as rugby or soccer fields, reducing costs, while more investment will be required to make streets and public amenities accessible for older citizens.
- Older populations are more likely to be dependent on fixed incomes and the point is often made that this will constrain councils' ability to increase property taxes, as older citizens will have less ability to pay for these increases than more economically active households. On the other hand, older citizens will make fewer demands on council services than younger households (more cost will be met by the State); communities may decide to reduce levels of service and/or councils can adopt rating policies that redistribute the impact of local property taxes to reduce the burden on certain types of households.
- Some concerns have been expressed at the loss of local volunteers due to population ageing and the fiscal impact that this might have on councils (which make use of many volunteers). However, it appears that the opposite is true, as people remain active and healthy in their retirement and participate more in community activities.

Question 5

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?

LGNZ's response

The growth in tourism numbers has placed considerable pressure on councils in areas favoured by tourists; many of these councils have small populations and limited rating bases. The pressures are experienced as demand for local infrastructure such as roads, and potable and wastewater networks, as well as amenities like toilets and car parking facilities, and camping facilities for freedom campers. Many of these activities also impose compliance costs on councils, such as the cost of regulating the camping and non-camping areas, and environmental clean-up.

Although not made clear in the issues paper, the direct benefits of the additional local tourism activity is mostly captured by central government through higher GST receipts, as well as through income and profit taxes.

Councils cover their tourist-related infrastructure costs out of general rates or use targeted rates, but neither is particularly well-suited to the task. In the first instance, the tax base is too broad, as many residents will not use tourism facilities, nor do they participate in the tourism sector, and in the second instance, the tax base is also too broad. Targeted rates tend to be focussed on accommodation providers and cannot be applied to tourists, who are mobile.

LGNZ agrees that there are opportunities to fund some of these pressures through user charges, such as "coin operated toilets" and pay-as–you-go camping areas; technology also opens up new opportunities.

The Tourism Infrastructure Fund and the new Tourism Levy will assist, however, they tend to fund capital rather than operational expenditure. LGNZ has commissioned further research on this issue, which will be presented to the Productivity Commission when complete.

In some cases, demand will require very expensive infrastructure upgrades, such as faced in Queenstown Lakes District; more substantial funding sources are needed in these cases. As stated above, the use of targeted rates on commercial properties offering accommodation is a very blunt tool in that it only targets a subset of tourism business, taxes them on the assumption of maximum demand, and does not capture smaller entrants into the market, such as AirBnB. LGNZ believes more accurate and nuanced funding instruments are needed.

LGNZ believes that councils should have the authority to establish local levies to address such issues and that a regulatory framework needs to be developed and implemented to allow this to occur in an accountable way. With reference to the answer in Question 3, the challenges of paying for tourism infrastructure again stem from poorly aligned incentives. Central government has a strong incentive to encourage domestic and international tourism activity because it directly accrues most of the financial benefits in the form of tax revenue, and bears almost none of the costs. Local government, by comparison, benefits indirectly in the form of targeted rates on accommodation providers and the increased level of local economic activity. Local government must also directly bear the costs associated with tourists discussed above, which are funded by the community.

Another important issue to consider is social licence; more pointedly, how long can we reasonably expect it to be extended to the tourism sector under the current arrangements. This is particularly so in those popular tourist areas where the resident population is dwarfed by the number of local and international visitors. For example, the resident population of Queenstown District Lakes Council is estimated at about 29,000 people as of June 2018, which pays for the infrastructure and services that support 2.9 million visitors annually. Similarly, Waitomo District Council has a resident population of just under 9,000 people, according the 2013 census data, yet it is estimated that more than 100,000 people come to visit the district's key tourist attraction, the Waitomo Caves, annually.

If the issue of local funding for tourist infrastructure is not addressed, there is a very real risk that the communities many withdraw the tourism sector's social licence, which may have implications for the ability to grow or even maintain the current number of visitors. While interventions from central government, such as the Tourism Infrastructure Fund (TIF), are welcome, they do not begin to address the scale of the problem. To illustrate, the Ministry of Business, Innovation and Employment estimates total annual tourism expenditure at $39.1 billion, or $107 million per day, whereas the Tourism Infrastructure Fund provides up to $25 million annually to develop tourism-related infrastructure – a glaring under-investment in LGNZ's view. Furthermore, since the TIF is allocated at central government's discretion, this ad hoc type of funding does not solve the incentive problem as councils cannot reliably estimate future revenues, thereby hampering their ability raise project finance.

Question 6

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?

LGNZ's response

The impact of changing legislation varies by council and by type of council, and can lead to either higher or lower costs on councils.

An example of the latter has been the establishment of Fire and Emergency New Zealand, which centralised the control and funding of fire services, including rural fire services, which historically had been funded by rural local authorities.

Recent legislative and/or regulative decisions that have resulted in additional costs beyond the discretion of councils to refuse include:

- The addition of fluoride to drinking water supplies: Although councils asked that the decision on whether or not to add fluoride to drinking water be transferred to the Ministry of Health (MoH), the Bill giving effect to that request transfers decision-making to MoH, but not the associated costs;
- Proposed drinking water standards: In the wake of the Havelock North contamination, new standards covering drinking water are under development. The estimated costs for upgrading water treatment plants to meet potential changes to the new drinking water standards has been estimated by BECA[1] for the Government. On the low end, the report estimates the cost to upgrade council-owned water treatment plants to be $384 million, with an increase in operational costs of $13 million pa. Capital costs vary across different regions and these are detailed in the report.
- Impact of new water quality standards: Changes to the NPS for Freshwater Management impose significant costs on regional (and unitary) councils as they give effect to the NPSFM in their planning frameworks. The costs are associated with science, consultation, hearings and appeal processes. Estimating the costs associated with amending the NPSFM would be a useful case study. There are also costs for territorial authorities who are required to upgrade their infrastructure to meet higher standards for freshwater quality. The costs to upgrade wastewater treatment plants (WWTP) to meet the objectives of the NPSFM have been estimated in a report by GHD/Boffa[2]. The total capital cost to upgrade all WWTP discharges to meet the Attribute B state is estimated at $1.4 to $2.1 billion. The annual operating cost across New Zealand is estimated to be $39 - $59 million.
- Resource Management Act 1991 (RMA) reform: Recent changes to the RMA have resulted in significant costs to councils. For example, the cost of implementing the new planning standards (previously known as the national planning template), which requires amending existing plans, has been estimated by Environment Canterbury at approximately $10 million.
- Proposed National Policy Statement for Indigenous Biodiversity (NPSIB): The NPSIB will be formally consulted on next year. LGNZ is currently reviewing the proposed NPS to determine the implications for local government including likely costs. A significant cost will be associated with identifying and mapping significant natural areas and then giving effect to these in plans, as they are inevitably controversial.

Rather than identify further examples of unfunded mandates, it is salutary to note that probably the only example of central government passing on regulatory responsibility accompanied by some form of sustainable funding is, as far as we are aware, roading. In this example, costs are principally shared on a 50/50 basis, and varies depending on the financial standing of the council, and Treaty of Waitangi settlements discussed in Question 7.

[1] https://www.dia.govt.nz/diawebsite.nsf/Files/Three-Waters-Review-Cabinet-papers-April-2018/$file/Beca-report-Cost-Estimates-for-Upgrading-Water-Treatment-Plants.pdf

[2] https://www.dia.govt.nz/diawebsite.nsf/Files/Three-waters-documents/$file/Costs-of-wastewater-upgrades-GHD-Boffa-Miskel-Final-report-Oct-2018.pdf

Question 7

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?

LGNZ's response

LGNZ agrees with the discussion in the issues paper. As more and more claims are settled, it is expected that the number of co-governance and co-management models will grow and this will be an ongoing cost for more councils than at present.

Recent research, led by Waikato Regional Council[3], found that while central government's provision of a one-off financial contribution to local government for the implementation of Treaty settlement outcomes was helpful, it did not cover all of the costs it imposed on both parties, or cover ongoing costs. Indeed, the analysis shows that both establishment and ongoing costs of co-governance and co-management arrangements are far greater than anticipated, and that Crown contributions have been significantly underestimated. It should also be noted that local government is not a party to Treaty of Waitangi settlement negotiations, and has no direct say in the process.

These costs are also likely to increase with the establishment of Mana Whakahono ā Rohe, or iwi participation agreements, which aim to increase iwi participation in resource management decisions. Local councils support the spirit of the law in this case, but in practice, again, this is a case of a policy that has been imposed on councils with no additional funding. These costs may not be burdensome for some councils, which only deal with one iwi, such Ngāi Tahu, but can be extremely burdensome for districts where there are a significant number of iwi.

Question 8

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?

LGNZ's response

Local councils are acutely aware of the need to adapt to climate change, and to manage the impact thereof on communities and local infrastructure. As such, the sector is highly active in developing and promoting prudent policy in this space. LGNZ's "Planning for sea level rise: Local government owned infrastructure exposed to the effects of sea level rise" report estimates that more than $4 billion of three waters infrastructure is exposed at a 1.5m increment of sea level rise. Roughly $1.6 billion of roading transport is also exposed at the same level, as well as $1.2 billion of buildings and facilities.

Councils are now beginning to consider how best to identify risk and assess cost. While this process is ongoing, it is very clear that New Zealand's legislative framework is ill-equipped to cope with the challenges related to climate change adaptation. This is specifically so in the areas of risk assessment, property rights issues related to adaptation, ongoing service delivery, and cost sharing.

[3] http://www.lgnz.co.nz/assets/Uploads/LGNZ-Treaty-Settlement-Report-V2-March-2018.compressedV2.pdf

LGNZ itself is working on a number of initiatives to assist councils identify the costs of future risks, and has proposed that:

- Central and local government lead a national conversation about levels of service currently provided and what can be anticipated in the short (1 - 10 years), medium (10 - 30 years) and long-term (30+ years). This should include comprehensive and targeted communication and engagement by local government with residents and businesses impacted by rising sea levels.
- Central and local government coordinate to establish a National Climate Change Adaptation Fund to improve local level and community participation in responding to climate change.
- A Local Government Risk Agency be established, to assist and guide consistent and expedited planning, decision-making and procurement, and build local government capability and capacity to understand risk.
- A National Master Plan to address the impacts of sea level rise be established, based on extensive consultation with businesses, iwi and communities.

Question 9

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?

LGNZ's response

The consumer price index is designed to measure changes in the prices of goods and services that are consumed by households, such as the costs of breakfast cereals and televisions – inputs that have little relevance to the cost of local government. Because of their role as infrastructure providers, the cost of local government is heavily influenced by the cost of construction – inputs such as fuel, steel, aggregate, skilled and unskilled labour – most of which are outside the control of local authorities (see the submission from the Society of Local Government Managers for an in-depth analysis of this question). Factors that drive these costs include:

- International demand, particularly infrastructure investment in countries like China;
- The impact of infrastructural renewal, which tends to follow a 25 – 30 year cycle; and
- Competition in the construction sector: While councils undertake competitive tendering for the bulk of their construction, renewal and maintenance work clustering and longer term procurement strategies might have the impact of reducing competition.

LGNZ can appreciate, to some degree, that CPI is a useful measure that the public can use to compare rate increases against their earnings (which are broadly linked with CPI movements). However, it is not an ideal tool for this purpose because CPI is a synthesis of a hypothetical basket of goods and services, with the relevant subcategories increasing and decreasing at different rates, to produce a weighted average for the period. There is no reason to assume that rates, as a subcategory, should move in lockstep with this aggregated measure. A better measure would be the Local Government Cost Index. The basket of goods measured in this case includes more directly relevant items like capital expenditure on pipelines, and earthmoving and site works, and operating expenditure such as salary and wage rates.

Question 10

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

LGNZ's response

The prices of goods and services procured by local governments will vary according to the degree that there are multiple providers and thus competition in local areas, which is frequently not the case. Larger centres are more likely to have multiple firms that compete for contracts, and where this is not the case, prices will be higher due to lack of competition.

Question 11

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?

LGNZ's response

There is no evidence of major shifts in the nature of the services and activities that local governments fund. Councils are formally and informally expected to provide or commission a wide range of activities that have broad public benefit, and the range of those activities and the amount spent on each is determined in consultation with citizens. S.17A (LGA 2002) also requires that councils regularly assess how services should be funded, to ensure that service delivery is efficient and effective.

Attempting to define activities as core or not is always problematic. For example, functions like recreation, sport, and libraries were not only specifically mentioned as local government responsibilities as far back as the 1867 Municipal Corporations Act, and earlier, but are also identified in s.11A of the LGA 2002 as core services.

The suggestion from some critics that local government functions should be frozen in time, ignores the impact of changing circumstances, which can create new demands for funding, such as, for example, earthquake strengthening, new technology and globalisation.

A cost driver that has continued unabated over the last two decades has been the demand for information, which has seen a significant growth in the number of staff who are primarily concerned with accountability and reporting, for example:

- Reporting on time taken for resource consents under the RMA 1991; and
- Reporting on time taken for building consents.

Examples of, and a discussion on, the cost of central government's information requirements is covered in the report "The impact of government policy and regulations on the cost of local government", LGNZ, 2012.

Question 12

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

LGNZ's response

The scope of services a council delivers or commissions is determined, in consultation with citizens, as appropriate to maintain and/or enhance the overall quality of life of its community. Of perhaps greater importance is the scale (levels of service), rather than scope, for example swimming pools. The cost of aquatic recreation will be affected by, for example;

- The number of pools provided;
- Size;
- Whether they are covered or not;
- Level of staffing, and
- The range of aquatic services provided in each facility.

Typically, urban centres with larger, concentrated populations tend to provide a wider scope of services and to higher standards.

While there is, of course, a clear relation between increasing cost and the scope of services offered, as noted earlier in this submission, communities increasingly want councils to play a more active role beyond the provision of core public services; a trend observable across the developed world. It is the view of LGNZ that this is entirely appropriate. Local government's proximity to communities means it is often better placed to manage a wide variety of programmes than centrally managed agencies, such as social housing, youth employment, and vocational training, to name but a few.

A more pertinent question to ask is whether communities are being faced with the true costs of their decisions as a necessary check and balance on the range of activities, and level of service, that communities expect of councils. Given that only homeowners and businesses directly pay local taxes, it is arguable that this is not the case.

Question 13

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

LGNZ's response

In in addition to the cost drivers described above in Question 6, council expenditure can be affected by uncertainty about central government's intentions towards local government.

For example, draft policies that appear to promote amalgamation of councils can encourage councils to delay making decisions on major renewals and other investments because of the uncertainty. Or, in the opposite case, encourage decision makers to bring future expenditure forward, either because of concerns that a new amalgamated entity will not support the investment in the future, or because the cost will be shared across a greater population.

Question 14

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

LGNZ's response

Technology has the capacity to both increase and decrease the costs facing local government. New technologies, for example, have enabled councils to develop accurate pictures of the state of their underground infrastructure, which allows renewal decisions to be both more accurate and more targeted to areas that might need attention. Also, technological advancements, such as the lining of underground pipes can extend the life of assets and delay costly infrastructure investment.

The introduction of smart city technology, while an additional cost, will enable more integrated and efficient decisions to be made with respect to council provided services and potentially reduce expenditure in the medium term.

It is worth restating the capability spectrum in local government. Large metropolitan councils have greater capacity and capability to identify and implement new technologies. As council population size diminishes, so does the rate of new technology adoption. The challenge for the sector is to encourage greater transfer of information so that technological improvements propagate through the local government network faster. This is a role that LGNZ and SOLGM perform; shared service providers also play a role in this regard, but more could be done to encourage knowledge transfer among councils.

Question 15

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

LGNZ's response

The LTP has multiple objectives, namely to:

- Describe the activities of the local authority; and
- Describe the community outcomes of the local authority's district or region; and
- Provide integrated decision-making and co-ordination of the resources of the local authority; and
- Provide a long-term focus for the decisions and activities of the local authority; and
- Provide a basis for accountability of the local authority to the community.

Affordability is not specifically highlighted but in the process of prioritising projects and programmes councils will consider the impact of the overall plan on the ability of citizens to pay.

Question 16

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?

LGNZ's response

The consultation document is primarily designed to explain the governing body's plans for the coming period and the cost of those plans, and provide opportunities for communities to provide their views on those plans and their cost.

The LGA 2002 describes the purpose as being to provide an effective basis for public participation in local authority decision-making processes relating to the content of a long-term plan (LTP) 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).

Although the consultation document is designed to align spending decisions with community preferences and willingness to pay, it is just the statutory minimum; councils may, if they choose, undertake additional consultation and engagement.

One limitation is that the consultation document is required to "provide a representation of the matters proposed for the LTP"; that is, the document does not include all the matters. The legislation actually makes it unlawful for a council to publish its full LTP, which potentially excludes much of the detail that citizens need in order to comment.

It is possible that the LTP is too prescribed and that more flexibility is required. This is one matter that the Productivity Commission might like to consider in more detail.

Question 17

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?

LGNZ's response

The LTP process combines a number of different functions, including a strategic plan, a corporate plan, an accountability document, an infrastructure strategy, among others. The scale of the work required to prepare the LTP every three years may diminish opportunities to engage citizens in key decisions about priorities, how functions should be delivered, and how they should be funded. One option could be to disaggregate the LTP into its different components.

Question 18

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

LGNZ's response

The framework seems both adequate and helpful for councils wishing to ensure their assets and services are managed efficiently. The more helpful question would be to look at whether or not councils are incentivised to make use of the potential within the framework to look at models that would lead to more efficient and effective service delivery.

There are examples of shared services that the Commission could interrogate to inform this question and we would be happy to provide these.

Question 19

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?

LGNZ's response

Councils, as they have general powers, have access to a range of tools and business delivery models which some councils make greater use of than others e.g.

- Contracting models;
- Contestability options;
- Benchmarking;
- CouncilMARK™ assessments;
- Transfer services into council controlled organisations;
- Place services into an internal business unit; and
- Section 17A assessments (to assess delivery options).

Decisions to make use of these options are influenced by council capacity and capability, ideology (the political preferences of the majority of councillors), and community views.

Question 20

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.

LGNZ's response

Councils learn about innovative practices from each other, through professional associations, through national and international excellence programmes (e.g. the Guangzhou Innovation Awards) and learning from their neighbours. In our experience, the update of new technologies amongst councils varies.

Question 21

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

LGNZ's response

The primary incentive is the political one created by the forthcoming election, and the desire of councillors standing for a second term to be able to show that they are fiscally responsible. Improving productivity enables councils to deliver more services for the same level of taxes or to reduce taxes in a future year, both of which we would expect to be at the forefront of elected members' minds. Other incentives include:

- The requirements of S.17A (LGA) that require councils to review how their activities are delivered on a regular basis;
- The regulatory oversight of delegated responsibilities under the Building Act and RMA by the Ministry for the Environment and the Ministry of Business, Innovation and Employment;
- The capacity of the Office of the Auditor General to initiate reports into aspects of local government; and
- The CouncilMARK™ assessment process.

Question 22

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

LGNZ's response

LGNZ has no data to inform our response to this question. However, it needs to be noted that there are 78 different local governments and, consequently, any one of the factors set out on page 43, a combination of them or none at all, may apply at any one time. We have not identified, at this stage, any structural issues with the local government framework that create barriers to either governing bodies or administrators seeking productivity improvements.

Question 23

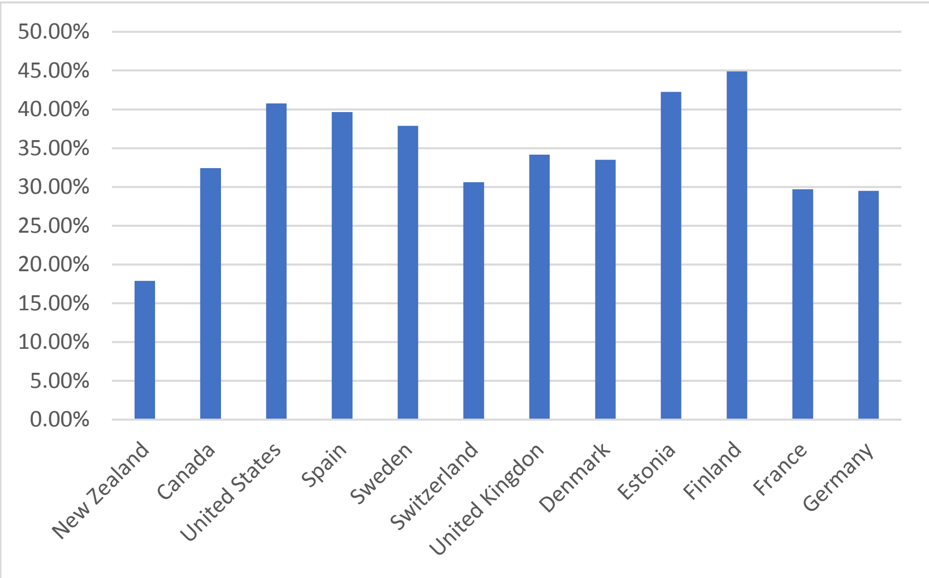
How does local government measure productivity performance? Are these metrics useful? If not, what metrics would be better?

LGNZ's response

Councils are required to prepare Statements of Service Performance that set out non-financial performance measures for their activities. In addition, central government sets out, through legislation, performance measures for five service areas (roads, flood banks, potable water, wastewater and stormwater). Councils also take part in benchmarking clubs across a number of activities. In addition, CouncilMARK™, established by LGNZ, provides a high level look at the systems councils have in place to provide for effective governance and, as part of the reporting process, guidance can be provided to councils on areas where performance can be improved.

A common way of assessing the efficiency of a local government system is to compare the amount spent on wages and salaries; it provides an indication of the degree to which services are subject to competition. Compared to other countries, New Zealand local government spends a proportionally small amount on wages and salaries. See Figure 1.

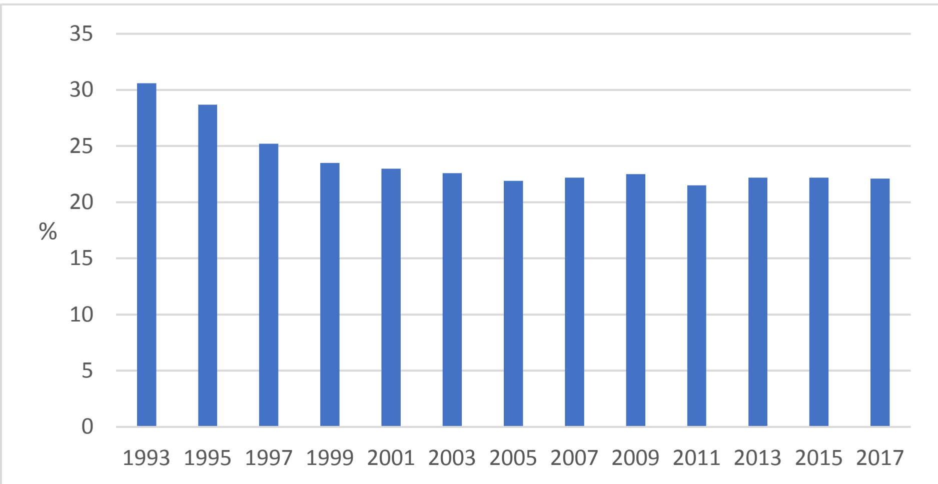
Figure 1: Staff expenditure as a share of total expenditure



Source: OECD UCLG 2016[4]

Looking at staff costs as a share of operational expenditure since local government reform in 1989 , see Figure 2, we see a significant decline in the first few years, reflecting the first wave of outsourcing and competitive tendering and a flattening of costs since then.

Figure 2: Staff costs as a share of operational expenditure, 1993 – 2017



Source: Statistics NZ

[4] Subnational governments around the world: Structure and finance A first contribution to the Global Observatory on Local Finances 2016, UCLG OECD

Question 24

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

LGNZ's response

This is not an area about which LGNZ has information. Any feedback from councils would be welcome.

Question 25

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?

LGNZ's response

LGNZ has no information on whether or not, and if so how, productivity is assessed.

Question 26

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

LGNZ's response

Councils have a broad range of measures as outlined in the issues paper. In addition, they also have general remission powers and can use uniform annual charges to diminish the impact of property taxes on high value properties. While all councils have policies for the remission of rates on Māori land, they have discretion on whether to set an amount or not. Not all councils have rates postponement policies.

LGNZ has no research on the proportion of councils that use these tools nor how frequently they are used.

Question 27

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

LGNZ's response

Councils balance the ability to pay and benefit principles through the funding policy process as set out in sections 101, 102 and 103 (LGA 2002). Funding policies are agreed at the beginning of each long term planning process. We note that affordability is not one of the principles set out in the LGA 2002.

Question 28

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?

LGNZ's response

As with previous questions, councils make decisions based on the circumstances of their communities and the values and priorities of the governing body, and they will differ from place to place. LGNZ would support a review of the funding policy process set out in the LGA 2002, including the balanced budget requirement.

Question 29

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?

LGNZ's response

Councils are required to consider the inter-generational distribution of the benefits of their activities when adopting funding policies (see s.101(3)). The degree of weighting between current and future generations is the choice of governing bodies and we expect that this will vary, to some degree, by council. This question also needs to be viewed through a political lens. There is a tendency for communities, mostly rural but not exclusively so, to see the use of debt as a mark of poor performance. However, in the case of inter-generational infrastructure, debt financing is an efficient and effective means of spreading the costs of long-lived infrastructure over many generations. As we see it, there is no policy solution to this problem, particularly as it is a political argument that must be won in each district.

Question 30

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?

LGNZ's response

The proposed principles are:

1. Efficiency;
2. Equity and fairness;
3. Revenue integrity;
4. Compliance and administrative costs;
5. Fiscal adequacy; and
6. Coherence with the broader (national level) tax system.

Principles 1 – 5 are supported, however we are not entirely convinced by principle six and it is far from clear what this principle means in practice. An additional principle for consideration is buoyancy.

Buoyancy refers to the ability of tax to move as an economy moves. The problem with existing council revenue sources is their lack of buoyancy. LGNZ believes that buoyancy is important as councils will be more incentivised to invest in growing their local economies if they are able to capture some of the fiscal benefits of investments through greater taxation receipts. By participating more directly in the economic cycle, councils will be incentivised to make better decisions. On the upside of the economic cycle, by allowing a portion of council revenues to be directly linked to the economic cycle, say through a share of GST, councils will be incentivised to pursue policies that encourage economic growth.

On the downside of the cycle, a direct link would encourage councils to reduce costs or increase productivity to make up for revenue shortfalls. The current system, which is heavily reliant on rates, does neither particularly well.

This is because of the political constraint discussed earlier in this submission, and because the statutory requirement to balance their operating budget means councils always recoup their operating costs from ratepayers, regardless of the economic cycle. There is, of course, political pressure to reduce costs when the economy is in contraction, but we believe this to be less effective.

Question 31

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

LGNZ's response

The degree to which councils make full use of the funding tools available to them is a choice of each governing body and will be influenced by local circumstances, including political values and pressures on property taxes. For example, some councils make significant use of targeted rates while others make little or no use of those taxes. LGNZ commissioned this report[5], which usefully informs this question.

LGNZ is primarily concerned that councillors are fully aware of the range of funding instruments available to them, and the way in which they can be used to ensure local government costs are distributed in a manner that is both fair and cognizant of where the benefits of council services lie.

Question 32

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?

LGNZ's response

As noted above, the case will vary from city to city, and the use of the different tools will be reflected by the views and preferences of decision-makers and local citizens. Debates about local taxes echo debates about income tax and other taxes that occur as a matter of course in parliament. Choices at the local level are as informed by political preferences as they are at the national level.

Question 33

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?

LGNZ's response

As the issues paper notes, there has been a gradual shift from land value to capital value taxes over the last two decades or so, and the issues paper correctly describes the reason, which is the link between capital value and the beneficiaries of council services. This shift is also encouraged by the principles set out in s.101 (LGA 2002). We note the claimed benefits from land value rating but note that these benefits largely exist in theory; in practice, councils adjust specific property rates where land value systems are by applying multiple differentials that ultimately undermine any theoretical benefits.

[5] http://www.lgnz.co.nz/assets/Uploads/45948-LGNZ-3-Waters-Funding-Document-3-FINAL.PDF

Question 34

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?

LGNZ's response

LGNZ has argued in previous submissions (see http://www.lgnz.co.nz/assets/Uploads/Our-work/Local-Government-Funding-Review.pdf) that the 30 per cent limitation on uniform general charges should be lifted and that Crown-owned land should be rateable. Also, there is no rational basis for the existing rates remissions as set out in Schedules 1 and 2 of the LGRA 2002.

Although LGNZ has not undertaken any research on the matter, it may be timely to review the basis on which targeted rates can be levied.

Question 35

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?

LGNZ's response

One of the advantages of the New Zealand property tax model is its certainty (unlike a direct tax on the value of a property) and predictability, which effectively assists councils when considering long term investments, particularly in the context of long term plans and the requirement to set out long term funding and financing policies. The role of the Local Government Funding Agency (LGFA) and the ability to share risk and raise their own bonds also supports decision-making for long term investments.

LGNZ also notes that for most councils debt levels are low to modest; reluctance to borrow to make long term investments tends to be related to local values and perceptions about public debt than the range of local government's financing tools, which are arguably broader and more flexible than other local government systems.

In contrast, high population growth councils are constrained from making long term investments by the limits on the level of debt that they can raise and hold. This issue has been canvassed in previous reports by the Productivity Commission and work has been underway for a number of years on models that would allow growth related debt to be ring-fenced rather than included in a council's overall debt profile.

Question 36

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?

LGNZ's response

Yes. LGNZ agrees with the findings of the Shand review that councils rely too much on property rates. The pros and cons are:

The value of property taxes includes their administrative simplicity and their:

- Visibility – the fact that citizens receive a tax bill at the start of the financial year is beneficial for multiple reasons, such as accountability (note that effect may decline as more people shift to automatic regular payments);
- Predictability – property taxes are an ideal source of income for organisations making long term investments as they don't fluctuate with economic cycles; and
- Relationship to place – the spread of benefits from local services provided by councils tends to be internalised within jurisdictional boundaries and taxes on properties are an economically efficient way of capturing those benefits.

The problem of relying on property taxes to the extent that occurs in NZ includes:

- Affordability for some households – while property tax has a correlation to ability to pay, it is a small relationship. Rates can constitute a high proportion of the expenditure of households relying on fixed incomes, which not only creates hardship but may constrain the willingness of councils to make important long term investments;
- Incentives – property taxes must be set annually and do not change as the economy changes. This lack of buoyancy can dis-incentivise councils from making investments that lead to stronger economies as the tax growth is received by central government; and
- Mobility – because of the certainty of property taxes there are fewer incentives on councils to ensure their services meet the needs and preferences of residents. If a proportion of their taxes came from local incomes, then councils would act more proactively to respond to their concerns.

Where the Shand review recommended that rates make up no more than 50% of council revenue, LGNZ recommends that councils have access to at least two taxes. In addition to property rates, councils also need a buoyant tax such as a local income tax or a share of GST raised locally. For example, allowing councils to retain 50% of all GST collected in their areas would provide an additional income source linked to local economic activity and would incentivise councils to further invest in services and infrastructure that will promote economic activity.

Question 37

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?

LGNZ's response

LGNZ has identified several circumstances where there is a case for central government transfers to local government:

- Where councils are undertaking delegated responsibilities on behalf of government departments. Such arrangements should be detailed in a contract that not only covers funding commitments but also service level expectations etc;
- Where the Government imposes service level standards on local authorities that are higher than what citizens themselves are prepared, or able, to pay, then some form of transfer can be justified;
- Equalisation payments – local governments in low socio economic communities are often unable to pay for the infrastructure, amenities and services that citizens in more prosperous localities take for granted. Some form of equalisation programme should be considered.
- Resource rents – where the Crown receives a royalty from a local mineral resource, such as those set out under the Crown Minerals Act, local government should receive a share, if not the majority, of these revenues since it bears the costs of the activity (impact on roading, pollution etc).

Question 38

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?

LGNZ's response

In LGNZ's view, the financial incentives are insufficient to encourage councils to nurture economic and population growth. This is because both are perceived as costs, in so much as the investment to accommodate them must be directly paid upfront by existing residents, whereas the benefits of these investments only accrue many years later (in the form of a bigger ratings base or higher economic activity). Furthermore, the benefits may be so diffuse that they are imperceptible to the voting public.

This issue has come starkly into focus recently with the increase in tourist numbers and the impact on districts with small populations, like Mackenzie and Buller. It is also a matter of significant concern in Queenstown Lakes District, with the council's call for an accommodation tax.

LGNZ would like to see a Local Government Rating and Funding Act that sets out a framework not only for applying property rates, but also the process for creating local levies to deal with locally specific funding issues, such as those affecting Queenstown at the moment.

Question 39

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?

LGNZ's response

Growth and decline reflect the life cycle of communities and are driven by multiple factors, from the changing nature of our economy to geo-physical factors like the prospect of sea level rise. Central governments can assist such communities through equalisation programmes and/or some form of transition funding.

Question 40

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?

LGNZ's response

It is not clear that this is a problem that should concern the Commission. While the case historically has been for councils with declining populations to be merged with neighbouring councils since local government reform in 1989, New Zealand councils are large by international standards and consequently this approach is unlikely to be necessary. Councils also have the ability to establish a broad range of joined up and shared service delivery models if required, to ensure the sustainability of services as well as the ability to contract with national and multi-national providers.

Question 41

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

LGNZ's response

LGNZ argues that councils should have access to one of these taxes because of their buoyant nature, that is, they reflect local economic activity. As such, they are more likely to incentivise councils to invest in local infrastructure, assets and services since councils themselves will benefit from the higher tax returns. This is not the case with the current way of setting rates.

Question 42

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

LGNZ's response

A pure local property tax, in which councils annually determine the rate at which a property will be taxed, has a level of buoyancy that the current process for setting property rates does not have, however there are a number of downsides:

- A property tax lacks the predictability and certainty, provided by rates, that gives councils the confidence to commit to long term investments;
- Setting property taxes to meet the balanced budget test on an accrual basis will be more difficult should a property tax apply;
- Because councils are expected to comply with the Golden Rule, that is, borrowing is for capital expenditure purposes, council will be exposed to financial risk when property values fall. This would be likely to increase risk and interest rates, and lead to a risk averse attitude to future investments.

Question 43

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

LGNZ's response

Yes. As part of its Localism initiative LGNZ is looking at a "tax swap" model, involving joint revenue sharing, in which local government and central government "swap" a portion of their relative tax bases, such that at a starting base neither tier is fiscally better or worse off. This would lead to councils having access to a share of income or goods and services taxes raised in their districts, while central government would receive a share of property taxes. As a result, councils would be able to access a buoyant tax that would increase as local economies thrive. A detailed outline of how this would work will be available by mid-February.

Question 44

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

LGNZ's response

LGNZ has no views on this matter at the moment, as it depends on the specific proposals.

Question 45

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

LGNZ's response

Considerably. Councils represent different communities and many of these communities face quite different challenges. The critical issue is that councils have access to a menu of funding tools (or the authority to develop appropriate tools) so that they can apply the relevant tool to whatever the local issue happens to be.

Question 46

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?

LGNZ's response

As noted in the answer to Q.35 the only constraint is the way in which debt is recorded on a council balance sheet. Some observations are:

- Internationally there are models, such as municipal utility districts (MUDs) where debt raised to undertake a stand-alone development (which will also be paid back by the residents of that development) stays with that development and does not become part of the local authority's total debt;
- While development contributions were designed to "pay for growth", current legislation limits their effect and current accounting rules do not recognise income from development contributions as "revenue", thus the amount collected cannot be used to off-set council debt.

Question 47

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?

LGNZ's response

Yes – a property tax regime will enable tax incremental financing (TIF) to work and this would address many of the growth-related financing issues faced by councils. TIF has the capacity to promote significant urban regeneration and should be a tool available to all councils to use as appropriate to their circumstances.

Question 48

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?

LGNZ's response

Private investor financing of local government infrastructure is constrained by the nature of some of that infrastructure. While finance, build, own and operate schemes are currently used by councils, they can be constrained by the way in which infrastructure is funded. Where funding is by a user charge then such schemes can offer an attractive alternative to current financing options, however, the advantage is not so clear where an infrastructure is funded by taxes.

One constraint is the inability of councils to apply road user charges without the agreement of central government.

Question 49

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?

LGNZ's response

The accountability framework for funding and financing in New Zealand local government is internationally regarded and works well. Key elements are:

- The requirement on the OAG to assess the underlying assumptions in draft Long Term Plans – this ensures that the information on which citizens are asked to give comment is fair and reasonable;
- The audit of annual reports and OAG's annual report to parliament is not only a mechanism for highlighting individual councils that may be facing financial risks, but highly symbolic;
- The statutory framework that requires transparency in setting financial policies; the balanced budget requirement; the golden rule governing debt; the pre-election reports, the prudent fiscal benchmarks and councils' infrastructure strategies all ensure the financial state of local authorities is well understood; and
- The role of third parties, like the LGFA, rating agencies like Standard and Poor's, and CouncilMARK™ all provide additional levels of scrutiny.

More important than all of the above are sections 115 and 121 of the LGA 2002. Section 121 makes it clear that the Crown is not liable for council debt and s.115 allows a creditor to establish a special rate to recover an unpaid debt. The first provision ensures that banks will only lend to councils that are managing their finances prudently, the second (s.115) sets out the risk to communities and their governing bodies should finances not be managed well.