Submission to Productivity Commission Inquiry into Local Government Funding and Financing

Donald Ellis

1.0 Preamble

I am a former senior manager at a peri-urban territorial authority. I have also consulted to local government over a number of years.

My experience is mainly in territorial authorities and my submission relates primarily to territorial authorities rather than regional authorities.

This is a personal submission.

2.0 Overview

Financially a council's main activity is the construction/acquisition and long-term ownership/management of physical assets that underpin the provision of a number of vital public services in the areas of public health, communication, recreation, and community safety. Even though outlays on these assets are irregular and expensive, the resident (ratepayer) effectively pays a daily charge to access the services built on these assets. Not only that but the ratepayer/resident is only paying for services delivered. Usually there is no contribution of new capital in rates.

Although there are grizzles from time to time about the level of rates the reality is that there is little groundswell for any change to current funding mechanisms or the quantum collected. Every local government election there are candidates for councils standing on some form of "lower rates" platform. They may poll respectably but they rarely get the opportunity to try to implement their promises.

When the system works it is fair and efficient. And the system works most of the time in most places. But I note:

- The current system, although clunky, works when the environment a council operates in is predictable
- For the last 15 years council rates have risen faster than CPI; this is mainly due to sharp rises in the prices of purchased inputs
- Council debt has risen considerably over the same period. This debt has been used to fund government-mandated projects. These projects are generally level-of-service projects that are the only form of council expenditure that doesn't have a natural funding stream attached to it.
- Council expenditures are overwhelmingly on purchased inputs. Internal efficiency improvements are expensive to implement while delivering minimal visible impact on rates.
- There are enough tools in the rating toolbox for a council to achieve whatever rates incidence outcomes it wants
- Rates are paid by all residents directly or indirectly. They pay for public goods that have to be paid for through some mechanism. Changing the collection mechanism won't significantly impact expenditure at the household or business level.
- Councils do not engage in any depth with their communities to develop future expenditure options.

- Rules around public consultation **hinder** public engagement over options for future expenditure
- The current system is weak for raising extra capital to either extend infrastructure or upgrade the level of service.
- Councils can avoid the inter-generational equity trap by being equally unfair on all generations. To acquire new capital they should either:
  - budget for a small surplus on infrastructure accounts (over and above the surplus generated by depreciation charges); or
  - receive a greater share of government tax revenues especially where council revenue would become more closely linked to local economic performance
- More use of long-term debt should be used for non-network-infrastructure assets such as libraries, aquatic centres and sports facilities. This debt should be raised after authorisation through targeted referenda.

3.0 Responses to specific questions

Q2 Depreciation and renewal expenditure

There is no reason to expect a match between depreciation and renewal expenditure. The whole point of this regime is to collect funds for renewal over decades and then, when the asset is functionally obsolete, to spend the collected funds on rebuilding. In the simple case you get decades of depreciation exceeding renewal then a short burst when renewal expenditure exceeds depreciation. Of course, with the networks of core infrastructure (but also libraries, aquatic centres, sports facilities and so on) having been installed incrementally over many years you would expect a level of renewal every year. But even so there is no reason to expect the sums to match even in aggregate.

On average New Zealand's water and roading infrastructure is young. The country's population has doubled since about 1962. Half of the infrastructure needed to support our population has been installed in the last 55 years. The accounting life of a water pipe is set at 70 years. In theory we are yet to get to the point where we would be thinking about renewing over half the infrastructure out there. So, at this time, I would definitely expect that, absent any other external factor, depreciation would exceed renewal expenditure **as a matter of course**[1].

To my mind the more interesting question and one that is central to this entire inquiry is not why renewal expenditure has fallen relative to depreciation but **why was renewal expenditure higher five years ago?**

The simple answer could be that it was a coincidence. It just happened that a lot of infrastructure installed immediately after the Second World War fell due for renewal. And now we have reverted to trend again. I don't place much weight on that explanation although it certainly forms a small part of the answer.

1 Note that when a project is undertaken for multiple purposes the allocation of funding across purposes is not a precise science. Councils will make a judgement call taking into account many factors. The figures the Auditor-General cites are **self-reported** amounts which largely depend on how councils choose to classify their projects. Who knows how accurate those figures are anyway?

Secondly, it could be that councils discovered they had a greater need for renewal than they had previously thought. Prior to about 1990 councils didn't need to keep a fixed assets register or depreciate their assets. The double whammy at that time was not only reforms to public finances that required central and local government to comply with generally accepted accounting principles, councils were also reorganised with almost all councils experiencing forced amalgamations with their neighbours. It was not a great environment in which to compile an accurate fixed asset register from scratch. The chances are that many councils didn't properly complete that work until 2004-6 at which time the Auditor-General made it clear that councils would not get their first full Ten Year Plans approved for public release unless they had completed thorough work on understanding the state of their assets. For various reasons councils may have chosen to start a programme of overdue renewal as a result of this work.

My favoured reason, however, is that a combination of government interventions and some external factors forced councils to upgrade their assets long before they were due for renewal.

The commission's own explanation of depreciation-funded renewal (p23) is fine as far as it goes. But real-life projects are rarely as simple as that. Councils often undertake projects that combine elements of renewal, expanding capacity, and improving the level of service.

Take, for example, a council finding a new source of drinking water to comply with new, tougher regulations. When it decommissions its existing water source infrastructure (e.g. wells, some supply pipes etc.) it can certainly allocate any accumulated depreciation to the replacement project. They could not justify using renewal money for all of the project however. Engineers always build for the future so the new source will be sized to accommodate population growth. The council can certainly also justify using some development contributions. Due to the technicalities of the development contributions regime the council will not bridge the gap from this funding source either. Besides which, the main reason for the project was to improve the level of service to today's residents. Unfortunately there is no funding source for level of service upgrades. It's either a capital levy through rates or debt-funding.

Notice the effect that this project has on the accounts for this water network. The new water source is bigger and better which means the depreciation collected on this component is higher than on the old source. It is also brand, spanking new. The clock is reset and renewal will be scheduled far beyond when the old source would have had to be renewed. For this network depreciation rises relative to renewal expenditure. Which, I think, is where we started.

One project isn't going to affect national aggregates. But several interventions by central government and some external drivers have had the effect of forcing councils into many similar projects **at the same time.** Nationally this has the effect of depreciation up, renewals down in the aggregate.

In brief since about 1990 we have had:

- mandatory higher standards for discharge of effluent to land and water (multiple sewage system upgrades)
- mandatory higher standards for discharge of stormwater to land and water (multiple stormwater system upgrades)
- mandatory implementation of Drinking Water Standards (multiple water supply upgrades)
- increasing road usage due to
    - increase in tourism numbers
    - increased ownership rates of cars

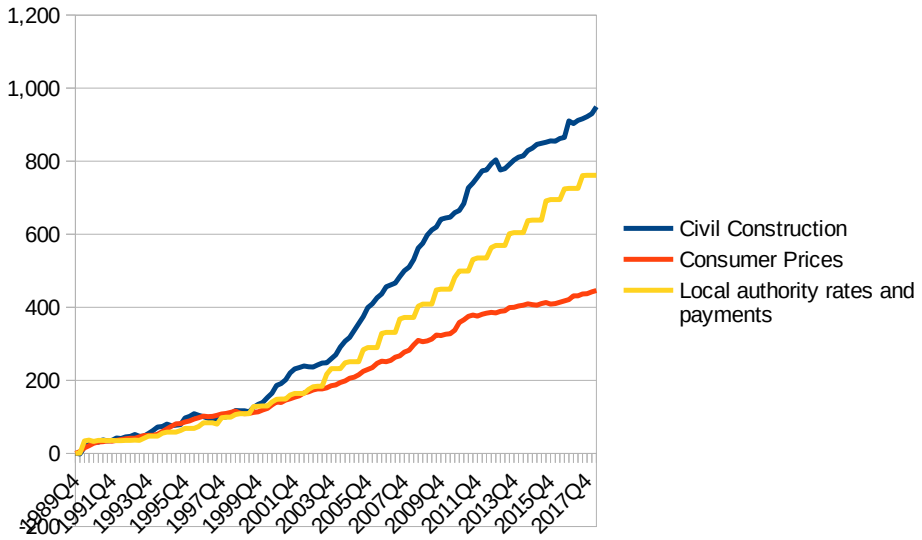
    - decline in use of coastal shipping and rail for freight and increase in road freight
- higher engineering standards for roads to improve safety
- retro-fitting of cycleways

It's probably an incomplete list but it gives some indication. The key thing is that there is more and better infrastructure in place (per person) than we had 30 years ago. Using some renewal money for these projects was justified. But now we collect more depreciation on average. And the addition of all the new components in a comparatively short time has made the average age of our networks younger.

Collecting more depreciation than we are spending on renewals now is what I would expect. It's the norm.

Rising Expenditure (p23)

Yes, per capita expenditure has risen in all councils (especially territorial authorities). This graph helps explain why:



Civil Construction is a subset of the Statistics NZ Capital Goods Price Index. It shows the prices charged for laying pipes, building roads, earthworks, building buildings. In other words the cost to councils of their most financially significant activities.

Obviously these rising prices impact the capital accounts but they also affect opex in four ways:

- the valuation of assets its based on their current replacement cost, and depreciation (an operating expense) is based on current valuation;
- insurance premiums are based on value insured
- since most construction and maintenance work is contracted out (often to the same companies) construction prices will spill over to maintenance charges
- higher debts to pay higher construction costs mean higher interest charges

Debt

The debt story is straight-forward.

By law councils can only take on debt for capital expenditure. So the increase in debt is related to the capital programme. As we have already noted if population and levels of service remain static then the funding derived from depreciation charges is sufficient to keep infrastructure going indefinitely. In other words councils would not have to look anywhere for funds except their operating revenue and would not have to raise extra capital via rates.

Basically when a council is forced to upgrade its infrastructure for level of service reasons (better drinking water quality, lower environmental impact, safer roads etc.) they only have two funding choices: a capital levy or debt. Note also that prior to 1 July 2004 population growth-related projects also had no identifiable funding source so the same choices applied during 2000-2004.

Capital levies are generally unfair in that they provide a free ride to subsequent generations. Although more expensive, debt provides perfectly for intergenerational equity. Also in debt-funding's favour is that it is easier to smooth out rates rises so that rates payments are more predictable.

As I noted above there have been many statutory and community pressures on councils to improve the quality of their infrastructure.

Demographics

The demographics of the next 30 years (the planning horizon mandated in the Local Government Act) has the potential to be kind to councils. At least three significant demographic trends will define this period:

1. New Zealand's natural increase will turn negative
2. Our population will age
3. Urbanisation will continue

From around 2030 deaths will exceed births so the country's total population will be determined entirely by migration. So, our immigration policy will largely shape the age structure, total population, and work skills of the population. Governments may also attempt to influence regional population distribution via its immigration policies.

Although there will continue to be significant levels of chain migration into all parts of the country, the default pattern will be migration into Auckland with a "drift south" out of Auckland to other parts of the country (this pattern replicates other magnet cities like New York; it's not unique to us).

The only "black swan" to change this measured control over population is the significant number of New Zealand citizens resident in other countries and the Australian citizenry who all have the absolute right to take up residence here any time they like.

Urbanisation is a global trend. And there is no reason to suppose that we will not continue to de-populate in rural areas in favour of our bigger cities. Actually only in three. I expect most population growth in the Auckland-Hamilton axis, and Greater Christchurch.

Having said that, the trend towards concentrating in these two urban areas may be mitigated by an ageing population. While we tend to concentrate on the numbers of people reaching the age of entitlement to superannuation payments we should also be focused on the life these people (soon to include me) can expect to live. Superannuitants are likely to continue in paid work (full- and part-time) for some years after reaching superannuation entitlement age. This work obviously will include self-employment which may be based from home. They will also contribute unpaid work: volunteering and/or helping family. And we can also expect superannuitants to be significant users of recreation services.

What does all this mean for councils?

Q3

Population decline

We need to get very honest about depopulation. Population growth levelling plus the general trend towards urbanisation plus the need for older people to have ready access to high levels of health care mean that smaller centres far away from hospitals can expect to get smaller. Everywhere between Hamilton and Waikanae, everywhere south of Rolleston needs to be able to scale **down**. There is nothing in our current system that enables districts to gracefully depopulate.

The problem is that councils have an already-built network of capital-intensive infrastructure that cannot be easily or incrementally reduced in size. Many years ago Whanganui District Council floated the idea of divesting itself of some remote roads that serviced only a single property. The idea was not well received by the local community.

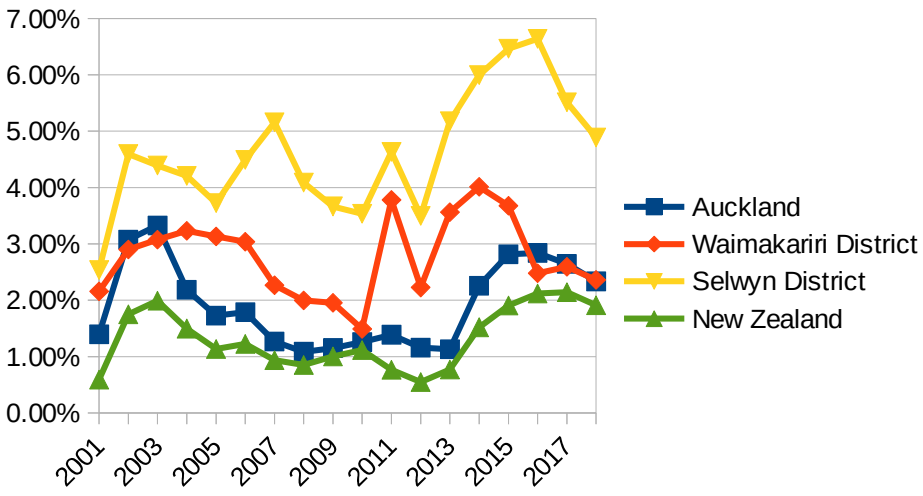
It is no accident that the councils that currently do not comply with the Drinking Water Standards tend to be the smaller rural councils. They are also more likely to be the ones discharging wastewater into our waterways. The capital cost of installing the equipment required to comply with current regulations is simply beyond these small communities. Especially if their population is static or growing only very slowly.

Note also that in rural districts comparatively few ratepayers are connected to water services (farms do their own) making residents in built areas that are serviced extremely vulnerable to even small shifts in population away from these serviced areas.

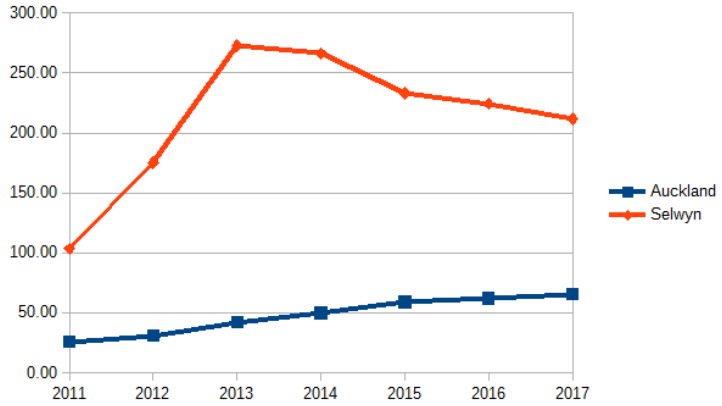
Population growth

Coping with population growth is a little more nuanced than most commentators realise. Recent experience in New Zealand seems to indicate that a sudden shift in the **rate of growth** is more problematic than high growth alone. In fact it is fair to say that a sudden shift from moderate to high growth is the worst problem. High growth to red-hot is more manageable.

After the earthquake in 2011 Christchurch lost some 10,000 houses. These houses were largely replaced in the neighbouring Selwyn and Waimakariri districts within three years. Around the same time Auckland experienced a population shock as residents stopped migrating out of the city causing a sudden rise in the rate of growth of population. This chart shows the rates of population growth in these areas over this time:



More importantly the following chart shows that Selwyn District was able to respond quickly (as was Waimakariri also) to a shock whereas Auckland wasn't. This graph shows the rate of consenting new residential dwellings per 10,000 population. You would want to see consenting rates move at roughly the same time as changes in the **rate** of population growth. You do see this in Selwyn, you don't see it in Auckland.



The key question is why? My experience is that councils whose internal processes are geared up for **continuous and predictable** high rates of growth are more responsive to lifts in growth rates. In high-growth communities council planners and engineers are continuously planning 10-15 years out and getting all the necessary preparation work done well before they have to start the statutory processes (District Plan and Ten Year Plan). They also ensure all infrastructure replacement and upgrade projects also include capacity enhancements to cope with decades of projected growth. Although this places a strain on funding it is achievable. Notably Selwyn and Waimakariri have coped with high growth and sudden changes in growth without house prices going too wild.

The Development Contributions regime is awful but the fact that it exists at least gives councils a funding stream to help pay for the costs of growth. In particular it mitigates the impacts of

mandatory level of service upgrades. It is very common in growing areas for any major capital work to be funded partly from depreciation, partly from development contributions, with the balance (the level of service portion) usually funded by debt. It is one of the quirks of the Development Contributions regime that councils must take a firm ten year view of not only population growth but the exact set of projects that will be required to maintain those levels of growth. The system more or less rewards councils that expect growth (and march unswervingly to their planned future) while hindering councils like Auckland that get hit with a population shock.

Are either of these population trends significant compared to other pressures? They don't have to be. Should the widely expected nationalisation of the three waters services happen then many of these pressures go away **for councils.** Some minor tweaks to the National Land Transport Programme would mitigate pressures on rural councils. For what's left I would replace the Development Contributions regime with an increase in local government's share of fuel tax (currently microscopic) with the express requirement that it be applied to growth-related roading capital projects.

Q4

On balance the pressures of an ageing population will not be as significant as other pressures.

Yes, there are rates affordability concerns with an ageing population structure. But, currently, these concerns are mitigated by the low income household rates rebate scheme as well as accommodation supplements for renters.

On the other hand there are some upsides. The 65+ age group use transport infrastructure differently. Even when in paid employment this group may use passenger transport and roads outside peak times. For councils an ageing population may mean more efficient use of roading infrastructure. It could also mean better use of public recreation services (walking, cycling, libraries, aquatic centres, sporting facilities). In places where there is a housing crunch an ageing population could also mean a demand for new medium-density development freeing up some existing larger housing for families.

Q5 & Q6

Councils can and do capture funding to provide services in support of tourism. Volumetric charging for water and "per pan" charges for sewer can cover the extra costs of temporary visitor populations. Development and financial contributions can be charged to developers of hotels/motels and shopping centres. Financial contributions may be attempted to be obtained from applicants opening a tourist activity (eg to upgrade a rural road leading to the activity's location). Traditionally councils have charged a "CBD" rate to businesses to cover extra amenities such as regular street cleaning, street furniture and plantings, or extra car parking. The problem with these sources of revenue is that they assume all visitors stay in formal accommodation (hotels, motels etc). The rapid increase in campervan usage as well as Airbnb accommodation bypasses those formal mechanisms.

While increased usage on rural roads will strengthen a council's case for subsidies from NZTA, there are few other identifiable mechanisms for getting funds to pay for the costs of hosting these new classes of visitors. Some councils are attempting to implement a targeted rate on informal accommodation providers but it's an ugly mechanism.

Tourism funding is an example of the government shifting the burden to local authorities. It is, after all, central government that actively encourages tourism to this country. It is also the biggest single beneficiary of tourism. It has been calculated that overseas visitors contribute $1bn annually in GST alone. Tourism NZ requires some $300m annually to operate. And, even if you were to direct some of that tax back into DOC, Health, Police and Immigration there would still be hundreds of millions in clear "profit". Until very recently government has been happy to use that money for other purposes while leaving councils to pick up the burden of hosting all these visitors.

Tourism, technically, is a better example, of shifting the burden than roading since roading always has been a local government responsibility. But it is right to point out that it is very difficult to draw up a 30 year Infrastructure Strategy when you can't rely on roading subsidies as a source of funding.

As I have pointed out above raising the bar is easily the greatest source of pressure on council funding. It is also largely unco-ordinated, undemocratic, and with virtually no accountability back to the departments that imposed the regulations.

Q8

Councils are only tentatively tackling the consequences of climate change. NIWA has been providing an official view of the likely consequences of climate change for years. But, to the best of my knowledge, councils are not engaging their communities in the various options for how to respond locally.

Apart from improving civil defence capability councils should already be consulting on:

- Drainage/stormwater: more frequent heavy rain storms mean that stormwater systems designed in the past will flood more frequently. Communities need to decide whether to accept a higher risk of flooding or spend large sums of money upgrading stormwater systems;
- Sea level rise: communities have to decide whether to retreat or build bigger defences;
- River flooding: likewise heavier rainstorms increase the threat of river/lake flooding. Already councils are starting to consider relocation of built areas like Franz Joseph.

These are all big ticket items. By default government is leaving the response to local authorities.

Q9

The usual rule of thumb is that salaries only account for about 20% of council expenditure. Some of the other 80% goes on interest but the overwhelming majority of total expenditure is on purchases. Of that the majority of expenditure is on non-tradable items such as contractors, energy, and telecommunications. Local government is not unique either: the September 2018 price indices published by Statistics NZ show that producers input cost rose 1.4% in that quarter while CPI only rose 0.9%.

Purchasing rules in councils mean that all material purchases are subject to competitive processes. In theory council input costs for purchases are the best value possible if not the lowest.

As I have already stated the difference between the rate of price rises for inputs compared to the rate of consumer price rises experienced by ratepayers causes the biggest political problem councils have.

Q10

In general, no. There may be some variation in contracting rates across regions but the criteria by which councils select contractors (largely defined by NZTA through their purchasing manual to which councils must conform in order to receive subsidies and grants) tends to lock out smaller contractors in favour of regional or national firms.

Q11

The concept of core and non-core activities is not only arbitrary but has only been around for about ten years. Councils have always provided the services that it made sense for them to provide and very few of them have ever been statutorily mandated.

The 18th Century English predecessors of today's councils rated landowners for the sole purpose of providing social welfare services (i.e. relief of the poor). Dunedin Corporation in 1903 operated the town's morgue, gasworks, tramways, abbatoir and fire brigade as well as many activities that are more familiar today. Thirty years ago towns and cities were still the main energy suppliers and bus operators.

The portfolio of services offered by local authorities changes all the time and there really is no such thing as core and non-core.

Today's council operates water supply and libraries on pretty much the same basis: because they always have. There is no legal requirement for a council to supply potable water any more than there is a requirement to offer a library service.

High transport and communication costs have until comparatively recently made local public organisations a necessity. In the telegraph era managing parks maintenance in Kaitaia from Wellington was impossible. And it wasn't just local government: the Reserve Bank had major branches outside of Wellington, there were once four stock exchanges and so on. But today you could manage all of the nation's water, sewer, stormwater, and roading infrastructure from one centralised organisation if you wanted.

Q12

Councils have begun very few new activities since they gained the power of general competence in 2002. And yet we see rates and charges diverging from CPI from about 2003 onwards. This indicates to me that funding pressures come from some source other than increasing scope of activity.

Some new ventures such as community services are offered through government contracts. Services such as restorative justice, injury prevention, and road safety promotion may be entirely taxpayer-funded through the relevant agencies.

Yes one or two councils have drifted into what are clearly poor investments in sports stadia, convention centres and the like. Not only are these examples exceptions but, as long as the

community backs the ventures and is willing to knowingly underwrite loss-making, we should respect the democratic process.

Q13

I have tried to emphasise that councils can find adequate funding as long as the environment in which they operate is reasonably predictable. External factors such as sudden shifts in central government policy or climate change effects can cause serious problems. My take is that the future is unpredictable. Central government faces enormous pressure on environmental, housing and climate issues. We can expect that it will continue to act unilaterally on those issues leaving local government to find the funding to implement the new policies. We cannot predict what will happen with population so managing growth in any predictable way will be difficult.

The local effects of climate change are already happening in the form of severe storms that occur more frequently than they have in the past. The location and impact of these storms is highly unpredictable. About the only thing we can predict is that more severe storms will hit somewhere in New Zealand more frequently than in the past and that that process has already begun.

Q14

There is no technology that will be a game-changer likely to impact within the planning horizon.

Transport-as-a-service, autonomous vehicles, electrification of the vehicle fleet, internet-of-things based monitoring and control, may all become standard technologies one day but there is no sign today of when any one of them will be a game-changer for councils.

Q15

The tools of the Ten Year Plan process give elected members an ability to try out various what-if scenarios. Councils use integrated spreadsheets that allow them to try out various expenditure proposals and implementation timetables. They can see immediately the impacts on rates and debt over a ten-year plus time frame. Elected members are sensitive to the politics of rates so this process is very useful in helping councils manage costs.

On the other hand the process is inflexible and tends to lock councils into a fixed view of what they will do over the ten year period. Councils can change their Ten Year Plans year by year but the system reinforces the idea that the three years between Ten Year Plan iterations is reasonably fixed.

Q16

The public consultation component of the Ten Year Plan is a very expensive waste of time. The documents are large, technical, and poorly written. The financial information is presented in a non-intuitive way. Even after years of helping construct these plans I cannot pick up a random TYP and understand what is going on financially in an activity. And, in fact, councils don’t use them internally. They are effectively a document produced purely for compliance reasons.

A handful of sophisticated organisations and individuals can and do engage. In my experience the average ratepayer is reduced to submitting some variation on “rates are too high, do something about it”.

The major fault is the rules of the Special Consultative Procedure. These require that a specific proposal be put before the public before submissions are sought. In 2018 New Plymouth District Council attempted to include some unstructured proposals ("do you want to spend some more on this type of project? if so what kind of project?") in their TYP but were forced by the Auditor-General to remove them before the draft could go out to the public. That is **exactly** the type of consultation we need in all our councils but the rules say you can't have them.

Q17

- De-link growth funding (development contributions) from the TYP by chucking out the whole development contributions regime and re-thinking growth funding from scratch
- Remove the three-year (inner years) concept from the TYP – basically return to the 1996 regime of rolling ten year plans
- Scrap the Special Consultative Procedure to allow more unstructured consultation
- Make the public presentation of budgets more intuitive (maybe by having them line up with the councils own working documents)

What we want to see is a lot more genuine choice-making. What we simply never see any more is a public presentation of the choices available to a council and what the consequences of each choice are. In activities like water, sewer and some of the regulatory functions there are no choices. The legislative environment creates a minimum service baseline that no council can afford to exceed. But there are choices to be made in other areas such as stormwater.

Q18

As already noted councils are price takers. 80% of expenditure is on purchases subject to tenders or other price comparison mechanisms. And the price levels on many of these classes of purchase have risen significantly faster than CPI over the last 15 years. A plateauing or even decline in these price rises will do more to take the pressure off input costs than any internal efficiency improvements.

If you pay a $500 p.a. sewer rate a 10% efficiency gain in terms of staff salaries (an impossibly high number in any council) would effectively knock about $8 off the rate. If prices of contracting out construction, maintenance and operation of the sewer system stayed **the same in nominal terms** for one year it would also effectively shave $8 off the rate.

A 10% efficiency gain is a very ambitious target. There is no reason for not seeking efficiency gains but the cost of achieving them is usually very high. In practice the real returns on improving internal efficiency will continue to be dwarfed by the pressures from rising prices for external purchases.

In this context those who seek lower costs (i.e. lower rates) need to understand that the only guaranteed way to do this is to lower levels of service or stop providing some services altogether.

Qq. 28-29

The services that are funded via rates generally fall into two classes: services to property and services to people. The former is basically the three waters and roading, while the latter comprises passenger transport, parks, reserves, sports facilities, aquatic centres, libraries, events, cemeteries, museums and art galleries.

Properties that lack any one of the basic services are either not viable for human activity or are devalued compared to a similar property. The other services are not essential for a property to function well. Councils have a number of rating options that allow them to allocate operating costs appropriately. Targeted rates and rural/urban differentials are widely used to fairly allocate the property services costs. Targeted rates can also recover business-specific costs from businesses. Something like a target rate or uniform annual general charge on residences can allocate people services fairly. The general rate finally can mop up the miscellanea while possibly allowing for a little cross-subsidising.

The reason I create these two classes is because of the different way ratepayers equity works in the two cases. In their balance sheets councils only have ratepayers equity and debt in the liabilities column. Councils, of course, prefer to have ratepayers equity and no debt. Unlike a private company, councils never have to return equity or pay a dividend on it. When a new property is developed developers (and then buyers) contribute a large amount of capital to the local council. First by way of the vested assets built by the developer, paid for by the end purchaser and vested in the council when the development is complete. Secondly by way of capital contributions (cash) which are also recovered by the developer through the sale price of the development. The key point is that this represents a considerable amount of money (classed as ratepayers equity) contributed by a purchaser. However, this equity would normally be returned to the owner when they sell the property.

All other capital contributions are basically money that is gone forever for the contributor. In this situation fairness is very difficult to achieve. We get very tied up in asking who pays for infrastructure. But ratepayers who are asked to contribute capital that is not applied to something that is capitalised in the value of their property **will get nothing in return for their contribution, ever.** As soon as an asset is built the same ratepayers will have to pay depreciation (i.e. they will be charged for lessening the life of the asset they just “paid for”) which will fund a future replacement so that no-one else ever needs to contribute capital again to keep that asset going in perpetuity.

My impression is that most councils only resort to a capital levy as a last resort. For instance, Auckland Council’s recent $100 Transport Levy was grossly unfair on today’s ratepayers. They will literally get nothing for their money. Where they are able, councils raise debt in preference to leving capital.

There are a few ways to avoid this inter-generational equity problem:

1. **Debt fund**. Debt funding is easily the simplest way to allocate a capital raising over a long time. In the simplest case where the term of the debt is matched to the life of the asset, depreciation is used to pay off the principal of the debt while interest charges are added to the operating budget. It is completely fair although more expensive. In times of moderate inflation councils can pay off debt early using just the standard practices and then acquire some no strings attached capital until the asset is fully depreciated.

Debt funding has another advantage. Councils very rarely conduct in-depth reviews of the “people” services. As long as they have a steady stream of depreciation money to replace assets as they go they never really need to go back to the community for a serious discussion about funding the continuation of the service. Some overseas jurisdictions hold mini-referenda at each local government election to confirm raising debt for a specific purpose. This forces councillors and other advocates to put the pro’s and con’s directly to the public.

2. **Make a profit.** The electricity lines sector does it so why don't councils budget for a modest surplus in some of their key activities to build a war chest for growth and level of service projects? If all residents made a small capital contribution each year then trans-generational equity issues also go away because everyone is equally badly treated.

3. **Take a slice of economic activity.** This is the central government approach. Councils already do this via their miniscule share of fuel tax. This is very similar to budgeting for a surplus except that the amount of contributions is linked to the economic well-being of the community.

Q33

Levying rates in proportion to property value is done to introduce some form of progression into rating. There is no real difference except at the margins between capital and land value rating. The latter tends to favour lifestyle block owners at the expense of commercial farmers for instance. Land value rating should not be confused with a land tax which is collected in proportion to the assessed value of the property (i.e. it is a wealth tax). Councils cannot levy that kind of tax.

As an aside, 18th Century rating was effectively an income tax. In an agrarian economy the value of land was directly linked to its productive capacity. So a higher rate based on higher land value was paid by someone who was earning more money from the land. Today the link between property value and income (i.e. the ability to pay rates) is not as strong as it once was.

Q36

By and large everyone in a district pays for the provision of local public goods either directly or through rents. Rating is an administratively efficient way of collecting the necessary funds to provide those services. Of course capitation or share of GST revenue would be even simpler. The key thing is that if we don't have rates then we have to fund from another source. The nett effect at the household level is unlikely to be very different.

Q37

Germany funds local government through capitation. A simple capitation formula (x% of total GST collected nationally transferred back per resident) will effectively transfer funds from higher income regions to lower income regions. Which could be a good outcome. But any capitation scheme will refocus council attention on lobbying for changes to the regime that benefit themselves.

In general there has been no appetite at central government for transferring any money into the local government sector without onerous accountability mechanisms. Rates are effectively controlled at the aggregate level by a form of fiscal envelope thinking and capitation would be no different. But the inherent distrust of local government will always be a barrier to a no strings transfer even if it was fiscally neutral at the government level.

There is a very strong case to be made for increased transfers into the roading activity specifically. Mechanisms already exist to to facilitate those transfers. It would make particularly good sense to repeal the remaining provisions of the development contributions, increase the allocation of fuel tax using the existing provisions of the LGA 1974 especially to high growth areas, and increase subsidies through the National Land Transport Programme in return for reducing rates. DC's for the

three waters could be replaced by connection charges under current legislation and would be entirely appropriate.

The only significant problems with replacing rates and development contributions with government transfers would be political. Taxes would have to rise to compensate for the reduction in rates. And it is hard to imagine landlords voluntarily passing on rates reductions to tenants.

Q38

Local authorities have no incentives to promote growth. LG budgets are developed on a break-even basis. Any capital invested in a productive asset will deliver no financial return ever. Any asset that is sized for future growth will have carrying costs associated with the unsubscribed portion of the asset. Those costs cannot be totally capitalised on the assumption that future profits will pay them off. They have to be borne by today's ratepayers with the hope that growth will be quick enough to reduce the per property share of those costs. This, in turn, discourages a nimble or flexible approach to managing growth.

It is in this context that any form of tax revenue sharing with central government would help. The whole rating system is disconnected from local economic performance. A council will charge whatever rates it needs whether the local economy is booming or declining. Any system that funds local government – even if only in part – in proportion to local economic activity will help to realign local incentives to promote growth.