LOCAL GOVERNMENT
BUSINESS FORUM

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Local Government Funding & Financing Inquiry
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LOCAL GOVERNMENT FUNDING AND FINANCING INQUIRY ISSUES PAPER

1. INTRODUCTION

1.1 The Local Government Business Forum ('the Forum') welcomes the opportunity to make a submission to the New Zealand Productivity Commission on its Inquiry into Local Government Funding and Financing.

1.2 The Forum comprises organisations that have a vital interest in the activities of local government. Its members include BusinessNZ, the Electricity Networks Association, Federated Farmers of NZ, NZ Initiative, NZ Chambers of Commerce, and Property Council NZ. The Forum was established in 1994 to promote greater efficiency in local government and to contribute to the debate on policy issues affecting it.

1.3 Local government is vitally important. It provides for democratic decision making within local communities and touches most aspects of people's lives. Councils provide a diverse range of goods and services, including crucial infrastructure and services such as roading and transport, water supply, wastewater, and stormwater, and rubbish collection. Councils provide parks and recreational facilities, museums, libraries and art galleries. And councils also undertake extensive regulatory functions, often at the behest of central government.

1.4 Collectively, the sector's operating expenditure exceeds $10 billion per annum, it employs around 32,000 people, and its assets are worth around $113 billion, partially offset by around $15 billion in debt. It is also getting bigger and since 2000 its operating spending has tripled, its employee numbers are up 42 percent, and its debt is up by a factor of more than five.

1.5 Yet for such a large and important institution, local government is not well regarded. Local Government New Zealand's three yearly Reputation Surveys have shown consistently poor results, with 2017's having an overall score of 28 out of 100. Meanwhile, interest in local elections is weak with falling voter turnouts. 2016's turnout was only 42 percent, barely half of the 2017 general election's turnout of 80 percent.

1.6 Ongoing spending increases have driven rates increases well above the rate of inflation, and these are causing serious concern about affordability and fairness. The way local government is funded and financed is also coming under pressure from the need to invest in infrastructure to meet additional demand, improve levels of service, and replace existing ageing assets.

1.7 This Inquiry is therefore very timely and very important. The Forum and its members are keen to engage in its stages. The Issues Paper provides is a good first step in providing an even-handed and objective discussion of local government funding and financing and asking the right questions.

1.8 Overall, the Forum considers there to be an urgent need for change. First and foremost, councils need to up their game and become more productive and efficient and to make the best use of the range of existing funding and financing tools. However, we are open to increased central government funding for specific issues (e.g., to help councils meet the costs of regulations imposed by central government to address infrastructure pressures caused by tourism) and additional tools for both funding and financing.

1.9 Some individual members of the Forum will be making their own submissions on the Bill and we acknowledge their submissions.

2. SUMMARY OF RECOMMENDATIONS

2.1 In addition to noting the answers of the 49 consultation questions, the Local Government Business Forum recommends that the Productivity Commission should:

(a) Investigate and report on the very large amounts of operating and capital expenditure allocated to 'council support services' and how it varies among councils;
(c) Investigate and report on how individual councils use funding tools overall and on how they use specific rating tools.
(d) Consider whether better guidance or direction is needed for councils when considering how activities should be funded, including identifying the appropriate beneficiaries.
(e) Investigate and report on how much of the rates burden is carried by residential, business and rural ratepayers.
(f) Include asset recycling as a potential source of finance.
(g) Acknowledge the particularly large increases in operating expenditure in the 2004 to 2011 period and investigate and report on why this was the case, including the role of the Local Government Act 2002's 'four wellbeings' purpose statement.
(h) Ensure that its analysis of councils should include regional councils as well as territorial authorities.
(i) Separately analyse affordability for each council of the rates paid by residential ratepayers, the rates paid by business ratepayers, and the rates paid by farm ratepayers.

(j) Investigate and report on the fairness of local government rates, particularly the extent to which rates reflect access to and benefits derived from council activities.

(k) Investigate and report on councils' actual spending and rates against the spending and rates forecasts in past long-term plans.

3. CHAPTER 1: THE INQUIRY

3.1 The Forum and many of its individual members have long advocated for a review of local government funding and financing. We were pleased when the Government announced that the inquiry promised in the Labour-NZ First Coalition Agreement would be undertaken by the Productivity Commission, which has built a strong track record of undertaking rigorous inquiries resulting in sound and objective findings and recommendations. These include previous inquiries addressing local government issues, such as local government regulation, supply of land for housing, and urban planning.

3.2 The Forum is comfortable with the Inquiry's terms of reference, although we would have preferred that 'substantial privatisation' be able to be considered. Asset recycling is a very legitimate option for financing new infrastructure.

3.3 Meanwhile, although we consider the structure of local government and the scope and responsibilities of local government to each have significant implications for funding and financing, we acknowledge that these are substantial and contentious issues which could deflect attention from funding and financing.

4. CHAPTER 2: LOCAL GOVERNMENT IN NEW ZEALAND

4.1 Chapter 2 provides discussion on local government in New Zealand, with overviews of local government structure, purpose and powers, and constitutional relationships. There is also discussion on differing circumstances across local authorities. We agree that the following factors are very relevant to funding and financing issues:

- Population size;
- Population growth and decline;
- Population age structure;
- Physical resources and industry structure;
- Tourism levels;
- Climate change and other environmental issues; and
- Impacts of natural disasters, including earthquakes.

4.2 Question 1: What other differing circumstances across councils are relevant for understanding local government funding and financing issues?

A factor not mentioned explicitly is geographic size and population density. This is especially relevant when considering infrastructure networks, such as roading and the three waters, and council services, such as solid waste and cultural and recreational facilities. Sparsely populated districts with small and scattered population centres will have significantly larger challenges for delivery of infrastructure and services and for their funding and financing.

Different types of council will also have different circumstances. Not all councils have the roles and responsibilities of city and district councils. For example, regional councils focus on the management of natural resources and unitary authorities have the combined responsibilities of regional and city/district councils. Even within the category of city/district councils, their individual circumstances will vary. As well as the factors listed in the discussion in this chapter, there are other external factors such as the expectations of communities (a key reason why Wellington and Clutha have very different proportions of spending by activity) and internal factors such as their financial positions (e.g., their levels of investments and debt).

5. CHAPTER 3: HOW FUNDING AND FINANCING CURRENTLY WORKS

5.1 Chapter 3 discusses how local government funding and financing currently works.

What do councils need to pay for?

5.2 Regarding areas of operating expenditure, the Forum agrees that there is significant variation in the demands faced by councils. Rural councils, which generally have small populations dispersed over wide areas, have higher percentages of operating expenditure on roading and water supply while more compact and densely populated metropolitan councils have lower percentages on these activities and higher percentages on other activities like culture, recreation and sport. This is well illustrated by the comparison shown between Clutha District and Wellington City. This makes sense from the perspectives of geographic and population size, but it will also reflect preferences and priorities of the councils and their communities (or perhaps more accurately those in their communities who make their voices heard).

5.3 One area of operating spending that is unclear is ‘council support services’, which overall is the second largest activity (only just behind roading). There appears to be wide variation among councils on its percentage of operating spending. Although the very large amount of overall spending for council support services could reflect bloated council bureaucracies it could also be due to how spending is allocated to activities, with some councils allocating overhead costs to ‘council support services’ that other councils might be allocating to specific activities. It would be useful for the Commission to get an understanding of this as it is relevant to the debate about efficiency of spending and how much is spent on ‘core’ versus ‘non-core’ activities.

5.4 We also agree that there is significant variation in the sources of and applications of capital expenditure between fast growing and slow growing local authorities. The comparison between Grey District and Tauranga City expresses this variation usefully. ‘Council support services’ is also a relatively significant activity for capital spending, in fifth place overall. Again, it would be useful for the Commission to get an understanding of what is included in this activity and variations among councils.

5.5 Recommendation: The Forum recommends that the Productivity Commission investigate and report on the very large amounts of operating and capital expenditure allocated to ‘council support services’ and how it varies among councils.

What funding sources are available to local government?

5.6 The discussion under this heading is a high-level explanation of the sources available for local government and does not seek to make judgments on them. While that is reasonable for this early stage in the Inquiry process, the Forum notes that there is a wide variation among councils on their use of funding tools. For example, although the local government sector relies on rates for 48 percent of its total revenue, the overall picture only tells part of the story and there is in fact wide variation among councils in their reliance on rates. This will reflect councils’ access to grants and subsidies, their use of user charges (especially for water services, consent fees, and development contributions), and whether they have significant investments which provide interest and/or dividend flows. It would be useful for the Commission to get an understanding of how different councils use available funding tools.

5.7 We also note that even within the ‘rates’ category there is wide variation among councils on:

- Rating bases (e.g., capital value and land value);
- General rates set on property value (as a percentage of total rates revenue);
- Uniform annual general charge (and compliance with the legislated 30 percent cap);
- Targeted rates (set on property value, or uniform basis, or other basis, e.g., land area); and
- Differentials for business and farm ratepayers.

5.8 Recommendation: The Forum recommends that the Productivity Commission should investigate and report on how individual councils use funding tools overall and on how they use specific rating tools.

5.9 The Issues Paper also does not discuss the appropriateness of the use of funding tools for specific council activities. Getting the funding and pricing signals right is a critically important issue for efficiency and effectiveness of goods and services provided by reducing the potential for under or over supply and ensuring they are produced cost effectively. It is also important for fairness in terms of who bears the cost of these goods and services. Both are maximised when private goods provided by local government are funded by user charges with rates confined to funding the provision of public goods.

5.10 A key question is what are private goods and what are public goods? The Forum addressed this in its 2008 publication *Local Government and the Provision of Public Goods*[1]. Although the report was done mainly from the perspective of the appropriate roles and responsibilities of local government it is also very relevant to the funding of council activities.

5.11 The distinctive features of public goods are that non-payers cannot easily be excluded from receiving the benefit that others pay for (non-excludability) and that one person’s consumption does not reduce the consumption opportunities for others (non-rivalry).

5.12 The Forum’s report attempted to categorise local government services on their public good characteristics. This is shown in the table below.

[1] *Local Government and the Provision of Public Goods*, Local Government Forum, 2008. Available from: http://www.localgovtforum.org.nz/

Table 1: Local Government Public and Private Goods

Rivalry in consumption

Excludability of consumption

Public goods

	Low	Medium	High
Low	Streetlighting, street and traffic signs, parks and reserves, civil defence, public health and safety (eg security cameras), democratic, representative and regulatory functions	Low use roads, footpaths & cycleways	Remedying marine pollution, biosecurity (pest and noxious plants) & graffiti removal from public facilities and areas
Medium	Flood protection	Sports grounds, public conveniences & bus ways	High use roads, tourism promotion, economic development
High	Museums & galleries	Public libraries, Swimming pools, in-door recreation facilities & public halls/venues	Ports, airports, public transport, water & wastewater, rubbish disposal, cemeteries, car parks, cinemas & housing

Private goods

5.13 As can be seen above while there are some 'pure public goods' and some 'pure private goods' many council activities fall between these two extremes, which means a mixture of funding tools could be justified.

5.14 In practice, many council activities that have strong private good characteristics (i.e., those in the bottom right-hand areas of the table) are funded substantially or in full by rates. There can also be wide variation among councils as to what tools are used to fund what activities and on the funding splits between rates, subsidies, user charges, and investment income. Variation is not necessarily a bad thing, as different councils will have different characteristics, but rigour is needed in how decisions are made.

5.15 Although section 101(3)(a) of the Local Government Act 2002 makes provision for councils to consider how activities should be funded, these are very high level and provide a great deal of discretion with no real guidance. This compares to the more detailed and prescriptive financial management sections of the Local Government Amendment Act 1996 (No 3), repealed in 2002. In particular, section 122E of that Act set out a three-step process for determining how expenditure needs should be funded and sections 122F, 122G and 122H set out several principles, consideration and matters for the funding of expenditure needs[2].

5.16 The 1996 provisions provided a rigorous framework for consideration of how activities should be funded and are likely to have resulted in greater efficiency in local government spending. The growth in council spending and rates revenue was

[2] Sections 122E and 122H of the 1996 Amendment Act are reproduced in Appendix 1 to this submission, as is section 101(3) of the current 2002 Act.

relatively contained in the 1996-2002 period compared to the years after 2002[3]. And although we are not aware of any empirical studies on the topic, we also suspect they would have resulted in fairer funding and rating systems (fairer in the sense that funding and rating systems should have better reflected use of and benefits derived from council activities).

5.17 It is unfortunate that the framework was dismantled in 2002 leaving councils with no guidance as to how to go about these important decisions. Political considerations and a need to pander to the voting majority (i.e., residential ratepayers as opposed to business and farm ratepayers) and vocal interest groups have filled the vacuum. The result has been a steady erosion in council funding and rating policies from the perspective of business and rural ratepayers.

5.18 There are numerous examples of rating differentials and targeted rates imposed with little evidence of rigorous, objective analysis, particularly of access to service and benefits derived. These include increased business differentials and imposition of new targeted rates. A particularly egregious example is Greater Wellington Regional Council's targeted rate for funding public transport where Wellington CBD businesses were considered the primary beneficiaries (rather than the commuters) and a 7 to 1 differential was imposed on those businesses.

5.19 There have also been ongoing large increases in farm rates despite in many cases static or deteriorating access to services. A 2019 Federated Farmers survey on rates[4] indicates the average farm paying $26,208 with 97% of respondents considering they do not get value for money from their rates. There were many comments about the lack of access to council activities which they pay more for than urban residents as well as complaints about deteriorating roads, the council activity of by far the most importance to farmers.

5.20 It is unclear how much of the rates burden is carried by residential, business and rural ratepayers and how the shares for each have changed over time. It would be useful for the Commission to investigate and report on this, both in aggregate and by council.

5.21 Recommendation: The Forum recommends that the Productivity Commission should consider whether better guidance or direction is needed for councils when considering how activities should be funded, including the appropriate beneficiaries.

5.22 Recommendation: The Forum recommends that the Productivity Commission should investigate and report on how much of the rates burden is carried by residential, business and rural ratepayers.

Sources of finance

5.23 The discussion under this heading is a high-level explanation of the sources available for local government. The Forum agrees that borrowing, done prudently, is an

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[3] From December 1996 to December 2002 local government operating expenditure grew by 23.1%. This compares to growth of 67.6% from December 2002 to December 2008.

[4] Results from Federated Farmers' 2019 Rates Survey, included in Federated Farmers of NZ's submission to this Inquiry.

appropriate way to finance capital projects, particularly large projects that have inter-generational lifespans.

5.24 However, applying the proceeds of asset sales is not included as a source of finance. Although 'substantial privatisation' has been excluded from the Inquiry's terms of reference, this should not preclude a factual discussion on asset sales being a potential source of finance for new assets (asset recycling). Auckland Council has substantial financial, property and commercial assets yet it is struggling to fund core infrastructure and it is closing in on its debt limits.

5.25 Recommendation: The Forum recommends that the Productivity Commission should include asset recycling as a potential source of finance.

Laws and regulations for funding and financing

5.26 The discussion under this heading provides an account of key legislation, such as the Local Government Act 2002's planning processes and financial reporting requirements, the Local Government Rating Act 2002 and the Land Transport Management Act 2003.

5.27 The Forum supports the use of financial prudence benchmarks and other accountability requirements. As mentioned above, however, the Local Government Act's provisions for how activities should be funded were in the Forum's view significantly weakened in 2002 to the detriment of efficiently and fairness.

6. CHAPTER 4: KEY FUNDING AND FINANCING TRENDS

6.1 Chapter 4 identifies key funding and financing trends.

Past trends in costs, funding and finance

Growth in operating and capital expenditure

6.2 While we agree that growth in local government operating expenditure has increased substantially over recent years, we disagree that the increase has been 'at a relatively steady rate'. The overall increase masks distinct periods of faster and slower growth. The Forum's 2018 paper *Local Government Role and Funding*, provided to the Commission, discusses these trends but we will make some further comments on this point[5].

6.3 Appendix 2(a) of this submission includes a table showing nominal amounts for operating expenditure and rates revenue for each year ended June since 1997.

6.4 Of the 22 years from 1997 to 2018, three saw annual increases in operating expenditure of more than 10 percent, with a further four annual increases of more than 7 percent. All seven of these large annual increases took place in the eight-year period from 2004 to 2011 (2010 being the one exception). These large expenditure increases also drove large increases in those years for operating revenue and rates revenue.

6.5 Appendix 2(b) includes another table adjusting Appendix 2(a)'s table for inflation (as measured by the Consumer Price Index (CPI)[6] and population growth. Again, the largest increases in real per capita operating expenditure took place in the 2004 to 2011 period, with seven years of that eight-year period having real per capita increases of more than 4 percent.

6.6 While there are likely to be a number of reasons why growth was so large over 2004 to 2011, the Forum is concerned that the activist 'four wellbeings' purpose statement of the Local Government Act 2002 played a part. This is relevant as the current Government intends to reinstate the four wellbeings in an amendment Bill currently before Parliament. The Forum has warned that reinstatement could act to further push up growth in local government operating expenditure and therefore operating revenue and rates.

6.7 Recommendation: The Forum recommends that the Productivity Commission should acknowledge the particularly large increases in operating expenditure in the 2004 to 2011 period and investigate and report on why this was the case,

[5] *Local Government Role and Funding*, Local Government Business Forum, 2018. Available from: http://www.localgovtforum.org.nz/

[6] The local government sector has claimed that CPI inflation is not a good proxy for local government inflation as it does not measure the same basket of goods and services used by the sector. That may be so but is little consolation for ratepayers whose reference point will be the CPI. We note the LGCI is the local government sector's preferred measure of inflation. Its increase over the decade June 2007 to June 2017 was 29.2% compared to 20.2% for the CPI. The difference is not enough to explain the 65.2% increase in the rates component of the CPI.

including the role of the Local Government Act 2002's 'four wellbeings' purpose statement.

6.8 It is important to look beyond the overall increases in operating expenditure and we note the Issues Paper has touched on how the mix of spending has changed both in terms of activities and cost sources. The *Local Government Role and Funding* paper analysed this as well, especially for the spending by activity. It found that 'other activities', community development, transportation, planning and regulation, economic development, governance, property, and recreation and sport all grew by more than the overall percentage increase in operating expenditure. Meanwhile, environmental protection, roading, council support services, solid waste/refuse, culture, water supply, wastewater, and emergency management all grew by less than the overall percentage increase.

6.9 In terms of cost sources, the Issues Paper pays close attention to depreciation, which comprises around 20 percent of total operating expenditure. The Forum agrees that over time the total amount of depreciation accumulated should roughly equal the total cost of replacing a council's assets. It is concerning that in practice this has mostly not been the case and in some cases substantially not the case, as stated in the Issues Paper.

6.10 Question 2: What explains the difference between the amount 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?
Depreciation could be set too high but deferring replacement of assets appears to be a major factor, especially on 'three waters' infrastructure (i.e., drinking water, wastewater and stormwater). Given the serious concerns about the state of three waters infrastructure, delay in replacement is inexcusable if accumulated funds are indeed available. We agree that accumulated funds being spent on other items is also possible and that would be most unsatisfactory, especially if it is a reason for the deferral of replacing critical assets. Changes to the way depreciation is funded could be merited, for example relaxing the current requirement for depreciation to be fully funded but it might be that councils need to improve their asset management and planning and ensure their spending is appropriate. We would welcome the Productivity Commission investigating and reporting on this.

<u>Low-growth and high-growth councils</u>

6.11 The Forum is pleased that the Productivity Commission is looking 'beyond the averages' and investigating how expenditure and revenue has changed over time for low-growth and high-growth councils, as well as for Auckland Council, metropolitan, provincial and rural councils. There are some interesting observations from the Issues Paper, including large increases in operating and per capita spending for low-growth councils (Table 4.1) and larger than average increases in rates per capita for most rural and provincial councils compared to most city councils (Figure 4.7).

6.12 We note a focus on territorial authorities in the figures and tables and we would also like to see attention being given to regional councils, especially as these have seen large increases in spending, revenue and rates over recent years. There are also unitary authorities which are district councils with regional council functions.

6.13 Recommendation: The Forum recommends that the Productivity Commission should ensure that its analysis of councils should include the regional councils as well as territorial authorities.

How has affordability of rates changed over time?

6.14 The Forum is very sympathetic to concerns about affordability and we certainly agree that in overall terms local government has become less affordable over time. Apart from the obvious of keeping its spending and rates under control affordability is not an easy issue for local government to address. Because it has no taxation mechanism attached to a person's income or spending (unlike central government) local government has no way of knowing what people earn or spend and few options to meaningfully address it. Some point to property value as a proxy for income and ability to pay. However, property value is a poor proxy for income, whether it is comparing a wage and salary earner in their prime earning years with an elderly retired person in similarly valued houses or to a business or a farmer. We encourage the Productivity Commission to bear this in mind when it considers whether and how affordability can be improved under the current system.

6.15 Turning to the affordability discussion in the Issues Paper, at an aggregate level comparing growth in rates revenue with growth in gross domestic product is not an unreasonable approach. However, as the Issues Paper acknowledges, it can only tell part of the story. Councils have had significant variations in growth in rates per capita with Figure 4.9 showing significant variability in changes in affordability for a median household. It would be more interesting and useful if each plot on Figure 4.9 was labelled and whether any observations could be made on the sorts of councils (e.g., rural, provincial, metropolitan, Auckland and/or low-growth, high-growth, etc.) that had improved affordability and what sorts had worsened affordability.

6.16 Another problem is the use of the 'median household' as the comparator. As acknowledged in the Issues Paper, the median does not take account of income differences and likely understates the affordability of rates for low income households and people on fixed incomes. And, as the Issues Paper also acknowledges, it does not address affordability issues for non-residential ratepayers such as businesses and farms.

6.17 A useful approach to assessing affordability would be to separately analyse by council the rates paid by residential ratepayers, the rates paid by business ratepayers, and the rates paid by farm ratepayers. Because businesses and farms will individually pay higher rates than individual residents, doing this will provide a more accurate analysis of affordability as well as help assess the fairness of rates (that is, the extent to which rates reflect access to and benefits derived from council activities).

6.18 Recommendation: The Forum recommends that the Productivity Commission should separately analyse affordability for each council of the rates paid by residential ratepayers, the rates paid by business ratepayers, and the rates paid by farm ratepayers.

6.19 As mentioned previously the fairness of rates is an important factor that needs to be considered alongside affordability. One person's $20,000 rates bill might be regarded as 'affordable' but that does not mean it is 'fair', especially if that person does not get the access to or benefit from council activities than another person with a $2,000 rates bill. The Forum's view is that local government is first and foremost a service provider and its role is not to redistribute income. That is the role of central government. For service providers like local government getting the pricing signals wrong through unfair funding and rating policies could (through encouraging the undersupply or oversupply of services) impact adversely on the effectiveness and efficiency of service delivery and therefore the cost of local government and its affordability. Fairness should therefore be an important consideration.

6.20 Recommendation: The Forum recommends that the Productivity Commission should investigate and report on the fairness of local government rates, particularly the extent to which rates reflect access to and benefits derived from council activities.

Projected Future Trends

6.21 The discussion under this heading takes information from council long-term plan forecasts to 2025 and compares them to actual results. This information suggests that operating expenditure and total rates revenue will continue to rise by an average of around 4-5 percent per annum over the coming years, while capital expenditure is forecast to decrease slightly from current levels.

6.22 The Forum is not convinced that in practice spending and rates will be as contained as suggested in those historic LTPs. Firstly, individual Forum members which submit on LTPs have found that while spending and rates forecasts are usually reasonably accurate in the first two to three years of an LTP's 10-year planning horizon the out-years often revert to lower 'baseline' increases, which usually mirror forecasts for the Local Government Cost Index (LGCI). These are usually increased in the next LTP. We encourage the Productivity Commission to investigate and report on how well councils' actual spending and rates adhere to what was provided for in their earlier LTP forecasts.

6.23 This is an issue also for central government's Budget forecasts, with successive governments increasing their operating allowances to enable expanded spending on existing programmes and to fund new spending programmes.

6.24 Secondly, and perhaps more significantly, we also note the very recent report by the Controller and Auditor General on the 2018-28 LTPs, which found that the LTPs "show significant forecast capital expenditure compared with previous LTPs. This will lead to challenges regarding how to fund this extra spending, particularly for growth councils that are starting to reach the debt limits they have set"[7].

6.25 Forum members also concerned that some councils (e.g., Auckland) have not been good at including detail of key projects in their LTPs, making it difficult for communities to have an informed discussion and affecting the credibility of the LTPs and the councils concerned.

6.26 Recommendation: The Forum recommends that the Productivity Commission should investigate and report on councils' actual spending and rates against the spending and rates forecasts in past long-term plans.

[7] *Matters Arising from our Audits of the 2018-28 Long-Term Plans*, Controller and Auditor General, February 2019.

7. CHAPTER 5: WHERE ARE THE PRESSURE POINTS?

7.1 The Forum will focus its response to Chapter 5 on answering the questions posed under each heading.

Population growth and decline

7.2 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?

7.3 The Forum agrees with the discussion in the Issues Paper about the challenges associated with population growth and decline, particularly around infrastructure. It is a very significant issue and one that will continue to be significant.

7.4 Question 4: What are the implications of demographic changes such as population ageing for the costs faced by local government?

7.5 The Forum agrees with the discussion in the Issues Paper on demographic change. The impacts will vary by council (depending on their age structures) but they will become increasingly significant over time. Given the relatively low incomes of many superannuitants, population ageing will likely put pressure on the sustainability of rates as the major source of local government funding.

7.6 Although not mentioned in the Issues Paper, strong net migration in recent years has added to pressure on infrastructure and services but it has also provided some breathing space to population ageing through a large influx of working age people and their families. Immigration has also provided a population and economic boost to many councils, including some that have been in decline.

Tourism

7.7 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?

7.8 The Forum agrees that tourism is putting pressure on councils, especially those with relatively small resident populations (and ratepayers) having to fund infrastructure to cater for large influxes of visitors. Property-based rates that merely allocate council spending against local ratepayers fails dismally to address the pressures caused by visitors, especially those who do not stay overnight in a rateable property and instead transit through the district. Central government has the most efficient tools for addressing this problem, through GST (which everyone, including international visitors, pays when purchasing goods and services) and levies at the border (which are targeted at international visitors).

7.9 Queenstown Lakes is the most cited example of a council facing acute pressure, but the pressures appear to be relatively widespread if funding from the Tourism Infrastructure Fund (TIF) is any indication. 42 territorial authorities received funding from the first two funding rounds, with 10 of them receiving funding from both rounds (Far North, Nelson, Selwyn, Southland, Tasman, Tauranga, Thames-Coromandel, Westland, and Whangarei)[8].

[8] https://www.mbie.govt.nz/immigration-and-tourism/tourism/tourism-funding/tourism-infrastructure-fund/

7.10 The TIF funds projects like carparks, toilets, freedom camping facilities, sewerage and water (tourism-related portion only), safety upgrades to public spaces (e.g., footpaths), and infrastructure for natural attractions. These are all areas where tourism numbers have imposed pressures for councils. However, other council infrastructure and services are also affected, including many that are shared with locals. Roads, the three waters, solid waste, and cultural and recreational facilities (e.g., museums, libraries, art galleries, parks and reserves, etc.) are notable examples.

An expansion of local government responsibilities

7.11 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 by local authorities?

7.12 The Forum is sympathetic to the concerns of local government about the shifting of costs and responsibilities from central government to local government. Significant examples include, as mentioned in the Issues Paper, reduced New Zealand Transport Agency (NZTA) funding for road maintenance and renewals; changes to the Resource Management Act (RMA), and new and strengthened national policy statements and national environmental standards under the RMA.

7.13 Changes to legislation for alcohol licensing, building (including earthquake-prone buildings), and Easter trading have also imposed costs on councils.

7.14 Looking ahead, the likelihood of stronger regulation of freshwater management and for drinking water will increase costs for regional councils to develop, implement and enforce new policies and plans for freshwater management and will increase costs for territorial authorities to repair, upgrade and in some cases replace water, wastewater and storm water infrastructure.

7.15 The costs will vary by council depending on the issue. For example, reduced funding for local road maintenance and renewal fell most heavily on small, rural, low growth councils and looking ahead the need to make three waters infrastructure compliant with tighter regulations will likely fall disproportionately on those councils too. Meanwhile, a stronger national policy statement on freshwater management will impose costs directly on regional councils (although some costs could also flow on to territorial authorities).

7.16 It is important that central and local government embrace good regulatory policy and practice. The Productivity Commission has investigated this issue in the past (inquiries on local government regulation and on regulatory institutions and practices) and found shortcomings on both sides. These shortcomings need to be addressed and we discuss this further in our comment on question 37.

Treaty of Waitangi settlements

7.17 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?

7.18 The Forum agrees with the Issues Paper's discussion on Treaty of Waitangi settlements, including the examples of additional costs. We believe this is an area where the Crown (as Treaty partner) could do more to assist councils with implementation of treaty settlements.

Climate change and other natural hazards

7.19 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?

7.20 The Forum understands that local government is giving this issue more attention, although we suspect in practice there will be considerable variation among councils as to how they are factoring in response and adaptation, including cost and funding implications. On 31 January 2019 Local Government New Zealand released a report stating that as much as $14 billion of local government infrastructure is at risk from sea level rise.

7.21 We note the Controller and Auditor General's recent report on 2018-28 LTPs also discussed the effects of climate change and found that it would compound pressure on capital expenditure forecasts and that many councils don't know the extent of the challenges they face[9].

Rising prices

7.22 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?

7.23 The faster growth for the LGCI compared to the CPI reflects the mix of goods and services purchased by local government. These will be different from those purchased by the average consumer but overall the LGCI's increase over the decade June 2007 to June 2017 was not substantially larger than that for the CPI (29.2% versus 20.2%).

7.24 According to BERL's 2017 update of the LGCI, the increases from 2007-17 for eight key price indices from the Producer Price Index (PPI) and the Capital Goods Index (CGI) and the Labour Cost Index (LCI) were:

- PPI inputs – local government administration: up 25.9%
- PPI inputs – arts and recreation services: up 20.0%
- PPI inputs – water, sewer, drainage and waste services: up 38.5%
- CGI – earthmoving and site work: up 35.5%
- CGI – pipelines: up 26.4%
- CGI – reclamation and river control: up 27.4%
- LCI – all salary and wage rates, local government sector: up 26.3%
- LCI – all salary and wage rates, private sector: up 22.9%.

7.25 This indicates that the highest cost pressures for local government during the 2007-17 decade were those associated with infrastructure maintenance and construction.

[9] *Matters Arising from our Audits of the 2018-28 Long-term Plans*, Controller & Auditor General, February 2019.

It is also notable that local government sector salary and wage rates have increased faster than for those of the private sector.

7.26 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?

7.27 Price pressures will vary across councils. Councils that have a high proportion of spending on infrastructure, such as roading and the three waters, will likely face higher price pressures when prices of infrastructure inputs (e.g., roading aggregate bitumen, pipes, plant and machinery, fuel, construction industry wages etc.) will be higher. As indicated above these costs increased rapidly in the 2007-17 decade but they can also be volatile and be influenced by commodity prices and demand in the construction industry.

7.28 In contrast councils that have a low proportion of spending on infrastructure will likely have more stable price pressures, closer to public sector wage and salary inflation. That said, even these employment-related cost pressures appear higher than for the private sector.

7.29 The comparison earlier in the Issues Paper between Clutha District (with much more of its spending on roads and water supply) and Wellington City (with much less of its spending on these items) would suggest that Clutha's price pressures are more acute than Wellington's.

7.30 It is also likely that the use of formal arrangements between councils to share services and/or procurement is helpful in reducing these councils' costs. At 2011 paper by Local Government New Zealand said *"literature on shared services or joint arrangements purports a range of common benefits that can be derived from such collaboration. Empirical evidence of such benefits is less documented, although there is a growing body of evidence on cost savings"*.[10]

7.31 The Forum notes the benefits of shared services arrangements and supports and encourages the use of these arrangements, but we would be cautious about going further to force consolidation or amalgamation of council activities. Bigger is not always better.

'Non-core' expenditure

7.32 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?

7.33 Councils have provided some types of sport and recreation activities (e.g., parks and reserves) for many years, but others (e.g., stadiums and indoor sports complexes) are more recent and are costlier to construct and operate. Similarly, economic development and community development are activities that are more recent have spread widely to most councils.

7.34 As mentioned in paragraph 6.8 above many of the less traditional non-core activities have experienced over the bigger percentage increases in operating expenditure

[10] *Shared Services for Local Government*, Local Government New Zealand, June 2011

than many of the more traditional core activities. Many of these are relatively small spending areas but they have still grown faster and will have (a) diverted resources from traditional core activities and (b) contributed to higher rates.

7.35 The Forum believes a driver of more rapid growth for non-core activities will have been the Local Government Act 2002, which its expansive requirement for councils to promote social, economic, environmental and cultural wellbeing (the 'four wellbeings'). We believe this has helped fuel community expectations, or more accurately the expectations of some people in the community who want councils to do more (regardless of the cost) and are effective at making their voices heard. As mentioned earlier in this submission council spending and rates grew rapidly from 2004 to 2011.

7.36 In 2012 the previous Government, concerned about these large increases, repealed the four wellbeings purpose statement from the Act and replaced it with a purpose statement for local government to 'meet the current and future needs of communities for good-quality local infrastructure, local public services, and performance of regulatory functions in a way that is most cost-effective for households and businesses.' It also included in the Act a list of core services: (a) network infrastructure; (b) public transport services; (c) solid waste collection and disposal; (d) the avoidance or mitigation of natural hazards; and (e) libraries, museums, reserves, and other recreational facilities and community amenities.

7.37 The Forum supported the change in purpose and the list of core services. Although it has not prevented councils from undertaking non-core activities, we believe it nevertheless was a factor in more contained spending and rates increases since 2012.

7.38 In 2018 the current Government introduced legislation to change the purpose statement back to promoting the four wellbeings. The Forum opposed this change and we are concerned that if it proceeds it could give renewed impetus to spending and rates, particularly on non-core activities – at a time when councils should be focused on core activities, especially the three waters.

7.39 As mentioned (and recommended) earlier in this submission we are keen for the Commission to investigate and report on the impact of the Local Government Act 2002's 'four wellbeings' purpose statement.

7.40 Question 12: Does the scope of activities funded by local government have implications for cost pressures? If so, in what ways?

7.41 The scope of activities will have implications for cost pressures, but the extent will depend on the mix of costs for each activity. For example, based on 2007-17 experience (and the future could be different) council cost pressures were most acute for infrastructure, particularly the three waters. This would suggest that cost pressures have been more pressing for core activities than for non-core activities. This does not mean councils should spend less on core activities and more on non-core activities. Rather it means councils need to be focused on productivity and efficiency across their entire operations and to prioritise on what matters most.

Other factors

7.42 Question 13: What other factors are currently generating local government cost pressures? What will be the most significant factors into the future?

7.43 Unfortunately, local government has a poor reputation, as evidenced by Local Government New Zealand's 2017 Reputation Survey showing an overall score of 28 out of 100[11]. The Forum is concerned that the sector's poor reputation is a factor behind ratepayers' reticence about or opposition to changes that could ease cost pressures and/or improve levels of service. Councils need to continuously strive to improve their performance to address the sector's reputation problem.

7.44 Question 14: How will future trends, for example technological advances and changes in the composition of economic activity, affect local government cost pressures?

7.45 The Forum agrees with the discussion in the Issues Paper. Technological changes and changes in economic activity and in land use will all have implications for council revenues and costs. It is important to acknowledge that these could be positive as well as negative.

[11] New Zealand Local Government Survey 2017, Local Government NZ, http://www.lgnz.co.nz/our-work/publications/new-zealand-local-government-survey-2017/

8. CHAPTER 6: MANAGING COST PRESSURES

8.1 The Forum will focus its response to Chapter 6 on answering the questions posed under each heading.

8.2 Question 15: How effective is the Long-Term Plan (LTP) process in addressing cost pressures and keeping council services affordable for residents and businesses?

8.3 Individual Forum members have significant experience in engaging with councils on their LTPs and annual plans.

8.4 LTPs and consultation processes for them were introduced in the Local Government Act 2002. The intention was for these to improve councils' financial planning and to be a tool for transparency and accountability for ratepayers. The latter was especially important when councils were empowered to be more activist, especially in promoting the four wellbeings.

8.5 The Act's consultation provisions imposed compliance costs on councils and there were also concerns that the provisions were not enabling good engagement with communities. Forum members' experience was that it can be very hard work to get changes to council spending proposals and to achieve even small improvements to a council's rating system on behalf of minority groups (such as businesses and farms) paying high rates.

8.6 In 2014 the Local Government Act consultation provisions were amended. These included introducing consultation documents as the main form of engagement for LTPs and removing the need to consult each year on the annual plan, instead only requiring consultation if there are significant variations to the current LTP (with 'significant' determined by councils' significance policies).

8.7 While the intention of the changes (to reduce compliance costs and to facilitate better consultation) was worthy, experience since 2014 has been patchy at best. As mentioned in the Issues Paper, the Controller and Auditor General has been critical of council consultation documents and the effectiveness of consultation processes[12]. Forum members agree with these criticisms and some practices have slipped badly. For example, councils no longer having to provide written responses to submissions and this has resulted in submitters getting no feedback on their submissions or even information on council decisions (beyond being told to check the adopted plan on the council website).

8.8 Annual plans have also become problematic with many councils no longer consulting or only doing so in a limited manner. This despite changes (including as a result of property revaluations) which have been significant, if not for the council as a whole, then to individual ratepayers or groups of ratepayers.

8.9 Question 16: How effective are councils' LTP 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?

[12] *Long-term plans: Our Audits of Councils' Consultation Documents*, Controller and Auditor General, August 2018. https://oag.govt.nz/2018/ltp-consultation-documents/docs/ltp-consultation-documents.pdf

8.10 In practice most people, if they are interested and engaged in LTPs (a big 'if'), will focus on operating spending and rates and the levels of service on the activities they care about. Despite its importance capital investment and the complex issues associated with it are of interest to fewer people. This is concerning considering the 2018-28 LTPs forecast significantly more capital expenditure compared with previous LTPs and that this will be challenging for some councils nearing their debt limits.

8.11 One useful change in 2014 was the requirement for councils to have 30-year infrastructure strategies. These should be helping to focus councils on their asset management and capital investment plans. It would be useful for the Commission to investigate and report on how the 30-year strategies have worked in practice.

8.12 Question 17: Is there scope to improve the effectiveness of LTP processes? If so, what, if any, changes would this require to the current framework for capital expenditure decision making?

8.13 As the Controller and Auditor General has observed there is considerable room for improvement in LTP processes. This is despite LTPs having been in place for 15 years and the 2014 changes having been in place for nearly five years (including two LTP cycles).

8.14 LTPs remain long and complex and the Controller and Auditor General has suggested that the required content for LTPs be reviewed to ensure they remain fit for purpose as planning and accountability documents[13]. While supporting changes to improve their fitness for purpose any changes will need to work for ratepayers as well as councils.

8.15 The Commission should engage with the Controller and Auditor General on what changes, if any, might be needed to improve LTP and annual plan processes. With its considerable experience in council planning documents and processes the Controller and Auditor General should be well placed to assist.

Improving efficiency in providing services

8.16 Question 18: How much scope is there for local government to manage cost pressures by managing assets and delivering services more efficiently?

8.17 Undoubtedly there would be much scope for councils to more efficiently manage assets and deliver services. An important first step for asset management is to understand the condition of critical assets and the Controller and Auditor General observed in its recent report on 2018-28 LTPs that councils need to do more better at this[14].

8.18 In terms of delivering services more efficiently, councils that have introduced water metering and volumetric water charging have experienced significant improvements in efficiency, lower wastage and have been able to extend the life of their water and waste water infrastructure. Kapiti Coast District Council's experience is outlined in a

[13] *Matters Arising from our Audits of the 2018-28 Long-term Plans*, Controller & Auditor General, February 2019.

[14] Ibid

2016 report *Measuring success: The Kapiti Coast experience*[15] and the Controller and Auditor General in 2018, *Managing the supply of and demand for drinking water*[16].

8.19 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?

8.20 The Forum is not familiar with the detail of council practices and business models, as opposed to the high-level, public-facing planning, policy and strategy documents and processes.

8.21 Overall, compared to the 2000s at least, since around 2010 we have seen a reining in of price pressures (as indicated by the LGCI) and since around 2012 there has been a slowing in growth in operating expenditure and rates revenue. However, given the diversity of councils we suspect that effectiveness of council practices and business models is mixed.

8.22 In its previous inquiries (e.g., Inquiry into Local Government Regulation), the Productivity Commission has found there to be capacity and capability issues within local government and for capacity and capability to be variable. This will also be the case for asset management and service delivery.

8.23 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.

8.24 The Issues Paper includes some examples and we are confident there will be others. We suspect there will be variation among councils in their capacity and capability to innovate and invest in new technology and their aversion to risk.

8.25 Question 21: What incentives do councils face to improve productivity as a means to deal with cost pressures? How could these incentives be strengthened?

8.26 The Forum is not convinced that rates provide a sufficiently strong incentive to improve productivity to deal with cost pressures. This is because rates are effectively a guaranteed revenue stream and rates are easy to keep increasing on an annual basis. Other funding tools are likely to provide more of an incentive, including user charges, where people have a choice whether to consume the good or service and how much to consume, and even central government subsidies, which often have strict criteria attached to the funding.

8.27 Question 22: What are the most important barriers to local government achieving higher productivity?

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[15] Cole, Martyn. 2016, *Measuring success: The Kapiti Coast experience*, Water New Zealand, Issue 193 (March/April), pp. 24-7

[16] *Managing the supply of and demand for drinking water*, Controller and Auditor General, 2018.

8.28 The Forum agrees with the four points listed in the Issues Paper taken from the Commission's Inquiry into State Sector Productivity, that is:

- Closed, risk-averse cultures in government agencies.
- Poor policy and commissioning practice.
- Restrictive rules and funding models.
- Patchy monitoring, evaluation and data use.

8.29 These will all be factors impeding productivity in local government. Another factor more specific to local government will be less contestability or oversight. Within central government, departments have to engage with other departments as they develop policy and are subject to oversight from 'control departments' like Treasury and State Services Commission. Despite the requirement for councils to submit information to the Department of Internal Affairs and for LTPs, annual plans, and annual reports to be audited there is no equivalent for local government.

8.30 Productivity performance will therefore vary considerably among councils and this is shown in Local Government New Zealand's CouncilMARK Excellence Programme[17]. The intention of the Programme is to lift performance of councils, which we strongly support. So far only there are only around 20 participating councils and we would like to see this increased significantly.

8.31 Question 23: How does local government measure productivity performance? Are these metrics useful? If not, what metrics would be better?

8.32 The Forum acknowledges that productivity is not easy to measure in either central government or local government. There is no shortage of performance and productivity measures used by councils and reported against, in fact there is a multitude of them. There are 'hard data' indicators such as numbers of visitors to council facilities, numbers of customer responses for service and timeliness of resolution, numbers of consents processed within statutory timeframes, condition rates of roads and footpaths, numbers of sewerage system faults, compliance with drinking water standards, etc. As well as 'hard' indicators councils also use satisfaction surveys to track their performance for specific activities. While customer satisfaction is a legitimate measure, it is only useful if the surveys used are robust in asking the right questions of the right people.

8.33 Question 24: To what extent and how do councils use measures of productivity performance in their decision-making processes?

8.34 Councils use these measurers in their activity statements contained in LTPs and annual plans. However, the measures are not always robust, including customer satisfaction surveys and the use in consultation documents of comparisons of the rates paid by an 'average ratepayer' for a council activity, such as roading, with the cost of, for example, a cup of coffee.

8.35 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?

[17] For information on CouncilMARK see http://www.lgnz.co.nz/about-councilmark/

8.36 Don't know.

8.37 Question 26: What measures do councils use to keep services affordable for specific groups, and how effective are they?

8.38 As per our previous comment council services should be funded according to use and benefit derived. User charges are most appropriate for pure private goods, taxation (i.e., rates funding) for pure public goods, with a mixture appropriate for those between the extremes.

8.39 In practice we are aware of councils subsidising the cost of some council services for certain groups such as children or the elderly (e.g., admission to council recreational and cultural facilities). However, as previously stated local government is in a poor position to assess a person's ability to pay so should avoid subsidising specific groups. Children can have parents with high incomes and many elderly people are also well off. Subsidising services to all of these people is not a good use of ratepayers' money.

8.40 As mentioned in the Issues Paper, the Rates Rebates Scheme provides more general assistance to offset the rates of those on low incomes, but it is a central government scheme. We note the Scheme's low uptake. but it probably remains the most appropriate way to provide targeted rates relief to low income ratepayers. We understand officials are working on a project to increase the Scheme's uptake through developing an automated service[18].

8.41 We agree that rates remission or postponement can be helpful but are not widely used as an affordability measure.

8.42 Question 27: How do councils manage trade-offs between the ability to pay and beneficiary pays principles? What changes might support a better balance?

8.43 As mentioned earlier in this submission there is not enough rigour and too often councils make these important decisions based on political or populist factors rather than an objective analysis of ability to pay and beneficiary pays. The Local Government Amendment Act 1996 (No 3) had what we believe were rigorous steps for councils to go through and useful principles, considerations and matters to guide them in going through those steps. These should be revisited.

8.44 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?

8.45 Individual councils' funding and rating policies and the impact of them will vary considerably on groups of ratepayers. However, the Forum contends that in many areas local government costs are not fairly distributed in terms of beneficiary pays. This is particularly the case for businesses and farmers, who generally pay too much to appease the voting majority (urban residents). As mentioned earlier in this submission there are numerous examples of rating differentials and targeted rates with little evidence of rigorous or objective analysis, particularly of beneficiaries. We reiterate the need for the Commission to investigate and report how the rates burden is distributed among groups of ratepayers and for it to consider whether a more

[18] See https://www.digital.govt.nz/blog/making-it-easier-the-rates-rebates-story-so-far/

rigorous and prescriptive process is needed, with the Local Government Amendment Act 1996 (No 3) a useful starting point for consideration.

8.46 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?

8.47 Again, this will vary considerably by council and will depend largely on their use (or lack of use) of their balance sheets to finance such infrastructure. The Forum supports councils making prudent use of debt, but we also think councils need to look seriously and objectively at the merits of asset recycling, i.e., selling assets (especially commercial assets) to fund investments in infrastructure.

9. CHAPTER 7: FUTURE FUNDING AND FINANCING

9.1 The Forum will focus its response to Chapter 7 on answering the questions posed under each heading.

9.2 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?

9.3 The Forum agrees with the list of established principles for assessing tax systems and reforms, set out in the Issues Paper. We do note that a significant portion of council revenue (around half) is from non-tax sources, including user charges, subsidies, income from investments, etc. Provided the principles can also apply (or be adjusted to apply) to these non-tax revenues then we would be comfortable with their use.

9.4 There will always be judgment calls and trade-offs required to be made when applying these principles. Provided the judgment calls and trade-offs are clearly described and explained, we would be comfortable with them being made.

9.5 Question 31: How effectively is the existing range of local government funding tools being used?

9.6 There is considerable variation among councils on use of funding tools. Overall, the Forum agrees that councils have considerable scope to make more and better use of them. The Forum strongly supports the greater use of user charges, including volumetric water pricing. We also support the greater use of targeted rates where the benefits of a council activity are clearly related to groups of ratepayers and those ratepayers can have a say on how the funds are spent.

9.7 A possibly over-used funding tool is differentials. Differentials that take account of rural ratepayers' lack of access to or lower benefit from council services are appropriate. However, many differentials, especially those on business ratepayers, are imposed to extract more revenue from these ratepayers often without any sound analysis or justification behind them.

9.8 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?

9.9 As mentioned above the Forum would support greater use of user charges and targeted rates, particularly for private goods and, for those that are mix of private and public goods, where the benefits can be clearly identified to groups of ratepayers. The main problems inhibiting their greater use will be political, so councils will need greater encouragement or even direction.

9.10 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?

9.11 Councils levy rates so they recover enough rates revenue to meet their spending needs, net of any other funding sources. As mentioned above, although there are processes councils go through for setting rates, the processes for assessing how expenditure should be funded (which influences who pays and how much) and how rates should be set, are in our view weaker compared to the period under the Local Government Amendment Act 1996 (No3).

9.12 Councils have considerable discretion on the types of rates they can use, and they can choose between land value, capital value and annual value for the general rate (with or without differentials) and they can use a per-property uniform annual general charge. In terms of targeted rates, councils can use value-based rates (land, capital, or annual), uniform annual charges, and land area rates and it can vary them by land use and by location.

9.13 There are shortcomings with any type of property value-based rates, capital or land value. While we acknowledge that there is economic theory in favour of land value (as set out in the Issues Paper) and they could be appropriate for fully urban areas, land value rating systems have practical problems especially for councils with a mix of urban and rural properties. If not moderated by extensive use of user charges and uniform annual charges, targeted rates or differentials on the general rate, land value will result in land-intensive ratepayers (e.g., farmers) paying disproportionately high rates completely out of line with their access to and benefit received from council services. The economic theory also suggests that it is easy to shift land to its highest value use but in practice land use regulation makes this harder than it sounds.

9.14 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?

9.15 The Local Government Rating Act has a 30 percent cap on the use of the uniform annual general charge and other district-wide targeted uniform annual charges. The cap is intended to prevent councils from making their rating systems too ‘regressive’ but 30 percent is arbitrary and we are not aware of any reason why that percentage was chosen.

9.16 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?

9.17 The Forum agrees that the reliance on funding streams that are paid only when or after developments occur is a problem, especially when there is public and political opposition to the use of higher rates and debt to meet the upfront costs and/or opposition to asset sales or to the use of private financing.

9.18 The high reliance on rates means that councils are not incentivised to support growth and development. Local government needs to make more use of non-rates tools, including debt, asset sales, and private public partnerships to fund the necessary infrastructure. We would also be open to investigation and consideration of new approaches discussed further in this chapter. Some of these will require policy and/or legislative change by central government to enable them to be used.

9.19 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?

9.20 The Forum acknowledges that property rates have some ‘pros’. They are a stable form of revenue, in terms of being resilient to economic ups and downs, and rates are also, compared to other tax regimes (e.g., income tax and GST), relatively simple for councils to administer despite the not insubstantial costs to councils of maintaining their valuation rolls and undertaking their three-yearly revaluations, and they do not impose significant compliance costs on ratepayers.

9.21 In terms of cons, property rates are merely a mechanism to allocate among ratepayers their share of funding a desired amount of revenue and to recover that amount from ratepayers. Rates do not reflect economic conditions (at least in the short-term) so they do not encourage councils to encourage growth. This contrasts with user charges, and investment income (both used by local government to a greater or lesser extent) or central government taxes like income tax, GST, and excise duties.

9.22 Property rates are also problematic because they do not (unless they are adjusted) reflect access to or benefit received from council services and they can result in groups of ratepayers paying too much or too little. This is obviously unfair for the ratepayers paying too much but as previously noted the resulting pricing failure means that councils are less able to focus their resources on what matters and to do so in a way that is effective and efficient.

9.23 Property rates also cause problems for affordability especially when people have no choice as to whether to pay and how much they pay regardless of their use (or lack of use) of council services or the benefit received from them.

9.24 These problems have been increasing as councils spend more on non-traditional, non-core activities and fund them through rates. The Forum contends that property rates are becoming less and less appropriate for funding modern local government.

9.25 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?

9.26 The Forum agrees that there can be good cases for central government transfers. As the Issues Paper states, central government should help with investments when there are spill-over benefits (e.g., spending by tourists visiting Queenstown which benefits other parts of the country) and when centrally determined standards are different from those that local government would choose (e.g., drinking water standards).

9.27 Another case, not mentioned explicitly, is where central government has the more appropriate funding tool. A good example is transport and roading, where the NZTA allocates to funding to councils from the National Land Transport Fund for maintenance and improvements of local roads. This funding comes from fuel excise duty and road user charges and reflects use of the roads and damage done to them. It is far superior to councils' reliance on property rates to fund their share of local road maintenance and improvement.

9.28 The most significant trade-offs will be the cost to central government of providing funding to local government and the potential loss of funding autonomy for local government when accepting funding with strings attached.

9.29 In terms of central government assisting councils to meet regulatory obligations, the Forum considers that cost could be reduced by central government and local government embracing good regulatory practice. In particular, the Forum supports the following principles of good regulation set out in the Regulatory Standards Bill, introduced to Parliament in 2011:

- Rule of law – legislation should be clear and accessible, not adversely affect rights or impose obligations retrospectively, treat people equally before the law, and resolve issues of legal right and liability by application of law, rather than exercise of administrative discretion.
- Liberties – legislation should not diminish a person's liberty, personal security, freedom of choice or action, or rights to own, use or dispose of property, except as necessary to provide for any such liberty, freedom or right of another person.
- Taking of property – legislation should not take or impair, or authorise the taking or impairment, of property without the consent of the owner, unless it is necessary in the public interest and full compensation is provided to the owner, such compensation to be provided to the extent practicable by or on behalf of the persons who obtain the benefit of the taking or impairment.
- Taxes and charges – legislation should not impose or authorise the imposition of taxes except by or under an Act, nor should it impose or authorise charges that exceed the reasonable cost of providing the goods or services or the benefit that payers are likely to obtain.
- Role of Courts – legislation should preserve the Courts' role of authoritatively determining the meaning of legislation and where legislation authorises a public entity to make decisions that may adversely affect any person or property it should state appropriate criteria for making those decisions and provide a right of appeal against those decisions to a Court or other independent body.
- Good law making – legislation should not be made unless those likely to be affected by the legislation have been consulted and there has been a careful evaluation of the need for legislation to address the issue concerned. Furthermore, the benefits of any legislation should outweigh its costs and any legislation should be the most effective, efficient and proportionate response to the issue available.

9.30 Unfortunately the Bill has not proceeded but we continue to strongly support these principles.

9.31 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?

9.32 As previously mentioned, we do not believe rates provide sufficient incentives. To remedy this local government needs in the first instance to make greater and better use of existing non-rates tools, including user charges, targeted rates, private finance, and proceeds from asset sales (asset recycling). Beyond that local government might need access to additional tools, such as more central government transfers, but such transfers should be contingent on meeting specified criteria.

9.33 Local government also needs to lift its performance in other areas, such as regulation and planning.

9.34 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?

9.35 The Forum agrees that the evidence of success of low growth (or negative growth) councils developing strategies to boost their economies and populations has been mixed at best. We also agree that support from central government to meet infrastructure needs of these councils is warranted but it needs to be contingent on councils taking sensible steps to adapt to the reality of demographic change. This might include greater use of shared services or even in some cases managed retreat of some network services.

9.36 Trade-offs include councils having to accept that decline is a reality for them and that this will restrict their options on how to respond. Funding from central government would provide needed funding to ease pressures but would reduce councils' funding autonomy. Shared services would likely result in more efficient service delivery but could potentially result in small districts losing control and residents finding their services to be more remote from them. Managed retreat would make sense in many cases but could signal the end of some small isolated communities.

9.37 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?

9.38 Quite possibly and we would welcome consideration of them.

9.39 Question 41: What are the pros and cons of local income and expenditure taxes?

9.40 Local income and expenditure taxes would be more responsive to economic ups and downs so would be more likely to encourage councils to be encouraging of growth and development and would also be more appropriate for funding non-traditional, non-core activities. However, we agree with the Issues Paper's reservations about introducing such taxes. The costs of implementation and administration would likely to be prohibitive and compliance costs for taxpayers would likely be a nightmare.

9.41 In practice such an approach would only be feasible through a revenue share with central government with a formula for allocating funds to councils. While this might be justifiable, especially if local government is expected to be more activist in promoting the 'four wellbeings', a revenue share, especially one with no strings attached, could heighten the risk of poor quality spending. The development of a formula could also be contentious, although the NZTA Funding Assistance Rate does provide a model.

9.42 Question 42: What are the advantages and disadvantages of a local property tax as an alternative to rates?

9.43 A property tax would be more responsive to economic ups and downs so would be more likely to encourage councils to be encouraging of growth and development. However, by no longer being tied to the recovery of a set amount of council expenditure, a property tax would weaken the relationship between the amount paid and the access to and benefit derived from the services funded by the tax, which would reduce fairness and affordability for many.

9.44 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?

9.45 With regard to environmental taxation, touched upon in the Issues Paper, it is correct that the Tax Working Group (TWG) has been considering environmental taxes and resource rents. It is also correct that some of these would be locally-variable tax instruments. Forum members have been engaging individually with the TWG. It is important that when considering environmental issues that a framework approach is taken where tax is considered alongside other approaches including regulation (which has been and is being toughened considerably) and education and information. Tax can also be used as both a carrot and a stick and there should be close and visible relationship between the expenditure being taxed and the activity being funded.

9.46 Tourism is another area which has come under attention and local government has promoted allowing councils to levy specific charges and taxes on visitors. Currently councils can impose targeted rates on accommodation providers but these 'bed taxes' have been controversial in part because of concern that there is not a close enough or visible enough relationship between the expenditure being taxed and the activity being funded.

9.47 Visitor levies are worth considering but will be tricky at a local level as they would need to be collected when visitors enter or leave the district which would only be practical for isolated areas with few entry and exit points. The Government is instead proceeding with a Visitor Conservation and Tourism Levy with funding to be used for funding conservation and tourism purposes, including infrastructure provided by councils.

9.48 Another option that could be considered is for councils to be encouraged to offer concessions to the private sector to operate tourism-related infrastructure and services.

9.49 The need to increase investment in transport infrastructure has put regional fuel taxes on the agenda with one in Auckland commencing in July 2018. Elsewhere these appear to have been put on the backburner following concern about large increases in fuel prices during 2018. Enabling legislation is in place but councils need to apply to the Government. Other options include tolling and congestion pricing. These are worth considering.

9.50 Question 44: How can the transition to any new funding models be best managed?

9.51 Any new funding models would need to go through rigorous policy and (if necessary) legislative processes and would need work in partnership between central government, local government and stakeholders (including residential, business, and farming representatives) to ensure they are well designed and well implemented.

9.52 Question 45: To what extent does the need for particular funding tools vary across local authorities?

9.53 We agree with the comments in the Issues Paper about there being a wide variation in council characteristics and in their funding pressures and councils with specific pressures will need specific funding and financing tools. Tourism is a good example.

9.54 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?

9.55 Of the financing barriers mentioned in the Issues Paper, the most significant is likely to be political pressures and community aversion to council borrowing. To some extent this reflects the low opinion many people have about local government. Improving the performance of local government will help address this barrier but it will take time.

9.56 Question 47: 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?

9.57 The Forum is strongly of the view that local government could do more to attract private investment. The problem with how the obligation to pay back the private public partnership (PPP) is counted as council debt is well described and we agree that it needs to be addressed. The proposal that central government takes on the debt for local government infrastructure investments and funds it by issuing 50-year infrastructure bonds is pragmatic and worthy of support.

9.58 The other impediment to PPPs appears to be more ideological, with there being a long-running irrational aversion to such arrangements. This needs to be addressed.

9.59 Question 48: If New Zealand replaces rates on property with a local property tax, should it also adopt tax increment financing (TIF) as a way to finance growth-related infrastructure investments? What are the advantages and disadvantages of tax increment financing?

9.60 The Forum agrees that TIF should be considered to finance specific growth-related infrastructure investments. For the reasons set out in the Issues Paper it would probably be a better way to finance these sorts of projects. Using a property tax would need to be confined to meet the costs of the specific project being financed. Otherwise, if a property tax were used to replace rates to fund general expenditure it would likely cause a breakdown in the relationship between the amount paid and the access to and benefit derived from the services funded by the tax, which would reduce fairness and affordability for many.

9.61 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?

9.62 As mentioned in the Issues Paper, there are accountabilities and requirements for local government revenue raising and expenditure. The Local Government Act covers financial planning, including financial strategies and funding and expenditure plans subject to consultation and review by the Office of the Auditor General. As mentioned earlier in this submission we are concerned about the weakening of the Local Government Amendment Act 1996 (No 3)'s rigorous requirements for how activities should be funded and the changes in 2014 to the Local Government Act's consultation requirements for LTPs and annual plans. These should be revisited.

9.63 The Forum supports the use of financial prudence regulations and requirements of councils to report against those regulations. It is useful for central government to be able to intervene in certain circumstances.

9.64 The Forum believes it is useful to look at overseas jurisdictions and we note the comment in the Issues Paper about Australian state governments regulating the amounts councils can collect in rates and/or setting caps on rates movements. While these might sound attractive they could come with risks and costs, including imposing a one-size-fits-all approach for 78 very different councils and potentially councils simply increasing their spending and rates by whatever general movement is allowed regardless of what is required.

10. CONCLUSION

10.1 The Local Government Business Forum thanks the Productivity Commission for the opportunity to make this submission on this important Inquiry.

10.2 The Forum would appreciate the opportunity to discuss its submission. To arrange a date and time please contact Nick Clark (phone 027 217 6731 or email nclark@fedfarm.org.nz).

Yours sincerely,

Michael Barnett
Chair

APPENDIX 1:

Section 122E to 122H of the Local Government Amendment Act 1996 (No 3)

Section 122E. **Funding of expenditure needs –** (1) In determining how any expenditure needs of the local authority are to be funded, the local authority shall –

(a) Identify the allocation of costs indicated by the application of such one or more of the principles specified in section 122F of this Act as the local authority determines on reasonable grounds to be relevant to those expenditure needs; and

(b) Determine the extent to which –

  (i) Any modification of the allocation of costs identified under paragraph (a) of this subsection; or

  (ii) Any alternative to the allocation of costs identified under paragraph (a) of this subsection –

  Is indicated by such one or more of the considerations in specified in section 122G of this Act as the local authority determined on reasonable grounds to be relevant to those expenditure needs; and

(c) Consider, having regard to the matters specified in section 122H of this Act, the extent to which it is practicable and efficient to fund those expenditure needs in a way that achieves, or approximately achieves, the allocation of costs determined pursuant to paragraph (b) of this subsection.

(2) No local authority is required to apply, in respect of any financial year beginning earlier than the 1st day of July 1998, the provisions of subsection (1) of this section.

Section 122F. **Principles relating to funding of expenditure needs** – The principles referred to in section 122E(1)(a) of this Act (which principles are not ranked in order of priority) are –

(a) The principle that the costs of any expenditure should be recovered at the time that the benefits of that expenditure accrue;

(b) The principle that, to the extent that any expenditure –

  (i) Is independent of the number of persons who benefit; or

  (ii) Generates benefits that do not accrue to identifiable persons or groups of persons; or

  (iii) Generates benefits to the community generally, -

  The costs of that expenditure should be allocated in a manner consistent with economic efficiency appropriate to the nature and distribution of the benefits generated, which manner may require the use of rating mechanisms under the Rating Powers Act 1988;

(c) The principles that the costs of any expenditure should be recovered from persons or categories of persons in a manner that matches the extent to which the direct benefits of that expenditure accrue to those persons or categories of persons;

(d) The principle that the costs of any expenditure to control negative effects that are contributed to by the actions of inaction of persons or categories of persons should be allocated to those persons or categories of persons in a way that matches the extent to which they contribute to the need for that expenditure.

Section 122G. **Considerations related to funding or expenditure needs** – The considerations referred to in section 122E(1)(b) of this Act (which considerations are not ranked in order of priority) are –

(a) The obligation of the local authority to act in the interests of its residents and ratepayers;

(b) The fairness and equity of any allocation of costs;

(c) Any lawful policy of the local authority, to the extent that the costs of any expenditure may be allocated in a way that effectively and appropriately promotes that policy;
(d) Balancing the avoidance of significant adjustment difficulties for any persons or categories of persons arising from sudden and significant changes in the total costs allocated to those persons or categories of persons, with achieving the indicated allocation of costs at the earliest reasonable date.

Section 122H. **Matters related to mechanisms for funding of expenditure needs** – The matters referred to in section 122E(1)(c) of this Act are –
(a) The extent to which any funding mechanism or combination of funding mechanisms lawfully available to the local authority can achieve any allocation of costs;
(b) The efficiency, including the costs, of the different funding mechanisms available to the local authority;
(c) The extent to which it is efficient and effective to fund any expenditure need by a funding mechanism that is separate from those used to fund any other expenditure of the local authority;
(d) The extent to which different funding mechanisms lawfully available to the local authority will allow persons or categories of persons to whom costs are allocated to identify the expenditure needs to which those costs relate.

Section 101(3) of the Local Government Act 2002

(3) The funding needs of the local authority must be met from those sources that the local authority determines to be appropriate, following consideration of,—
(a) in relation to each activity to be funded,—
(i) the community outcomes to which the activity primarily contributes; and
(ii) the distribution of benefits between the community as a whole, any identifiable part of the community, and individuals; and
(iii) the period in or over which those benefits are expected to occur; and
(iv) the extent to which the actions or inaction of particular individuals or a group contribute to the need to undertake the activity; and
(v) the costs and benefits, including consequences for transparency and accountability, of funding the activity distinctly from other activities; and
(b) the overall impact of any allocation of liability for revenue needs on the community.

APPENDIX 2: TRENDS IN LOCAL GOVERNMENT FUNDING

Local Government Operating Expenditure, Operating Revenue and All Rates Revenue 1997-2018

	Operating Expenditure		Operating Revenue		All Rates Revenue	
Year-end June	$m	% Inc	$m	% Inc	June 2017=1000	% Inc
1997	3,253	5.8%	3,343	5.0%	1,882	6.3%
1998	3,322	2.1%	3,457	3.4%	1,922	2.1%
1999	3,466	4.3%	3,626	4.9%	1,993	3.7%
2000	3,508	1.2%	3,750	3.4%	2,103	5.5%
2001	3,608	2.8%	3,839	2.4%	2,200	4.6%
2002	3,792	5.1%	4,140	7.8%	2,305	4.8%
2003	4,026	6.2%	4,252	2.7%	2,445	6.1%
2004	4,370	8.5%	4,626	8.8%	2,625	7.4%
2005	4,810	10.1%	4,981	7.7%	2,785	6.1%
2006	5,277	9.7%	5,352	7.5%	3,025	8.6%
2007	5,705	8.1%	5,753	7.5%	3,320	9.8%
2008	6,277	10.0%	6,179	7.4%	3,585	8.0%
2009	6,816	8.6%	6,435	4.2%	3,912	9.1%
2010	7,073	3.8%	6,884	7.0%	4,144	5.9%
2011	7,934	12.2%	7,376	7.1%	4,350	5.0%
2012	8,453	6.5%	7,803	5.8%	4,512	3.7%
2013	8,274	-2.1%	7,801	0.0%	4,603	2.0%
2014	8,466	2.3%	8,120	4.1%	4,764	3.5%
2015	9,017	6.5%	8,440	3.9%	5,003	5.0%
2016	9,402	4.3%	8,938	5.9%	5,304	6.0%
2017	9,936	5.7%	9,497	6.3%	5,532	4.3%
2018	10,418	4.9%	10,019	5.5%	5,782	4.5%

Sources: Statistics NZ Local Authority Statistics, Consumer Price Index, and National Population Estimates

Local Government Real Operating Expenditure, Operating Revenue and All Rates Revenue per Capita 1997-2018

Year-end December	Real Operating Expenditure per Capita		Real Operating Revenue per Capita		Real All Rates Revenue per Capita (June 2017 dollars)	
	June 2017 Dollars	% Increase	June 2017 Dollars	% Increase	June 2017 Dollars	% Increase
1997	1,285	3.2%	1,321	2.4%	744	3.7%
1998	1,279	-0.5%	1,331	0.8%	740	-0.5%
1999	1,332	4.2%	1,394	4.7%	766	3.5%
2000	1,314	-1.4%	1,405	0.8%	788	2.9%
2001	1,302	-0.9%	1,385	-1.4%	794	0.8%
2002	1,310	0.6%	1,430	3.3%	796	0.3%
2003	1,344	2.6%	1,419	-0.8%	816	2.5%
2004	1,403	4.4%	1,485	4.6%	842	3.3%
2005	1,484	5.8%	1,537	3.5%	859	2.0%
2006	1,548	4.3%	1,570	2.1%	887	3.2%
2007	1,625	5.0%	1,638	4.3%	945	6.6%
2008	1,703	4.9%	1,677	2.4%	973	2.9%
2009	1,799	5.6%	1,698	1.3%	1,032	6.1%
2010	1,815	0.9%	1,766	4.0%	1,063	3.0%
2011	1,918	5.7%	1,783	1.0%	1,052	-1.1%
2012	2,013	5.0%	1,858	4.2%	1,075	2.2%
2013	1,943	-3.5%	1,832	-1.4%	1,081	0.6%
2014	1,929	-0.7%	1,850	1.0%	1,085	0.4%
2015	2,008	4.1%	1,879	1.6%	1,114	2.7%
2016	2,042	1.7%	1,941	3.3%	1,152	3.4%
2017	2,076	1.7%	1,985	2.2%	1,156	0.3%
2018	2,104	1.3%	2,023	1.9%	1,168	1.0%

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