Submission by

BusinessNZ

GROWING PROSPERITY AND POTENTIAL

to the

Productivity Commission

on the

Local Government funding and financing Issues Paper

February 2018

SUBMISSION BY BUSINESSNZ[1] ON THE PRODUCTIVITY COMMISSION'S LOCAL GOVERNMENT FUNDING AND FINANCING ISSUES PAPER

1.0 INTRODUCTION

1.1 BusinessNZ welcomes the opportunity to comment on the *"Local Government Funding and Financing Issues Paper" (the "Issues Paper")*

1.2 BusinessNZ would like to congratulate the Productivity Commission on the quality of the Issues Paper and the clarity with which it deals with the many funding and financing issues facing local government. The quality of the Commission's work on a range of matters sets a benchmark to which other central and local government agencies should aspire.

1.3 The Paper covers a number of issues with which BusinessNZ is fundamentally in agreement and so are not addressed in this submission.

1.4 The submission is in two sections. Section one covers a general discussion on the appropriate role and functions of local government, crucial for informing funding and financing options. Section 2 is a response to many of the questions asked in the Issues Paper.

1.5 BusinessNZ would be happy to meet with the review team to discuss our submission and/or to provide feedback as funding and financing policy options are developed in more detail.

[1] Background information on BusinessNZ is included as Appendix 1.

2.0 SECTION 1: DISCUSSION ON THE ROLE AND FUNCTIONS OF LOCAL GOVERNMENT

2.1 BusinessNZ notes the Issues Paper, particularly in chapter 2, talks at some length about local government in NZ, including its size and scale.

2.2 It is important to establish the role local government should play in NZ before deciding what, for the future, will be the most appropriate local government funding and financing arrangements.

2.3 BusinessNZ has actively supported the concept of an inquiry into the costs and revenue base of local government given the pressures the sector is currently experiencing. This is true of both high-growth and low-populated areas, with, in the latter case, infrastructure upgrades needed although ratepayers' ability to pay is squeezed.

2.4 There are strong perceptions that local government is not as efficient and effective as it should be. This is reflected in Local Government New Zealand's own research which shows that *'local government does not have a strong reputation with business and the public'*[2].

2.5 While individuals, businesses, business organisations and ratepayer representatives all have different views on local government, one common thread is a concern over the increasing rates burden. The aggregate rates burden is running at close to twice the rate of inflation with in some cases, significant associated inequities. This is essentially a nation-wide issue, although the problem is greater with some councils than with others.[3]

2.6 The business sector pays about half the country's rates bill and the level of rates paid is often entirely disproportionate to the level of services received. The situation is exacerbated by the widespread use of business/commercial rating differentials despite strong evidence supporting their removal. Where councils have agreed to reduce the differentials, they have often been tardy in doing so, tending to incremental change due to 'expenditure pressures'.

2.7 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. A particularly egregious example is Greater Wellington Regional Council's targeted rate for public transport where Wellington CBD business are considered the primary beneficiaries (rather than commuters) and a 7.5 to 1 differential imposed in 2018 on those businesses.

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[2] Local Government NZ, *Building a Stronger Local Government for New Zealand – a survey of New Zealanders' perceptions of local government 2015*.

[3] It is noted that a publication by the Controller and Auditor-General 'Local government: Results of the 2013/14 audits' (February 2015) had the following to say on rating practices. '*In our report last year, we highlighted some rating practices that did not comply with statutory requirements. Some local authorities justified these practices as being pragmatic. We stated our view that a pragmatic approach was an unacceptable risk, particularly given that the power to set rates is a power to tax people for services provided. Rating practices needed to improve.' (p.5)*

2.8 BusinessNZ considers it desirable for local government to focus on the provision of local public goods, since their provision otherwise will likely be inadequate. There is little incentive for the private sector to provide goods and services where the return on investment is probably low or, in the worst case, non-existent.

2.9 Public goods have two distinctive features: first, non-payers cannot easily be excluded from receiving the benefit others pay for (that is, public goods are susceptible to free riding) and second, one person's consumption does not reduce others' consumption opportunities. These are known as the non-excludability and non-rivalry characteristics of public goods.

2.10 On the margins at least, what constitutes a public or private good will continue to be debatable but a diagram from a Local Government Forum (LGF) publication, "Local Government and the Provision of Public Goods" (November 2008), provides a very useful overview of some of the key goods and services many local authorities currently offer. Based on the fundamental tests of *rivalry in consumption* and *excludability of consumption* (private good) and *non-rivalry in consumption* and *non-excludability of consumption* (public good), the goods and services are categorised either as relatively pure public goods or as private goods. The table below provides a good basis for focusing on local government provision of core public goods.

Figure 1: Characteristics of local government services – rivalry and excludability

Rivalry in consumption →

Excludability of consumption ↓	*Public goods*		
	Low	Medium	High
Low	Street lighting, street and traffic signs, parks and reserves, civil defence, public health and safety (eg security cameras), and democratic, representative and regulatory functions	Low-use roads, footpaths and cycleways	Remedying marine pollution, biosecurity (pests and noxious plants) and graffiti removal from public facilities and areas
Medium	Flood protection	Sports grounds, public conveniences and bus ways	High-use roads, tourism promotion, economic development
High	Museums and galleries	Public libraries, swimming pools, indoor recreation facilities and public venues	Ports, airports, public transport, water and waste water, rubbish disposal, cemeteries, car parks, cinemas and housing
			Private goods

Source: Local Government Forum (LGF, November 2008), "Local Government and the Provision of Public Goods.

2.11 The above outline of local government's role is important in that it sets out the infrastructure provision in which local government should ideally be involved - public goods as opposed to the provision of private goods.

2.12 While the search for new funding tools should be seen as positive, there is a distinct danger of new funding mechanisms being used to source additional revenue without any clear understanding of the proper role of local government. There are already arguable cases where targeted rates (including development contributions) have not been based on sound economic principles but seen as additional revenue-generating devices.

3.0 SECTION 2: QUESTIONS AND BUSINESSNZ RESPONSES

3.1 BusinessNZ notes the Issues Paper asks 49 questions. While BusinessNZ does not have specific comments on all the questions, outlined below is its response to some of them. Where BusinessNZ does not wish to comment it will state 'no specific comment'. In some cases questions are likely to be best answered by particular councils and/or businesses (and other) groupings within specific communities as, for example, in respect to which councils are experiencing the greatest funding pressures given the effects of population growth and/or population decline.

Question 1 (page 11):

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

BusinessNZ Response:

3.2 No specific comment.

Question 2 (page 23):

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

BusinessNZ Response:

3.3 Assets often have a long-term life and upgrading and renewing them can involve "lumpy" investments over time. In this respect, it may in some cases be quite appropriate for the amount spent on renewing assets to be either low or high depending on particular time frames, population pressures and the like.

3.4 In general, it is important to account for depreciation so that the real costs associated with investments are transparent to asset users over time. However, it may also be appropriate to modify depreciation levels depending on the costs associated with asset upgrades e.g. if the cost of new and innovative products is lower and/or if a new product will last longer than the original infrastructure. Other factors also need to be considered when determining depreciation levels. For example, public perceptions of what is an acceptable level of service might change or government (through legislation) might require higher (or possibly lower) standards than are currently in force, possibly requiring a change in local government asset plans.

3.5 Given the above, it is suggested that where possible, local decisions should be made by the people most affected by them who have to pay the associated costs. Currently, many decisions are unduly foisted on local government without the provision of adequate compensation. A number of examples can be identified such as drinking water standards, and mandatory earthquake strengthening requirements. In many cases these changes have significantly affected local councils' ability to fund upgrades.

3.6 Further, unless there are extraordinary reasons for not doing so, all depreciation associated with particular asset classes should be ring-fenced to prevent its inappropriate use for unrelated purposes. Transparent reporting of depreciation is also essential to prevent the risk of funds being improperly used. BusinessNZ considers that Councils should be required to adopt consistent reporting practices in respect to both depreciation and wider reporting of financial management of assets in general.

Question 3 (page 30):

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?

BusinessNZ Response:

3.7 The Issues Paper clearly outlines how both population growth and population decline affect councils' ability to fund new and replacement assets. This is almost taken as a given. However, other issues which affect the ability of local government to fund central government-imposed requirements, without adequate compensation, are perhaps of equal significance.

3.8 Over recent years, the above effect has been well laid out by Local Government NZ in various publications and discussion documents. See also BusinessNZ's response to Question 6.

Question 4 (page 31):

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

BusinessNZ Response:

3.9 While demographic changes, such as population ageing, might affect local government costs e.g. the provision of land for retirement villages etc., much cost will depend on what local government sees as its role, that is, on what it decides to fund and also, and perhaps more importantly, on what it is required to fund in the future. See response to Question 6 for further examination of this issue.

<u>Question 5 (page 32):</u>

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?

<u>BusinessNZ Response:</u>

3.10 A number of (particularly) smaller councils and communities are affected both positively and adversely by an increased numbers of tourists. While there are obviously benefits for local communities and businesses associated with tourism growth (e.g. employment opportunities etc.), equally there are downsides which have been well documented in recent times, in particular stress on infrastructure (water) and waste services, including lack of toilet facilities etc. The situation is often exacerbated by the somewhat seasonal nature of tourism in some districts.

3.11 The current and previous government have looked at a range of options to partially overcome the tourism growth problem, from mechanisms such as a tourism fund to which cash-strapped councils can apply for funds to provide basic tourist infrastructure, through to bed taxes and border fees to fund both border security and the wider costs associated with tourism.

3.12 Many of these funding mechanisms are sub-optimal; bed taxes, for example, often have little relationship to the costs imposed by tourists, hitting every person whether a tourist, on business or otherwise obliged to travel.

3.13 New technologies, however, mean it will sometimes be possible to move towards a more user-pays regime in respect to tourism costs. For example, it would be relatively easy to impose a specific tax on campground users at specific sites during peak times (many campgrounds already track cars and people and many are privately run). And apps on various devices would allow individuals to pay promptly for the use of toilets/showers etc. BusinessNZ considers these technologies should be embraced and expanded where possible to ensure users of tourism-related infrastructure pay their fair share of the costs involved. Such an approach is preferable to the more generic funding mechanisms used to date, including those mentioned above as, in their absence, it is the local ratepayers picking up the tab.

Question 6 (page 33):

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

BusinessNZ Response:

3.14 There are really two issues to be considered here. First, the impact of central government decision-making which has imposed added costs on local government and second, the nature of local government legislation, particularly the move towards reintroducing the four 'well-beings' into the Local Government Act. Taking each issue in turn:

3.15 There are a number of instances where central government imposes costs on local government without taking account of the full ramifications of its actions. One response might be to require central government to pay compensation to local government for the costs associated with what are seen as inappropriate controls or where local ratepayers receive little or no benefit. BusinessNZ is not averse to considering such an option although our clearly preferred approach would be to ensure central government adopts a principled Regulatory Responsibility Act (RRA) to minimise the risk of inappropriate regulations and controls. However, in the absence of any central government desire to implement such an Act, BusinessNZ would support further consideration of a compensation regime for local government.

3.16 Regulators usually have strong incentives to minimise their own risk by imposing higher standards than might otherwise be justified. Because regulators do not bear the costs associated with their decisions (costs will ultimately be passed on to consumers), they may over-regulate rather than be aware of, or adequately consider, the cost/quality trade-offs consumers are willing to make. Given that each is unique, individuals will have different risk profiles - some willing to pay a considerable amount to minimise risk, others wanting to invest little in reducing either real or perceived risk.

3.17 From an economic perspective, risk involves a consideration of two matters:

1. The need for more resources, including time and money in order to reduce risk; and
2. That people's actions, in light of what must be given up in terms of increased cost or whatever else is seen as desirable, indicate an acceptable level of risk well short of zero.

3.18 In respect to the second issue of expanding the role of local government, BusinessNZ notes that the Local Government (Community Well-being) Amendment Bill (the Bill") is still before Parliament, the Select Committee having been unable to reach a consensus position as to whether or not the Bill should proceed.

3.19 The Bill seeks to restore the Local Government Act 2002's purpose pre the 2012 amendment Act - *'to promote the social, economic, environmental and cultural well-being of communities', the four well-beings'.*

3.20 The 2012 amendment replaced the four well-beings with the more robust '*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'.*

3.21 BusinessNZ supported the 2012 amendment as more effectively clarifying local government's core role. While there will always be arguments over the exact wording of the purpose statement and whether this can be improved, in general it would be fair to say the statement appears to be having a satisfactory effect. In no way that we are aware of has it stopped councils from getting involved in what should be their core activities.

3.22 The current Bill also seeks to restore territorial authorities' power to collect development contributions for any public amenities needed as a consequence of development. It reinstates the broad definition of community infrastructure applying prior to a 2014 amendment narrowing the Act's definition.

3.23 BusinessNZ supported the 2014 amendment. Although we are not opposed to development contributions per se, our concerns prior to 2014 revolved around the lack of clarity in their use and the tendency for this to extend beyond a justified use – for example, into funding community infrastructure not a consequence of the development.

3.24 BusinessNZ considers there is potential for the current Bill's proposed changes to result in significant expenditure creep, much of which will fall on the business sector principally as a result of the wide-spread use of business differentials. For example, the business differential set by the Wellington City Council is currently 2.8:1, meaning businesses pay almost 3 times more in rates than households for an equivalent level of capital value.

3.25 The business sector pays about half the country's rates bill and the level of rates paid is often entirely disproportionate to the level of services received. The situation is exacerbated by the widespread use of business/commercial rating differentials despite strong evidence supporting their removal. Where councils have agreed to reduce the differentials, they have often been tardy in doing so, tending to incremental change due to expenditure pressures.

<u>Question 7 (page 35):</u>

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?

<u>BusinessNZ Response:</u>

3.26 BusinessNZ has no particular comment on this question and considers individual member companies and councils may be in a better position to respond with specific examples.

3.27 Notwithstanding the above, BusinessNZ is of the view that significant uncertainty over property rights in relation to the use of natural resources (such as water) is a major issue in NZ. However, this is not necessarily related to 'co-governance' and 'co-management' arrangements per se but has more to do with legislative uncertainty about the issue.

3.28 BusinessNZ acknowledges a great deal of work has been undertaken to try to improve the efficiency and use of water resources, particularly through the Land and Water Forum (LWF). But to date, while progress has been made, a number of controversial but important matters in respect to water use remain unresolved, being politically fraught.

<u>Question 8 (page 35):</u>

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?

<u>BusinessNZ Response:</u>

3.29 Councils are using various mechanisms to manage the risks associated with climate change and other natural hazards e.g. earthquakes/soil erosion etc. BusinessNZ notes that on 31 January 2019 Local Government NZ released a report stating that as much as $14 billion of local government infrastructure is at potential risk from sea level rises over time.

3.30 The establishment of a Risk Management Agency focused on local government could perform a valuable advisory role for councils in better understanding and managing the various risks they face.

3.31 While BusinessNZ understands the rationale for better management of risk (not only in respect to local government but also central government, businesses, households and individuals in general), we have some concerns about the approach taken to the erosion of property rights and lack of compensation for businesses and households when local councils unduly restrict activity.

3.32 It is important to understand up-front that there is an optimal amount of resource which should be utilised to reduce risk from natural hazards, just as there is an optimal amount of resource that should be spent on crime prevention, health interventions etc. The crucial and undeniable fact is that resources are limited and risk cannot be completely eliminated or if it can, not without great cost. While it might be possible to reduce risk, beyond a certain point the marginal cost of taking action becomes progressively higher and the potential returns reduce. Therefore it pays for companies and individuals to invest in risk minimisation strategies only up to the point at which the marginal cost equals the marginal benefit.

3.33 It is not a case of eliminating risk; doing so would effectively close down all productive activity.

3.34 Often, market-based mechanisms for determining risk will be far more effective than council-controlled outcomes and will fairly reflect the actual risk associated with hazards. For example, in a competitive insurance market, individuals and businesses seek competitive quotes when dealing with hazardous situations. In some cases insurers may be unwilling to insure a building at all if the situation is considered too hazardous. This approach naturally incentivises people to assess the costs and benefits of building in areas where natural hazards have been identified. However, it is acknowledged that while insurance may incentivise people to assess costs of building in risker areas, insurers are pricing risk for the year ahead and so short term signals may sometimes be muted in regard to long-term risks.

3.35 Notwithstanding the above, given NZ's exposure to natural disasters, it is critical that NZ maintains access to international risk-capital to support the on-going development of private insurers in NZ.

3.36 As a general principle, individuals and companies should generally bear the full cost of their behaviour (i.e. cost should be internalised). Over-consumption of resources is always likely if the cost can be shifted on to third parties. Management of land use - and risk – is no different. If individuals and companies are to make rational decisions about land use, they should ideally bear the cost (and benefits) associated with specific options/outcomes. If, on the other hand, individuals and companies are forced to pay a greater amount than any cost they impose, the outcome will either be a more expensive product and/or reduced commercial activity, with associated flow-on implications for employment etc.

3.37 Before contemplating restrictions on land use or on particular risks, it is first important to understand fully the nature of the problem - who it affects, the cost of taking action, and who bears the cost. Regulatory intervention, because it is not costless, should generally be considered as a last resort, only to be taken when all other cost effective approaches have been exhausted, including greater education about risk in particular communities.

3.38 Even putting aside the issue of risk, it is fair to say New Zealand communities, towns and regions are not homogenous in respect to size, population density, contributions to Gross Domestic Product (GDP), and indeed income levels. What one community would be prepared to pay to reduce risk in respect to any number of issues, might well differ substantially, depending on the trade-offs which must be made. Some regions are in a relatively strong growth phase while others are showing negligible growth. Some regions are showing strong population growth and others are showing a steady decline.

3.39 In order to justify the imposition of restrictions, current land use arrangements must result in clear and significant cases of market failure. To the best of Business NZ's knowledge, to date this has not been happened; land use has not demonstrated significant market failure. There is also the potential for regulatory failure too readily to replace market failure.

3.40 Provided individuals are reasonably informed about known and potential risks, BusinessNZ considers they should be free to go about their lawful business. This can, for example, include developing housing on potentially flood-prone land provided any potentially adverse effects on third parties can be mitigated.

3.41 Notwithstanding the above, there will be cases where individual councils might need to make decisions restricting potential building sites and/or land use options if there is a clear public benefit in doing so – in the above case, such as the potential impact on communities and third parties should significant flooding occur. However, such restrictions should be imposed on a local case-by-case basis, not nationally.

3.42 Moreover, restrictions of this sort should be based on sound scientific evidence also taking into account the costs and benefits of restricting land use. Where potential restrictions are to be placed on current land users, those users should be fully consulted and ideally compensated for any losses incurred under current or future land use options. Current planning sees regulations increasingly likely to restrict or control land use for aesthetic purposes (however defined).

3.43 There are also a number of instances where local government controls not only affect the property rights of existing landowners but seriously restrict land available for housing development. This in turn increases the cost of available housing and as a result, rental prices.

3.44 Residents in the Kapiti Coast District Council area opposed a proposal to place new "hazard lines" (from the Lim report) on about 1800 properties along the coast, a proposal which sparked fears the lines would affect valuations and insurance. Resident opposed the unilateral imposition of annotations with immediate effect to their LIMs, asserting their property were at risk, without prior notice or consultation, or indeed any probabilistic analysis whatsoever.

3.45 The Lim Report proposal, the product of questionable analysis, not only had the potential to undermine the value of the land in question but placed restrictions on the ability of affected residents to expand beyond their current property footprint.

3.46 Putting aside the debate as to whether the erosion hazard identified by the council was within the reasonable bounds of probability (and there was considerable debate on this issue), the risk, even should it eventuate, would largely be borne by people whose residences were on or close to the foreshore. Arguably, the risk of further erosion would mainly affect the individuals concerned in the sense their property values might decline and/or they would no longer be able to secure insurance, at least not without considerable cost. It is hard to see how such outcomes (even though unlikely) would involve adverse effects on external parties of such a magnitude as to justify the council's draconian response.[4]

3.47 The above is not to say there will not be instances where the risks are so great that there may be justification for restricting where development may occur, particularly if the costs cannot be internalized in the event of a natural event and where politically it becomes unrealistic for landowners to internalise all the costs. The key is providing as much information as possible for individuals and communities to make informed decisions as to the costs and benefits of taking particular action. The threshold for action needs to be set at a level which does not unnecessarily impinge on the rights of individuals to generally develop property in a way which meets their unique needs given the costs and benefits.

3.48 In general, however, there are strictly limited reasons why councils should be unnecessarily concerned about land use hazards provided the externalities associated with any adverse event are internalised as much as possible (for example, parties involved in building on flood plains being responsible for any adverse impacts associated with their behaviour).

3.49 This general principle has been upheld in a decision of Judge Jackson and Commissioner Manning in the case of *Otago Regional Council v Dunedin City Council and BS and RG Holt* [2010] NZEnvC 120 where essentially BS and RG Holt wished to build a house on land which could be prone to flooding:

> *'We have thought carefully about the way in which Mr and Mrs Holt have said they understand and will accept the risk of flooding of their property at 96 Stornoway Street, Karitane. We do not believe they are being foolhardy in proposing to build and live in a house on the property, but have assessed the probabilities rationally….. There comes a point where a consent authority should not be paternalistic (at least not under the RMA) but leave people to be responsible for themselves, provided that does not place the moral hazard of things going wrong on other people." (p.4)*

3.50 Given that land users largely internalise the costs and benefits of land use, the case for controls is weak, and will, as outlined above, have unintended

[4] It is understood that after much opposition, the Council has withdrawn its proposals.

consequences, particularly by adding to the cost of land and housing. This increased cost will ultimately be reflected in reduced economic growth, not to mention reduced housing affordability, with associated poverty implications.

3.51 BusinessNZ is also of the view that greater consideration should be given to the payment of compensation for loss of property rights and regulatory takings to ensure local and central government more fully consider the implications of unnecessarily restricting the use of property.

3.52 A fundamental principle on which a market economy (such as New Zealand) is based is that property owners (including businesses) have relative security in their property rights with the right to use their property in the manner they choose (while respecting the rights of other property owners).

3.53 Investors too must have confidence that any assets purchased or improved will be safe from confiscation and unreasonable restrictions, or alternatively, that they (the investors) will be compensated for any erosion of property rights. If this is not the case, there will be limited incentive for anyone to undertake long-term investment.

3.54 Property developers who see themselves as at the mercy of the territorial authority, with little guarantee of long term security in their investment, will have little incentive to invest in project development. And territorial authorities will have little incentive to investigate fully different housing affordability options; confiscating developers' land and money is an easy option.

3.55 The real danger is that regulators will minimise their own risks with little certainty the rules won't be changed down the track and at relatively short notice - hardly encouraging investment in building activity.

3.56 Apart from the Public Works Act, there is currently no allowance, other than in one or two specific instances, for the payment of compensation for regulatory takings (that is, where private property rights are reduced in the public interest).

3.57 Regulatory takings should not be legislatively condoned and an acknowledgment of the right to compensation is at the core of the property rights issue, with a general presumption property rights should not be diminished without compensation - a long-held view. The presumption of compensation is a vital check and balance for the economic system.

3.58 The need to compensate for regulatory takings is hardly new or novel in public policy terms. Over recent years the Crown, in the process of regulating private property rights in the public interest, *has* provided compensation, most notably in the areas of carbon emissions and fisheries management.

3.59 The compensation principle recognises that local democracy and the ability for local communities to make relevant choices are important but not costless.

3.60 Therefore, BusinessNZ considers Resource Management Act (RMA) provisions relating to compensation where property is taken, or its use or value is restricted, require strengthening (in the case of section 85, this means the *reversal* of the current presumption there be no compensation). Currently, compensation is the only relief available and at that, there is an exceedingly high threshold to be met. Compensation will be paid only if the taking or proposed taking would render the land incapable of reasonable use.

3.61 If local authorities were required to provide compensation for regulatory takings BusinessNZ would expect they would be more careful when regulating private interests in the public interest. Then, hopefully, the need for regulatory takings would be low, perhaps based initially on one or two test cases.

3.62 Compensation claims would need to rest on more than an assertion of impaired land use requiring evidence to support a claim of changed land use.

3.63 The claims' process would not be costless and both parties would have to assess the value of the compensation sought, the likelihood of gaining (or paying) compensation and the cost of participation. Rules such as requiring the losing party to pay the other's costs would help provide an incentive for claiming or opposing the compensation right.

3.64 Finally, BusinessNZ recognises that in some cases, the transaction costs of determining the winners and losers involved in a regulatory taking might be disproportionately high, making the payment of compensation impractical. This possibility reinforces the importance of having both a sound process (including robust decision-making requirements) and appeal rights.

<u>Question 9 (page 36):</u>

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?

<u>BusinessNZ Response:</u>

3.65 As the Issues Paper correctly states, the Local Government Cost Index (LGCI) has risen at a faster rate than the Consumers Price Index (CPI) over a number of years.

3.66 Detailed information on what is driving these discrepancies is something Local Government NZ is probably in the better position to provide but BusinessNZ would suggest a few factors might be at play, although we have no concrete evidence that in fact the following are driving cost increases.

3.67 First, it is possible the resources required by local government are not subject to the same degree of competition applying in respect to many everyday goods and services acquired or used by businesses and households in general (i.e. they may be of a more specialist, one-off nature).

3.68 Second, with local government's power to tax future ratepayers (i.e. guaranteed revenues via legislation), the incentive to monitor cost might not be as strong as it is for businesses facing a competitive environment where they are subject both to domestic and international competition.

3.69 Third, some local government councils could be locked into long-term arrangements as a means of better managing costs, even though such arrangements might not necessarily provide the best deal for ratepayers.

3.70 BusinessNZ would stress the above points are only suggestions for cost increases and are not based on actual case studies. But such factors need to be carefully investigated if key cost drivers are to be better understood.

<u>Question 10 (page 36):</u>

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

<u>BusinessNZ Response:</u>

3.71 No specific comment.

<u>Question 11 (page 38):</u>

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?

<u>BusinessNZ Response:</u>

3.72 The Local Government Business Forum (LGBF) commissioned a report on *"Local Government Role and Funding"* (April 2018) which found that:

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

3.73 Notwithstanding the above, the LGBF report noted that while this broadening scope is not the main driver of growth - many new growth areas are coming off a low base – it is nevertheless significant and ongoing.

3.74 To answer the second part of the question regarding the drivers of this shift, the LGBF report provided a number of reasons including: infrastructure demands, cost rises, central government requirements, inefficiencies, broadening scope and community expectations – all contributing to growing local government expenditure.

3.75 Finally, the question asks whether other parties can better provide for such activities.

3.76 The answer is not as simple of yes or no as it depends on the nature of the goods and whether they are largely public or private goods, as noted earlier in the submission's first section.

3.77 In general, goods and services of a private good nature can be best provided by the private sector. Public goods will more usually be underprovided by the private sector owing to an inability to extract payment from users (due to the non-excludability and non-rivalry in consumption associated with public goods).

3.78 BusinessNZ considers local government should focus on the provision of local public goods where their provision will likely be inadequate, there being little incentive for the private sector to provide goods and services for a low or in the worst case, non-existent, return on investment.

Question 12 (page 38):

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

BusinessNZ Response:

3.79 In short, yes. See BusinessNZ response to Question 6 (above).

Question 13 (page 38):

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

BusinessNZ Response:

3.80 BusinessNZ has nothing to add in response to this specific question. See responses to earlier questions, including specifically Questions 3,4,5,6 and 11.

<u>Question 14 (page 38):</u>

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

<u>BusinessNZ Response:</u>

3.81 While it is difficult to determine the future with any degree of accuracy, there is significant potential for technological advances to reduce the costs associated with local government and to allow much more efficient use of assets. For example, time of use data for water/electricity usage provides consumers with detailed costings of water use and a number of councils have introduced water metering as a consequence. This has provided significant benefits by delaying the need for new infrastructure and dams since consumers have a better understanding the costs and benefits of using the resource at specific times.

3.82 There is potential for much greater use of user-pays in respect to many resources provided by local government, as mentioned earlier in relation to tourism growth etc.

<u>Question 15 (page 41):</u>

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

<u>BusinessNZ Response:</u>

3.83 While BusinessNZ and the wider BusinessNZ family have submitted on a number of long-term plans both at the local and regional council level, it would be fair to say that in most cases the LTP process arrives at a foregone conclusion, there being little time for robust debate either orally or through the formal submission process. In BusinessNZ's experience, it is very much a rubber stamp process with marginal tweaks here and there and therefore likely to deter groups from spending time and effort making submissions.

<u>Question 16 (page 41):</u>

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

BusinessNZ Response:

3.84 See response to Question 15 (above).

Question 17 (page 41):

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

BusinessNZ Response:

3.85 In order to improve processes, it is necessary and desirable to have a robust debate over the types of activities councils are involved in, including whether these meet the criteria of local public goods, and with input not only from users but from the goods' principal funders.

3.86 As this submission has noted, businesses pay a disproportionate share of the rates burden.

Question 18 (page 42):

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

BusinessNZ Response:

3.87 There is considerable scope for local government to manage cost pressures by managing assets and delivering services more efficiently.

3.88 There are three key areas that could significantly improve cost pressures.

3.89 First, greater aggregation and sharing of local government resources across local and regional boundaries, thereby achieving greater economies of scale. Second, greater use of user-pays principles to send users of services clear signals (in real time) as to the cost associated with the provision of certain goods and services, thereby limiting overall costs to wider ratepayers. Third, the divestment or recycling of assets.

3.90 Dealing with each issue in turn.

Economies of scale

3.91 In many cases the greater aggregation of resources across local and regional council boundaries could result in better resource use. For example, in the case of water supplies, it seems absurd for most councils to have their own system despite the logic of combining resources in service provision.

3.92 Achieving greater resource efficiency for a resource such as water is likely to involve political considerations with who pays and asset valuation of significance for some councils. Furthermore, a concern over loss of local control will probably also make some smaller councils nervous. The current government, it is noted, is considering options for the better use of natural resources across local council boundaries.

User charges

3.93 Charging for the use of private goods and services would also bring greater efficiencies. For example, paying for waste disposal out of general rates and supplying every ratepayer with a rubbish disposal bin takes no account of the amount of rubbish ratepayers generate. This could actively encourage waste generation because effective cross-subsidisation means the full costs of waste disposal are not sheeted home. Water, as indicated, is another good example of clear user-pays pricing principles encouraging greater efficiencies.

3.94 While some councils charge for water and waste on a user-pays basis, many still fund such activities out of general rates, sending strictly limited signals to consumers as to the real costs associated with their behaviour.

3.95 There is also greater scope for the government and councils to use toll roads or bridges and cost-reflective pricing for water infrastructure.

Divestment or recycling assets

3.96 The previous Government successfully partially privatised its power generation assets but still owns many more. In many cases councils own assets that could be sold or partially sold for the building of new infrastructure. Shares in council-owned assets could be sold to pay for urgently needed infrastructure, recycling one asset into another, higher priority asset.

3.97 While a number of councils obtain significant investment income from revenue-generating assets, the justification for continued local authority ownership is weak. Some councils try to justify their exposure as a mechanism to reduce the general rates burden but the exposure potentially puts ratepayers at risk should returns on assets be less than expectations. It also raises the problem of funding expansion for local authority-owned assets, with a potential tension between a council's desire for investment returns in the form of dividends and a company's asset base need for reinvestment and growth. Moreover, given that in general private sector companies out-perform state-owned companies, logically, the private sector should be prepared to offer a premium on the current valuation of many local authority assets; hence ratepayers would receive a windfall gain from asset sales.

3.98 Arguably, local government can obtain debt funding at lower rates than some private sector participants but this does not justify local government involvement in the provision of private good infrastructure. Lower funding rates generally reflect a lower risk because ultimately local authorities can call on their ratepayers either to fund any shortfall or to carry the risk of low investment returns. It is important to accept that local authority funding does not eliminate risk but transfers it from the private sector (which is often better placed to manage risk) to ratepayers.

3.99 There would appear to be significant scope for councils to divest themselves of a number of commercial businesses where there is no sound continuing rationale for ratepayer ownership e.g. electricity lines businesses, airports and ports. This would free up significant funds either as returns to shareholders (i.e. ratepayers) or to invest in core local public goods activity. The difficult part is encouraging local councils to give up their commercial activities voluntarily, without either covert or overt pressure from central government.

Question 19 (page 42):

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?

BusinessNZ Response:

3.100 While a few councils have moved towards greater use of user-pays principles for some resource use (e.g. in respect to water) such moves have not been widespread. Given the general public's reluctance to openly embrace user-pays principles for goods such as water (falsely assumed to be 'free' despite being paid for through general rates), the politics have made progress difficult in many cases.

Question 20 (page 42):

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?

BusinessNZ Response:

3.101 A number of councils have introduced volumetric charging for water use and smart meters for electricity. This has had a significant impact, allowing for significant cost savings by delaying infrastructure upgrades and the need for new expanded infrastructure.

3.102 The effectiveness of councils in using new technologies to manage infrastructure assets has, however, varied; some have been proactive while others have succumbed to political pressure and largely retained the status quo in respect to pricing and asset management.

Question 21 (page 42):

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

BusinessNZ Response:

3.103 Arguably, cost pressures on ratepayers are likely to drive incentives on elected councils to improve productivity. Given local government, like central government, has the power to tax, incentives for improving productivity are likely to be strictly limited.

3.104 A range of measures could be used to strengthen local governments' incentive to improve productivity.

3.105 First, unlike central government where expenditure is often scrutinised by government departments (e.g. Treasury as a gatekeeper), local government is not necessarily subject to similar scrutiny.

3.106 Perhaps the use of a Regulatory Responsibility Act (for both central and local government) would be a good starting point, requiring local government to abide by a sound set of principles before deciding to undertake a particular activity and/or develop infrastructure.

3.107 Second, constraining what it can and should do is likely to be another effective tool for ensuring local government focuses on key core activities rather than provides 'nice to haves' paid for by local ratepayers. The expansion of the purpose statement of the Local Government Act to include the four well-beings can be considered a backward step in this respect.

3.108 Third, benchmarking activity and costs associated with local government service provision (an 'honours board') could provide local government with an impetus to improve performance.

3.109 Fourth, there might be scope to allow local councils to achieve outcomes which do not necessarily fit within the regimented requirements of legislation. For example, provided the base minimum required to ensure public health and safety is achieved, arguably local government should be allowed to provide goods and services that meet the needs and aspirations of their local community. Too often, centrally regulated requirements may not fit with a local community's expectations and ability to fund, particularly where a smaller community is quite capable of making its own trade-offs.

3.110 However, implementing the above could be difficult and significant monitoring of local councils might be required. Also, having markedly different requirements and/or laws across the country could potentially create an even greater problem requiring households, and particularly businesses, to deal with varying approaches to issues across local and regional council boundaries, although it could be argued that in respect to a number of issues this is already the case.

3.111 Fifth, some people have suggested that with some sort of revenue sharing arrangement (e.g. local income tax or share of GST etc) between central and local government local productivity performance might improve. While superficially appealing on a conceptual basis, BusinessNZ is not in favour of this approach for a range of reasons.

3.112 A local income or consumption tax would be heavily discounted as it would involve identifying the area in which individuals and businesses earn their income - well-nigh impossible given the many complex business arrangements entered into by both businesses and individual ratepayers. Moreover, local income or consumption taxes might have little relationship to the amount of goods or services consumed via local government.

3.113 Another option various groups and organisations promote is that local government should, both as a funding mechanism and to incentivise the issue of consents, move towards receiving a partial share of any royalty payments. The BusinessNZ Energy Council considers this has significant risks *(see p21-22 under "Should local authorities have a prior claim on exploration royalties".* http://www.bec.org.nz/__data/assets/pdf_file/0005/89420/BusinessNZ-Energy-Council-Energy-Briefing-2014.pdf

3.114 The BusinessNZ Energy Council publication found that: *"On the face of it, the case for such a diversion of monies is seductive….However, there are also reasons not to support it."* BusinessNZ urges policy makers to consider carefully the implications of pursuing a local share of royalties' solution given the issues outlined in the BusinessNZ Energy Council's publication.

<u>Question 22 (page 43):</u>

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

<u>BusinessNZ Response:</u>

3.115 Local government's role is not clear so the signals regarding what councils should be delivering for local residents and businesses and what should be left to the private sector are blunted.

3.116 Further, political imperatives override sound decision-making. A key issue facing local government decision-making is the number of vested interest groups with strong incentives to retain the status quo.

<u>Question 23 (page 43):</u>

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

<u>BusinessNZ Response:</u>

3.117 No specific comment.

<u>Question 24 (page 43):</u>

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

<u>BusinessNZ Response:</u>

3.118 No specific comment.

<u>Question 25 (page 43):</u>

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

<u>BusinessNZ Response:</u>

3.119 No specific comment.

Question 26 (page 44):

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

BusinessNZ Response:

3.120 Local government uses a range of measures to control the costs facing particular groups, although the measures are problematic to say the least.

3.121 Councils should not be in the business of income redistribution. Unlike central government (with the information it has through income tax), local authorities have no information on residents' incomes so any decisions made to assist people in this regard will inevitably be flawed. If the Government wishes to provide relief through a rates rebate scheme, then this should be administered centrally through Work and Income rather than by councils.

3.122 While the motivation for a rates rebate scheme is clearly understood, the wider business community is generally concerned the scheme can be only a short-term stop-gap measure. It would not effectively address the real issue: protecting people from an ever-growing rates burden.

3.123 Clearly the focus needs to shift to ensuring local authorities contain their rate rises by focusing on their core business, having activities funded by those who benefit from them, and providing ratepayers with transparent information.

3.124 In respect to rates remission and postponement notices, it is understood that while most local authorities offer some kind of rates postponement options, the number of ratepayers currently postponing their rates is low.

3.125 While conceptually BusinessNZ is not opposed to the use of rates postponement options, we question the need for activity of this sort to be undertaken by local authorities rather than by the private sector through reverse mortgages and the like. Increasingly, the private sector is providing this type of arrangement for those who are effectively asset rich but income poor, as a means of ensuring people can continue to live in their family home while being aware the payments are a debt against their property or assets.

3.126 As stated above, BusinessNZ sees some merit in the greater use of relatively new financial instruments such as reverse mortgages or home equity conversions as a way of enabling people on lower incomes, but with an asset base, to deal with the many cost pressures affecting them.

3.127 However, given a noticeable reluctance to adopt reverse mortgages (for a number of reasons), it might be desirable to market these to the general public as mechanisms for shifting expenditure and revenue streams over time. But apart from providing general advice to ratepayers, BusinessNZ does not see this as a core role for councils; councils should not become involved in the process of setting up reverse mortgages and the like. Private sector institutions, mainly banks, are in a much better position to market and manage such instruments.

3.128 Whether increasing numbers of people buy-in to rates postponement will depend on several factors, including: ratepayers' current and future income and assets, the cost of delaying payment as opposed to up-front pay-as-you-go, household responsiveness to risk, financial literacy and the threshold criteria for postponements. It is quite likely, given the competitive nature of financial markets, new and innovative products capable of meeting consumers' needs will come on to the market in due course. Therefore it is possible that in time many more people will look to different payment options, depending on their particular circumstances.

3.129 Differential rating and sometimes targeted rating (generally with businesses paying a disproportionate share of the rates burden), are other mechanisms which unfairly penalise business owners, the former widely-used.

3.130 Differential and targeted rating are acceptable where a clearly identified community (such as a remote rural area) is provided with a distinctly different level of public goods from other ratepayers and the differential or targeted tax reflects the difference in the level of services supplied. There should also be an objective test for benefits received to ensure a consistency of approach. However, rates differentials, if used at all, should be used sparingly not, as some councils have done, as a general revenue raising device on unprincipled and unsubstantiated grounds.

3.131 Sometimes differential rating is applied to the business sector on the basis the business sector benefits proportionately more from council services. Such a conclusion is often groundless, yet councils continue to apply significant differentials simply because they can, not on any principled economic basis. Where councils have agreed to reduce such differentials, they have generally proceeded to do so at a snail's pace, being mindful not to upset the majority of residential ratepayers who enjoy the advantages of a lower rates burden courtesy of the business sector.

3.132 In the past, a number of people have argued (and many still do) that businesses are advantaged relative to residential ratepayers because they can deduct rates for income tax purposes and claim a credit for the GST paid on them. These claims have been discredited by reputable economists for the following reasons. First, a firm can only claim a tax deduction for rates because its income is subject to tax and nobody could seriously argue it is an advantage to be subject to income tax. Second, a GST registered person or firm can claim a credit for GST paid on inputs because supplies (outputs) are subject to GST. But as the net GST collected is paid to Inland Revenue, businesses get no advantage.

3.133 BusinessNZ remains concerned about targeted rates (taxes) mainly because there is a danger these can be used as another simple way of raising needed revenue without taking into account whether the "user" of those services is paying.

3.134 There might be cases where levying additional rates (taxes) on a particular class of ratepayers is appropriate, for example, where specific local public goods benefit a clearly defined subset of ratepayers such as schemes to control floods. However, for such taxes to be justified on both economic efficiency and equity grounds, the target group must be clearly identified and share equally in the benefits. And ideally, the group's consent should be sought before any targeted taxes are considered. More importantly, targeted taxes should not tap into previously untapped pockets of revenue-raising potential – a distinct danger without clear controls on when and how such tools are to be used.

Question 27 (page 45):

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

BusinessNZ Response:

3.135 See response to Question 26 (above).

Question 28 (page 47):

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?

BusinessNZ Response:

3.136 See response to Questions 26 (above).

3.137 In addition to the comments made above, there are a number of other mechanisms that could also be looked at.

3.138 While BusinessNZ supports much greater use of user-charges where practicable, there is scope for increasing, if not completely removing, the 30% cap on the Uniform Annual General Charge (UAGC). It is noted that use of the UCGC varies widely across the country with some councils utilising it to the full 30% provided for and others not using it at all.

3.139 Greater use of user charges for most service provision might lessen current concerns about the UAGC. Some councils do not fully use the existing cap, sending distorted signals to ratepayers about the costs associated with the provision of services to, and the benefits received by, individual households.

Question 29 (page 47):

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?

BusinessNZ Response:

3.140 No specific comment.

Question 30 (page 49):

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-off across these principles?

BusinessNZ Response:

3.141 Councils should arguably receive better guidance on the use of available funding tools to ensure greater consistency across the country, underpinned by an economically principled approach to funding council activities. There should also be greater clarity in distinguishing among the following:

a. *Appropriate pricing and user charges for local authority services.* Charging for the use of private goods and services would bring greater efficiencies. Some councils charge for water and waste on a user-pays basis but many still fund such activities out of general rates, sending strictly limited signals to consumers as to the real costs of their behaviour.

b. *Taxes imposed on a subset of a local authority's ratepayers to fund local public goods of clear benefit to subset members.* There may be isolated cases where levying additional rates (taxes) on a particular class of ratepayers is appropriate, for example, where specific local public goods benefit a clearly defined subset of ratepayers such as schemes to control floods.

c. *An appropriate tax to fund local public goods of benefit to all residents.* The administrative costs of council operations could fall into this category, along with the cost of other public goods such as footpaths and street lighting.

d. *Charges justified as internalising external costs imposed on people or firms.* For example, these could include emission charges.

<u>Question 31 (page 50)</u>

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

<u>BusinessNZ Response:</u>

3.142 See response to Question 26 (above).

3.143 In broad terms, the use of funding tools is very much a mixed bag across the country.

<u>Question 32 (page 50)</u>

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?

<u>BusinessNZ Response:</u>

3.144 See response to Question 26 (above).

<u>Question 33 (page 50)</u>

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?

<u>BusinessNZ Response:</u>

3.145 See response to Question 30.

3.146 There are pros and cons associated with capital value rating as well as land value rating. Both have significant weaknesses, hence BusinessNZ's generally held position that wherever practicable, greater use of user-pays principles so the costs and benefits of resource use are internalised to the users of those services.

3.147 Both capital value and land value often bear little relationship to the costs imposed on local government services. Perhaps the classic example often correctly promoted by agricultural interests, is rural land.

3.148 Particular parcels of land may be valued highly but this often bears little relationship to the costs the owners of that land impose on local government nor necessarily does land (or capital value) have much relationship to the ability to pay rates etc. Both have considerable downsides, hence

BusinessNZ's support for greater use of user-pays principles and for increasing, if not completely removing, the 30% cap on the Uniform Annual General Charge (UAGC).

Question 34 (page 51)

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?

BusinessNZ Response:

3.149 In addition to the comments made earlier on targeted rates and user charges, BusinessNZ is seriously concerned about the Issues Paper's proposal to develop new tools to address 'Value Capture' (i.e. where increases in land values generated by public action such as investments in infrastructure directly benefit private landowners). Currently, councils can use targeted rates to capture this benefit indirectly.

3.150 Policy makers need to be very clear to differentiate between property rights adversely affected by government or local government action and acts of nature or people's changing preferences which might similarly affect land values. The latter effect has been visible of late in a number of areas in NZ which, almost overnight, have become 'trendy' with people prepared to pay significant amounts of money to buy land or houses.

3.151 It is nonsense to assume that if a railway station is established very close to someone's house the person concerned will receive a direct benefit and therefore have an enhanced property right. The assumption is that nearby rail transport will automatically be used and that is not necessarily the case. It might equally be claimed that someone who dislikes skateboarding but is able to walk to a local, rate-payer funded, skate board park also receives a benefit requiring a contribution to the cost. But what constitutes a benefit is in the eye of the beholder.

3.152 Identifying which properties will benefit from council investment is no easy task since whatever is decided on will likely conflict directly with individual values – that is, with what is valued and what is not. For example, a flood prevention rate targeted to a clearly identified group of ratepayers can be considered relatively straight forward and appropriate. But trying to put a value on the change in land values as a result of an infrastructure upgrade would be extremely difficult, taking no account of individual preferences. For example, a reasonably recent council road extension in Churton Park (Westchester Drive Extension), Wellington, saw the residents of a nearby street, for a variety of reasons, either strongly supporting, strongly opposing or neutral to the extension proposal. Similarly with a private sector (New World) investment decision in the same area – with no council funding involved. Whether individuals consider they benefit from or are disadvantaged by such developments will inevitably vary, although on the margin at least, associated land prices will more probably have gone up rather than down.

3.153 Land values will likely be tied in to much more than the provision of council (or publicly) funded infrastructure and where people choose to live will be based on a number of factors that might or might not be related to specific infrastructure provision (apart perhaps, from obvious services such as sewerage and water).

3.154 Except where everyone benefits (as in the flood control scheme), the council investment approach suggested in the report raises real issues as to where the boundaries of any council scheme should start and end. The result could be the promotion of public infrastructure which many of those affected would not support. Consider the numerous activities in which councils are currently involved, cycleways are a case in point.

3.155 There could be specific, isolated cases where land prices radically increase as a result of public investment in infrastructure but BusinessNZ would caution against using any such proposal without rigorous analysis of the overall costs and benefits. This is particularly pertinent if councils have a relatively free rein when deciding what to be involved with. Just about every investment decision will have some impact on land values but this does not justify using targeted rates as a mechanism to extract money from householders who personally see little or no value in the particular development.

3.156 At its worst, an investment proposal could be seen as an easy funding mechanism for councils wanting to involve themselves in all sorts of projects which do not necessarily meet a rigorous public goods test – or if they do – are not necessarily sought (and happily paid for) by ratepayers.

<u>Question 35 (page 52)</u>

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?

<u>BusinessNZ Response:</u>

3.157 While local government, like central government, has the power to tax future ratepayers, there is arguably a case for greater use of debt instruments to spread costs associated with long-life investments.

3.158 By most standards, local government debt, on average, is still relatively low (compared with the asset base), and combined with the power to tax, use of debt should be more prevalent than is currently the case, provided the debt is covering core assets that local government should be involved in, such as water and waste.

3.159 A number of reports, as far back as the Shand Report, have suggested councils could make greater use of debt than was the case then (and arguably is still the case today).

3.160 A number of other concepts are being touted around at the moment, including the use of infrastructure bonds as a mechanism for spreading the costs of major infrastructure over time. Indeed, the Hon Phil Twyford suggested a similar concept in relation to paying the development costs of new housing subdivisions. He proposed costs should ideally be spread over a property's lifetime rather than the developer having to fund them up-front and immediately passing them on to the new home owner. Bonds issued over say a 50-year period for development costs would be spread over the lifetime of a house with householders paying back the interest and capital costs over that period (more or less). Given the security of such bonds, it is likely finance could be sourced at relatively low rates.

Question 36 (page 52)

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?

BusinessNZ Response:

3.161 On the positive side, property rates, while in many cases very distortionary, are an easy way of raising required revenue (from a purely administrative/practical point of view).

3.162 On the downside, see response to Question 33 (above).

3.163 Property rates often have little relationship to the amount of goods or services consumed within a district. The impact of tourism growth in certain regions (with small councils) is an example of this.

3.164 Property rates are largely no longer fit for purpose but are likely still to remain a significant source of council income for the foreseeable future.

Question 37 (page 53)

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

BusinessNZ Response:

3.165 There are a number of instances where central government imposes costs on local government without taking into account the full ramifications of its actions. One response might be to require central government to pay compensation to local government for the costs associated with what are seen as inappropriate controls or where local ratepayers receive little or no benefit. As stated earlier, BusinessNZ is not averse to considering such an option although our clearly preferred approach would be to ensure that central government adopts a principled Regulatory Responsibility Act (RRA), minimising the risk of inappropriate regulations and controls. However, in the absence of any central government desire to implement such an Act, BusinessNZ would support further consideration of a 'compensation' regime for local government.

3.166 BusinessNZ believes the following principles and should be ingrained in central government policy development, namely:

- Local government will be consulted on all proposals and their cost implications and the cost benefit analysis will cover the costs and benefits for local government; and
- Where a policy is intended to generate national as well as local benefits (or generates only national benefits and no local benefits) central government will provide councils with a proportionate amount of co-funding in order to meet implementation costs.

Question 38 (page 54)

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?

BusinessNZ Response:

3.167 Rather than asking if local authorities have sufficient financial incentives to accommodate economic and population growth, the better question would be: what constraints on local government are inhibiting economic and population growth?

3.168 With growth constraints, financing is not necessarily the issue but rather the myriad of central and local government controls on what can and cannot be developed.

3.169 Looking at population growth for example, town boundaries still have significant implications for the price of land and together with councils' own rules about the size of building platforms/type of materials used etc., (including massive and complex planning rules and regulations and associated appeal rights) seriously undermine the ability of individuals, businesses and developers to proceed with major projects. Yes, funding is an issue but more important are the unjustified regulatory constraints on activities that can be provided for and over what time period. One can have some sympathy for councils who find things all too hard.

3.170 As mentioned earlier, as a general principle, individuals and companies should bear the full cost of their behaviour (i.e. cost should be internalised). Over-consumption of resources is always likely if the cost can be shifted on to third parties. Management of land use - and risk – is no different. If individuals and companies are to make rational decisions about land use, they should ideally bear the cost (and benefits) associated with specific options/outcomes. If, on the other hand, individuals and companies are forced to pay a greater amount than any cost they impose, the outcome will either be a more expensive product and/or reduced commercial activity, with associated flow-on implications for employment etc.

3.171 In short, removing regulatory barriers is likely to be much more important to ensuring economic and population growth than funding mechanisms per se, particularly if the private sector sees merit in a particular development and hence will be likely to fund the activity if it makes commercial sense.

Question 39 (page 55)

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?

BusinessNZ Response:

3.172 One option to better control mentioned earlier in this submission is to allow communities, where possible, to make trade-offs between service quantity/quality based own their own community's needs.

3.173 There has been a tendency for central government to impose undue costs on local government based on a-one-size-fits-all approach rather than being cognisant of the trade-offs individual communities are willing to make.

3.174 For example, some rural businesses may be prepared to adopt effective risk-management tools to deal with occurrences such as electricity outages, water shortages and the like, based on robust data about the costs and benefits of alternative options.

3.175 Where possible, councils need to consult with their communities of interest as to the potential trade-offs involved in different options, including potentially exiting the supply of certain services if the costs are prohibitive. Potentially gifting assets to local communities to manage/control/fund might also be a viable option in some cases.

3.176 While there is a risk associated with this approach (in terms of consistency of service), this has to be considered alongside the potential benefits of lower cost for those individuals living in areas where population decline is an issue.

Question 40 (page 55)

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?

BusinessNZ Response:

3.177 See response to Question 39 (above).

Question 41 (page 58)

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

BusinessNZ Response:

3.178 As mentioned earlier, one of the key problems associated with local income and expenditure taxes is that they can bear little, if any, relationship to the costs to local government of providing core local public goods.

3.179 If such taxes are to work, there must be an assumption they will closely mirror local government costs.

3.180 BusinessNZ notes the third report of the Local Authority Funding Project team *Alternative Tax Bases for Local Government*[5], looked at a number of options other than current rates (property based) taxes including:

- A local income tax
- Local consumption tax
- Industry and commodity-specific taxation
- Citizen's tax (poll tax)
- Payroll tax

3.181 The funding Project team concluded: "*...none of the alternatives provide a clear and compelling alternative to property taxation as a means of funding a local government that has traditionally had a high level of autonomy and a high level of accountability to its communities." (p.32)*

[5] *Alternative Tax Bases for Local Government,* third report of the Local Authority Funding Project Team, December 2006, p 32.

3.182 All the suggested mechanisms have inherent weaknesses. A local income or consumption tax would be heavily discounted since it would mean identifying the areas in which individuals and businesses earn their income. This would be well-nigh impossible given the many complex business arrangements into which both businesses and individual ratepayers enter. Moreover, low income or consumption taxes might have little relationship to the amount of goods or services consumed via local government.

3.183 Industry or specific-commodity taxes (such as 'bed taxes') are inherently distortionary since often there is little or no relationship between the 'payer' and the alleged benefits received.

3.184 The history of poll taxes suggests they are highly unpalatable. There would not only be practical enforcement and fairness difficulties but the late 1980s' UK experience showed them to be notably unpopular. Poll taxes often provide a very poor indication of the actual use of central or local government services or of ability or willingness to pay. However, people-based payments might be appropriate where the goods and services provided benefit every citizen e.g. local government administration.

3.185 Payroll taxes are inherently distortionary, targeting only one aspect of production – labour. A report prepared for Business NZ[6] found that:

"[A payroll tax]…would distort the economy by making one factor relatively more expensive i.e. labour, and with this distortion comes deadweight losses to the economy. The size of this deadweight loss may be considerable since this tax would be across the entire New Zealand labour market. Thus, although the government may aim for it to be revenue neutral, they should consider the indirect deadweight losses within this decision. The deadweight losses come from reduced efficiency of markets, artificially high labour costs, which will lead to capital being substituted for labour, higher administrative costs, and knocking marginal companies out of business." (p.3)

3.186 In addition, a payroll tax would be a highly targeted tax based on salary and wages, with no relationship at all to the consumption of local government goods and services. It would penalise wage and salary earners while other potentially asset-rich ratepayers would be exempt.

3.187 As to land taxes, BusinessNZ notes that a land tax is nothing new. NZ had such a tax up until 1992 but with considerable exemptions so only a small group of taxpayers was affected and the tax was highly distortionary. Like a capital gains tax (CGT), the temptation to grant exemptions over time is often politically hard to ignore, potentially undermining the benefits associated with any comprehensive form of land tax.

[6] Is there a case for a payroll tax? Report to BusinessNZ by Business and Economic Research Ltd (BERL) February 2006

3.188 Another option promoted by various groups and organisations is for local government to move to receiving a partial share of any royalty payments both as a funding mechanism and to incentivise the issue of consents. The BusinessNZ Energy Council considers this has significant risks *(see p21-22 under "Should local authorities have a prior claim on exploration royalties".)* http://www.bec.org.nz/__data/assets/pdf_file/0005/89420/BusinessNZ-Energy-Council-Energy-Briefing-2014.pdf

3.189 The publication found that: *"On the face of it, the case for such a diversion of monies is seductive….However, there are also reasons not to support it."* BusinessNZ urges policy makers to consider carefully the implications of pursuing a local share of royalties' solution given the issues outlined in the BusinessNZ Energy Council publication referred to above.

<u>Question 42 (page 56)</u>

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

<u>BusinessNZ Response:</u>

3.190 No specific comment.

<u>Question 43 (page 57)</u>

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

<u>BusinessNZ Response:</u>

3.191 No specific comment.

<u>Question 44 (page 57)</u>

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

<u>BusinessNZ Response:</u>

3.192 No specific comment.

Question 45 (page 57)

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

BusinessNZ Response:

3.193 As both this paper (as stated earlier) and the Issues Paper note, the funding pressures facing local government differ widely depending both on population growth (or decline), size of council and pressures such as tourism. Therefore the need for variable funding tools and arrangements will inevitably differ.

3.194 Notwithstanding the above comments, BusinessNZ would also point to the need for greater consistency in approaching various funding options across the country as outlined in the response to Question 30. For ease of reference this is repeated here:

"Councils should arguably receive better guidance on the use of available funding tools to ensure greater consistency across the country, underpinned by an economically principled approach to funding council activities. There should also be greater clarity in distinguishing among the following:

*a. **Appropriate pricing and user charges for local authority services.** Charging for the use of private goods and services would bring greater efficiencies. For example, while some councils charge for water and waste on a user-pays basis, many still fund such activities out of general rates, sending strictly limited signals to consumers as to the real costs associated with their behaviour.*

*b. **Taxes imposed on a subset of a local authority's ratepayers to fund local public goods of clear benefit to subset members.** There may be isolated cases where levying additional rates (taxes) on a particular class of ratepayers is appropriate, for example, where specific local public goods benefit a clearly defined subset of ratepayers such as schemes to control floods.*

*c. **An appropriate tax to fund local public goods of benefit to all residents.** The administrative costs of council operations could fall into this category, along with other public goods such as footpaths and street lighting.*

*d. **Charges justified as internalising external costs imposed on people or firms.** For example, these could include emission charges."*

Question 46 (page 59)

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?

BusinessNZ Response:

3.195 While financial barriers are likely to be an issue in some cases (e.g. political aversion to debt), arguably the ability to deliver local infrastructure and services is more adversely affected by regulatory barriers.

3.196 The almost unlimited ability of individuals, households and businesses to object to almost any new development creates perverse incentives on both local government and businesses in trying to improve infrastructure.

3.197 Stripping away regulatory barriers is probably even more important for growth and development than the removal of financing barriers.

Question 47 (page 60)

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?

BusinessNZ Response:

3.198 The public-private partnership (PPP) model is well-suited to meeting infrastructure needs – private partners can cover a project's upfront costs while recovering them over time from those who use the outcome. Consideration should be given to greater private sector participation in infrastructure development, operation and service provision.

3.199 Other options could include greater use of council balance sheets to fund new expenditure. It appears councils are currently constrained from debt financing where a local authority owns the infrastructure. In such cases new infrastructure can be debt-funded only on the basis of a multiple of existing income. But the development of long-life assets is not necessarily constrained to the same degree if infrastructure is in a Council Controlled Trading Organisation (CCTO) or other commercial structure.

3.200 It might also be possible to provide for more of what are in effect, 'government to government' joint funding initiatives, where assets are transferred between government agencies to boost balance sheets, e.g. the Accident Compensation Corporation (ACC) and the New Zealand Superfund purchasing a stake in KiwiBank. It is possible some local government assets would be commercially acceptable to private sector investors. But given general public resistance and the Government's effective commitment to no more substantial asset sales, government to government transfer might be an alternative mechanism officials could explore further.

Question 48 (page 61)

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

3.201 BusinessNZ would require more information and examples of how tax increment financing would work before making any detailed comments on the matter. Obviously we would be concerned if the result were a further decoupling of funders and beneficiaries associated with particular investments.

Question 49 (page 61)

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?

BusinessNZ Response:

3.202 As mentioned in the Issues Paper, there are accountabilities and requirements for local government revenue raising and expenditure.

3.203 BusinessNZ supports the use of financial prudence regulations and a requirement for councils to report against the regulations. It is useful for central government to be able to intervene in certain circumstances.

3.204 Notwithstanding the above comments, BusinessNZ would also point to the need for councils to receive better guidance on the use of available funding tools to ensure greater consistency across the country, underpinned by an economically principled approach to the funding of council activities.

APPENDIX 1

Promoting New Zealand's success through sustainable market-led growth

BusinessNZ is New Zealand's largest business advocacy body, representing the majority of New Zealand private sector companies as members, affiliates or through membership of BusinessNZ divisions such as the Major Companies Group, ExportNZ, ManufacturingNZ, Sustainable Business Council and Buy NZ Made.

BusinessNZ represents around 14,000 businesses that are members of four regional business organisations:

Employers & Manufacturers Association *(EMA) - northern half of North Island*
Business Central *- central region*
Canterbury Employers' Chamber of Commerce *(CECC)*
Otago-Southland Employers' Association *(OSEA)*

BusinessNZ's **Major Companies Group** *(MCG) works with and represents around 80 of New Zealand's largest companies.*

ExportNZ *and* **ManufacturingNZ** *work with and advocate for New Zealand exporters and manufacturers.*

The **Sustainable Business Council** *(SBC) provides mainstream leadership on sustainable business matters.*

The **BusinessNZ Energy Council** *(BEC) is a group of New Zealand organisations taking on a leading role in creating a sustainable energy future for New Zealand.*

The *Buy NZ Made* Campaign encourages consumers and organisations to help create local jobs and growth by buying New Zealand goods and services.

BusinessNZ's *Affiliated Industries Group* (AIG) is a grouping of 75 industry associations affiliated to BusinessNZ that work together on pan-industry issues.