
LOCAL GOVERNMENT IN NEW ZEALAND

AN OVERVIEW OF ECONOMIC AND
FINANCIAL ISSUES

NEW ZEALAND BUSINESS ROUNDTABLE

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EXECUTIVE SUMMARY

Local government is an important sector of the New Zealand economy. It accounts for over 3 percent of GDP and employs about 36,800 people. In terms of income, expenditure and assets many councils rank with New Zealand's largest business enterprises. Moreover, regulatory functions undertaken by local government have a significant effect on community welfare.

The local government sector includes regional and territorial authorities, as well as the trading operations owned within the sector such as energy, bus, port and airport companies. A diverse range of goods and services is produced by local government. Typical core activities of territorial authorities are road maintenance and construction; drainage services; sewage reticulation, treatment and disposal; provision of carparks, libraries, art galleries, recreation facilities (such as sportsfields, playgrounds and parks); and civil defence. In addition, local authorities frame or administer many bylaws or regulations, particularly in relation to resource management, building and health matters. Regional councils are primarily regulatory agencies whereas territorial authorities (city and district councils) undertake regulatory functions and provide other services.

The role of local government is devolved from that of central government. Parliament is sovereign, and local government may perform only those functions explicitly allocated to it by legislation or implied as reasonably necessary or incidental to the performance of its expressed functions. However, it is not appropriate to view local government as an agent of central government. Local authorities are separate government entities which are accountable to local electors rather than to central government.

There are economic advantages in undertaking some government functions locally. Local government may possess better information on the costs and benefits of local services than central government. Furthermore, where the costs and benefits of government activity mostly affect specific regions, cities or districts, local electors generally face superior incentives to take sound decisions. These observations apply both to the provision of goods and services and to regulatory activities.

The advantages of local decision making need to be set against the potential weaknesses of local government. In the past there may have been weaker

accountability and less transparency of decisions in some local authorities than was the case in central government. Limitations on the activities that local government could undertake and on its borrowing powers possibly reflected this perception. Many recent reforms, for example the amalgamation of numerous special purpose authorities and the requirement to publish detailed annual plans and reports, were motivated by a desire to make local government more transparent and accountable to local electors.

Considerable changes to local government have been implemented since 1987. The functions of regional and territorial authorities have been clarified and the sector has been extensively reorganised. Most special purpose authorities have been absorbed by territorial and regional councils, while territorial authorities have been expanded by amalgamation. A few local government trading activities have been sold and some have been corporatised. In addition, port, airport, bus and energy companies have been corporatised under specific legislation. The reforms have improved substantially the quality of financial and other information which is available to electors.

Local government has been encouraged to become more efficient. Certain business activities undertaken by local authorities have been subjected to commercial disciplines to a greater extent than previously, with gains in operating efficiencies. Local authorities have contracted with the private sector for the supply of some services that they previously produced themselves. Public transport, road construction and maintenance, refuse collection, park maintenance and regulatory activities have been affected by these developments.

There is, however, substantial room for further improvement in the efficiency of local government. Most councils, particularly larger city councils, have not undertaken a sufficiently rigorous examination of their proper role. Many activities cannot be justified in terms of standard criteria for government intervention in the economy and where local government action is desirable, its current form is often inappropriate.

Local authorities continue to hold interests in a large number of commercial enterprises such as forestry, quarries, refuse collection and disposal facilities, rental housing, commercial property development, off-street parking, ports, airports, energy supply and transport operations. There are no compelling grounds for local government to engage in these activities and there is substantial evidence that public ownership of commercial businesses is less efficient than private ownership. Subject to the resolution of any outstanding regulatory issues, local government interests in commercial businesses and activities should be sold. While some progress has been made in recent years, a much faster programme of privatisation is desirable to free

resources for private sector growth, reduce ratepayer risk and increase national income.

Local government services are commonly subject to inadequate competition. Local authorities are often the sole suppliers of services or their output is highly subsidised, thereby discouraging private providers from competing. Competition, including a genuine threat of competition, is essential to focus suppliers on satisfying consumers, containing costs and innovating.

Where there are valid grounds for government intervention, local authorities should facilitate competition by contracting for a wide range of services. The right to supply core services such as roading, water supply and sewage reticulation could be subject to competitive tender on a regular basis. Services could be supplied under a franchise arrangement as is the case with reticulated gas. The local authority's role would be to arrange for the supply of services and monitor whether suppliers were meeting their obligations.

Alternatively, maintenance, new work and other services, including operations such as the collection of rates, could be handled under contract with private operators. In this case, local authorities would continue to provide services to consumers but most work would be undertaken by independent contractors on their behalf.

There is also considerable scope to increase competition in the supply of regulatory services. The engagement of independent qualified persons to carry out certification functions under the Building Act is an example of the way in which the competitive supply of regulatory services can be facilitated.

Over recent years, public policy in a number of countries has promoted greater private participation in the provision of local government services. This follows a more rigorous application of accepted criteria for government involvement in the economy and a greater appreciation of the costs associated with intervention. Local communities have benefited from improved services and lower costs.

An appropriate application of user charges is necessary to foster competition and to encourage a better use of resources. User charges require consumers to take the costs of services that they demand into account. This promotes appropriate conservation of resources such as water. User charges provide information to suppliers on the value consumers place on services. They help producers to decide the type and quantity of services that should be supplied. If user charges are not applied, less efficient

allocation mechanisms, for instance, queuing, waiting and product degradation, are necessary to limit demand. Excessive reliance is also placed on rates to fund services.

Most services provided by local government should be subject to direct user charges. The main exceptions relate to roading where road user charges and excise duties are appropriate given present technology, some recreation facilities where the costs of collecting user charges might be excessive, civil defence and administration of democratic processes which may be viewed as public goods.

In many cases user charges are not applied, or are set at inadequate levels, for services such as water, sewage (for which charges can be tied to water use), libraries, art galleries, dedicated sport facilities and regulatory services. High subsidies for these activities are unlikely to be justified on efficiency and/or equity grounds.

Rates provide a financial base for local government which is independent of central government, relatively cheap to administer and capable of being adapted to suit local circumstances. However, to the extent that they are a narrowly based tax, rates score poorly against generally accepted taxation principles.

A common theme of submissions to the 1988 review of local government finances was that rates were inadequate. This concern has since diminished. In 1988 most local authorities advocated additional sources of funding such as local income taxes and goods and services taxes, or a share of taxes collected by central government. These options are unlikely to be attractive. The administration and compliance costs of local income taxes and GSTs would be high. Revenue sharing proposals would reduce the incentive for local government to constrain expenditure and would weaken its accountability for spending decisions. Moreover, if the activities of local government were scaled back to those that fall within its proper role and if appropriate user charges were applied, pressure on rates would be substantially reduced.

The distribution of the rates burden may be inequitable in many cases, especially where councils use a land value rating system. Differential rates have shifted part of the burden of rates to the business community. The extent of differential rating in many cases seems to have gone beyond the amount that could be justified by additional services supplied to businesses. This may reflect the voting strength of householders relative to businesses. The argument that businesses are advantaged because they can deduct rates for income tax purposes and claim a credit of GST paid does not withstand scrutiny.

Businesses should bear the costs of any disproportionate use which they make of local government services. This would occur if greater reliance were placed on appropriate user charges. Where user charges are not applied, a differential rate may be justified. The imposition of penalties on businesses or any other group through excessive user charges or rates is neither desirable nor sustainable in the long run. It would reduce regional output and encourage disadvantaged businesses and groups to locate in regions, cities and districts that provide a more attractive fiscal environment.

The borrowing powers of local authorities are restricted. Local authorities are subject to the annual financing principle which assumes that present ratepayers should finance current expenditure (including interest) only, and should not generally be required to fund past debts and liabilities. Similarly, present ratepayers are not required to fund expenditure which benefits future ratepayers. Expenditure relating to works that extend over more than a year is required to be funded by borrowing.

The borrowing powers of local authorities have been under review since 1987. Central control of local authority borrowing is to be abolished. There are important grounds for increasing the transparency of borrowing plans as proposed in a Bill currently before parliament. Local authorities are subject to relatively weak monitoring arrangements leading to a potential divergence between the interests of the principals (ratepayers) and their agents (councils). Pressures for excessive spending can arise where benefits are highly concentrated amongst ratepayers but costs are spread thinly over a diffuse majority. Excessive debt may be incurred if present voters and councillors put self-interest ahead of future generations. Such debt would lead to high interest costs that would constrain other spending options.

Local authorities are to be required to limit their debt to a prudent level. The current Bill envisages some desirable reforms, in particular the requirement that local authorities borrow within an explicit and comprehensive up-to-date debt management framework. There are grounds for strengthening the transparency of local authority borrowing arrangements and for going somewhat further in removing constraints, for example on borrowing in foreign currency.

Local authorities carry out many regulatory functions. In respect of these it is recommended that:

- regulations be reviewed from time to time on a first principle basis;

- a greater effort be made to encourage, as far as practicable, voluntary arrangements to help solve perceived regulatory problems;
- the question of whether local regulatory functions should be undertaken by local government entities that are separate from those that carry out other functions should be re-examined. One possibility would be for all regulatory activities to be undertaken by regional councils. Another option would be to establish directly elected regulatory entities to service cities and districts with existing territorial councils providing services only;
- the effectiveness of local government administration of regulations should be subject to ongoing review;
- provision should be made for greater contracting out of regulatory tasks; and
- councils should examine carefully their policy on charging for regulatory services.

The financial management of local government has been significantly improved. Local authorities have responded positively to the changes, which contrasts with their resistance to earlier reform efforts. They are still adjusting to the changes that have been introduced since 1987 and the full effects of the reforms are not yet apparent. Nevertheless, there can be little doubt that the greater transparency of local authority activities has facilitated monitoring by external parties and is increasing pressures on local authorities to improve their performance.

Recent reports by the Controller and Auditor-General suggest that there is considerable room for better financial management practices, particularly in respect of core services such as drainage, sewage and water supply, and in the management of trading activities. An examination by the New Zealand Business Roundtable of some larger city councils suggests that the development of performance indicators which meet the intent of the legislation has not yet been achieved. Some councils, for example Christchurch City, have made more progress than others, for instance Auckland City. The quality of annual plans has improved but still varies markedly.

An important priority is to ensure that the financial reforms are fully implemented. Their progress should be monitored. In due course a detailed study should be undertaken to assess the benefits that are being achieved, to weigh these against the costs involved and to examine whether any further changes should be implemented.

The local government sector has a large effect on the welfare of the community. It is important that it fulfils its proper role in the economy, that it uses resources wisely and that its regulatory activities are soundly based. The quality of the services provided by local governments and their costs have an important effect on the international competitiveness of the economy. Local government performance is now a priority issue for many business organisations. There is some evidence of a slackening in performance, such as a tendency for rates to move up again, following the gains that occurred in the late 1980s and early 1990s. This must not be allowed to happen; productivity improvements in the local government sector must be part of overall efforts to maintain the present momentum of economic growth. The main conclusion of this study is that, while commendable progress has been made, there is still substantial scope to improve the contribution of local government to community welfare.

1 INTRODUCTION

Local government is a major undertaking. A survey by *Management* put total expenditure by New Zealand's 50 largest territorial authorities at \$2.8 billion or 3.4 percent of GDP in 1993/1994.¹ This expenditure is equal to almost 10 percent of central government expenditure. The authorities surveyed levied rates (including water rates but excluding regional rates) amounting to \$1.3 billion. This is equivalent to \$417 a person and almost 20 percent of total GST collections. The authorities surveyed managed assets amounting to \$25 billion. *Management* observed that in terms of income, expenditure and assets many councils rank with New Zealand's largest business enterprises.

The spending, taxing, borrowing and regulatory policies of local government have a pervasive effect on the well-being of the community. If local government uses resources in activities that yield a lower return than that available in other sectors, national output and income are reduced. Unjustified levels of rates, for example, reduce the competitiveness of businesses with an adverse impact on employment. They drive residents and businesses to centres that offer a more attractive financial environment. Inappropriate regulations have similar effects on residents and businesses.² Welfare can also be impaired if services that should be organised on a collective basis are not provided or are supplied in insufficient quantities, or if desirable regulations are not adopted.

The efficiency of the local government sector has improved over recent years. However, local government activities have not generally been subject to the same level of scrutiny as that applied to many central government operations, and the pressure to upgrade the performance of local government has not been as intense as that faced by much of the private sector. As a consequence, local government continues to realise inadequate efficiency gains and generally lags behind the progress recorded elsewhere.

1 *Management* (1994), "New Zealand's Top 50 Local Bodies", *Management*, April, pp. 29-53. While some reservations have been expressed concerning the accuracy of the survey, it is the most accessible source of comparative information on local government.

2 The term regulation is used in its economic sense, unless the context indicates otherwise, and includes provisions which may be implemented by legislation, statutory regulation or bylaw.

Privatised or corporatised businesses have typically achieved productivity gains of the order of at least 20-30 percent in recent years. The OECD reported that contracting out a range of government services in four countries produced efficiency savings of between 6 and 50 percent, with most savings falling between 15 and 25 percent.³ Comparable gains should be possible in the local government sector. There is little evidence, however, that most councils have set their sights firmly on realising such gains within an appropriate timeframe.

The purpose of this paper is to discuss the main economic and financial issues relating to local government in New Zealand. It is intended to serve as a platform for further work by the New Zealand Business Roundtable aimed at promoting ways in which particular activities of local government might be improved from an economic and financial point of view.

The balance of the paper is organised as follows:

- section 2 outlines the structure of local government in New Zealand. The development of local government is summarised and the present boundaries, organisation and broad functions of the sector are described;
- section 3 discusses the role of local government. The devolution of power from central government to local government and the economic rationale for local decision making are discussed and assessed;
- section 4 addresses the provision of goods and services by local government. The rationale for the delivery of services by local government and factors affecting its choice of activities are examined. The allocation of goods and services by price and other mechanisms, approaches aimed at encouraging the efficient delivery of services and the ownership of commercial businesses are analysed. The question of whether local government should engage in income and wealth redistribution is also addressed in this section. Proposals aimed at improving the efficiency of local government supply of goods and services, including the appropriate application of user charges, are presented;
- section 5 examines the financing of local government. This section focuses on rates and debt. The existing rating system and the borrowing powers of local

3 Organisation for Economic Co-operation and Development (1993), *OECD Economic Outlook*, No. 54 (December), Organisation for Economic Co-operation and Development, Paris.

authorities are described. Alternative forms of local taxes and changes to local government borrowing powers are examined;

- section 6 reviews local government regulation. The general purpose of regulation is discussed and the regulatory functions of local government are described and assessed; and
- section 7 discusses financial accountability and management of local government. Recent reforms and reviews by the Controller and Auditor-General are examined.

The conclusions of the report are contained in the Executive Summary.

2 STRUCTURE OF LOCAL GOVERNMENT

2.1 DEVELOPMENT OF LOCAL GOVERNMENT

Local government was only slowly established in New Zealand.⁴ It began when the Municipal Corporations Ordinance 1842 decreed that any district with a European population of more than 2,000 could be proclaimed a borough. A council was to be set up for each borough with powers to carry out road works, construct water and sewage systems, prevent fires and nuisances, construct market places, conduct cleaning activities and levy rates. The ordinance was based on a United Kingdom statute.

Wellington was the only district of sufficient size to become a borough, and a council was elected in October 1842. However, the imperial government declared the ordinance to be invalid. It was effectively replaced in 1846 by a more limited Public Roads and Works Ordinance which provided for the establishment of roading districts that were to be administered by elected commissioners. Auckland's first charter of incorporation in 1851 was more successful from a legal perspective than Wellington's but public apathy toward the new authority resulted in its demise in less than a year.

The New Zealand Constitution Act 1852 (a United Kingdom statute) established six (later nine) provinces with responsibility for local government. This led to the first effective steps to establish local government. Provincial governments had the power to collect rates and initially the annual value system (the rent at which the property would be let from year to year) was adopted.

The provinces were not able to grant municipal authorities all the powers necessary for effective local government. There was also concern at wide disparities in the services provided by local authorities. Central government stepped in to solve these problems by passing the Municipal Corporations Act 1867, the first comprehensive legislation relating to local government. The Act did not confer on municipalities the power to impose taxes. A Bill which was intended to provide for local government in rural

⁴ This section is based on Department of Statistics (1990), *New Zealand Official Yearbook*, Department of Statistics, Wellington; McLintock, A. H. (ed.) (1966), *An Encyclopaedia of New Zealand*, Government Printer, Wellington; and Palmer, Kenneth A. (1993), *Local Government Law in New Zealand*, Law Book Company, Sydney.

areas was not passed by the General Assembly. It was more far-reaching than its counterpart and included taxing powers.

By 1876 local administration was provided by municipal councils in major settlements and by 314 road boards. Most local government functions in other areas, excluding roading, were undertaken by provincial councils.

Local government increased in importance following the abolition of the provinces in 1876. Central government became wholly responsible for local government administration and it put in place a system which was broadly retained until 1989. The country was divided into 63 counties, created under the Counties Act 1876, and the 36 municipalities then in existence.⁵ Road boards were rationalised and were placed in a subsidiary relationship to counties with the intent of encouraging their gradual disappearance.

The desire for some form of local authority suited to the needs of smaller settlements led to the enactment of the Town Districts Act 1881. Town districts were limited to areas not constituted as boroughs, not exceeding two square miles and containing not fewer than 50 householders. Friction between town boards and county councils over the division of responsibilities led to legislation in 1906 which provided that no town districts with a population of more than 500 should form part of a county.

A large number of special purpose authorities were established. Among the most important were harbour (1870), education (1877), river (1884), hospital (1885), fire (1906) and electric power (1918) boards. By 1950 there were 537 special purpose authorities. The main reason for their establishment was that small territorial authorities had neither the resources nor the inclination to undertake and develop many newly acquired services and activities. Taxing powers were conferred on some special purpose authorities.

The number of authorities grew rapidly until 1960. Limited reorganisations of territorial authorities were arranged by the Local Government Commission which had been established in 1946 but these were offset by the establishment of special purpose authorities. The fragmentation of local government had been perceived to be a problem shortly after its inauguration in 1876.

5 Some references put the number of municipalities at 45 rather than 36.

There has never been an immutable demarcation between the responsibilities of local and central government. A government committee concluded that:

The closest study of the ways functions have been allocated between central and local government in the past fails to identify any principles which have been consistently followed.⁶

Not surprisingly, the allocation of functions has changed from time to time. However, local government has continued to be responsible for its core activities of local roading, water, drainage, sewage reticulation and disposal, and refuse collection and disposal.

Finance

A unified rating scheme based on the annual value system was introduced in 1876. Each local body was required to appoint a valuer and to prepare a valuation roll. Concerns that property speculators were exploiting the annual value rating system resulted in the adoption of the capital value system in 1882. The capital value is the amount that the vendor might receive from the sale of his or her property on reasonable terms and conditions, and free of mortgage. Responsibility for property valuations was later transferred to central government. Objections to both moves led to exemptions for some authorities. A choice between annual and capital value rating systems was subsequently permitted.

The partial unimproved value rating system (similar to capital value except that the value of improvements is omitted) was introduced in 1896 and was extended to a fully unimproved value system in 1912. By then three rating systems operated side by side. The application of differential rates to particular classes of property was introduced in 1969 for counties and later extended to municipalities.

Local authority finance has been frequently reviewed by government commissions and committees. Before 1988, the main focus of such reviews was the need for additional revenue and possible new sources of revenue. There has been broad support for the retention of rating as the main form of local taxation.

In 1958 a Royal Commission concluded that rates should "remain as the foundation of [local authority] revenue", that there was little scope to increase rates and that user charges were unlikely to provide a substantially higher proportion of local authority

⁶ Report of the Local Authority Finance Committee (1973), *Local Authority Finance in New Zealand*, Government Printer, Wellington.

revenue.⁷ It sought to reduce the rate burden on owners or occupiers of residential properties. While some of the Commission's recommendations were adopted, its more radical proposals were not implemented. The latter included a citizen's tax on earnings and profits to be collected by central government and distributed to local authorities, withdrawal of the exemption from rates of Crown property and the establishment of a local authority finance corporation.

A 1963 Committee readdressed the wider proposals of the Royal Commission.⁸ The Committee recommended that the Crown should make a greater contribution to local government by way of grants in lieu of rates. It suggested that a retail sales tax, which was to be applied on a regional basis, should be examined further by government departments. The proposal to establish a separate finance corporation was opposed by all but one member of the Committee.

In 1970 a committee recommended the introduction of what is now known as the local authorities petroleum tax.⁹ Alternative sources of revenue were examined and rejected by the Committee. Another committee concluded in 1973 that:

Because there is no new form of a separate tax suitable for administration by local government, central government must provide any additional finance for local government from its general taxation revenue.¹⁰

The Labour government decided in 1985 to introduce revenue sharing. A working party was established in 1986 to examine practical ways and means of implementing revenue sharing.¹¹ However, the proposal was overtaken by the comprehensive reform of local government which was announced as part of a wider economic policy statement on 17 December 1987.

7 Report of the Royal Commission on Local Authority Finance (1958), *Report on Local Authority Finance*, Government Printer, Wellington.

8 Committee on Local Authority Finance (1963), *Report of the Committee on Local Authority Finance*, Government Printer, Wellington.

9 Local Authority Finance Committee (1970), *Report of the Committee on Local Authority Finance on Proposals for a Local Authority Tax on Petroleum Products*, Government Printer, Wellington.

10 Local Authority Finance Committee (1973), *Report of the Committee on Local Authority Finance*, Government Printer, Wellington.

11 Working Party on Revenue Sharing (1987), *Report of the Working Party on Revenue Sharing*, Department of Internal Affairs, Wellington.

Local authority borrowing has been controlled since the inception of the local government system in 1876. The broad principles adopted then still apply. Essentially local authorities may raise loans to construct public works, to refinance maturing debt and to finance other projects of a capital nature. There are tight limits on their ability to borrow in anticipation of revenue (that is, to fund current expenditure). The Local Authority Loans Board was established in 1926 to assist in controlling borrowing by local authorities.

Local government finance has been under review since December 1987. There has been little discussion, however, on revenue sharing or on new sources of funding since 1987 as the focus has been on the role and organisation of local government. The government announced in September 1994 that legislation is to be introduced to parliament which will apply new borrowing and financial management provisions to local government. Central government control of borrowing is to be reduced and the principles of the Fiscal Responsibility Act 1994 are to be applied to local government. These changes are discussed in sections 5 and 7.

The Evolution of Regional Local Government

The structure of local government was examined in 1960 by a parliamentary committee chaired by Henry May.¹² The May report was the first comprehensive political assessment of the evolution and efficiency of local government. It found that the efforts of the Local Government Commission to rationalise local government had proved largely fruitless due to a requirement for amalgamations to be approved by local electors. The report concluded that the vested interests of councillors and parochial opposition to any real change would continue to frustrate reform efforts. It recommended the establishment of regional bodies to assume responsibility for strategic functions such as water, sewage and regional roading and to absorb the functions of special purpose authorities.

The May report was an important influence on subsequent reforms, especially those implemented by Labour governments in 1972-75 and 1984-1987. Legislation governing local government was progressively consolidated in the Local Government Act 1974, and the last provisions of the Municipal Corporations and Counties Acts were repealed with effect from 1 April 1980.

12 Report of the Local Bills Committee (1960), *Inquiry into the Structure of Local Government*, Government Printer, Wellington. This report is referred to below as the May report.

The first unit of regional government was introduced with the establishment of the Auckland Regional Authority in 1963. The authority, which was directly elected, was given responsibility at the regional level for urban passenger transport, planning, parks and reserves, urban water supply, drainage, refuse collection and disposal, roading, community development, civil defence, assistance to beach patrol and rescue services, and a regional orchestra. Its territory included the Auckland metropolitan area and adjoining rural districts.

The Wellington and Northland Regional Councils were established considerably later with less extensive responsibilities than their Auckland counterpart. The Wellington Council's functions included water catchment together with regional planning, civil defence, parks and reserves, urban water supply, forestry and public passenger transport planning.

Between 1977 and 1983, united councils were established in 20 regions. They provided a form of regional government for areas that were unwilling to establish, or did not warrant, a regional council. Unlike regional councils, united councils were appointed by, and funded by a levy on, territorial authorities. United councils required the approval of territorial authorities before they could establish new functions.

Recent reforms

The Labour government, elected in 1984, introduced a number of important changes. It:

- restored stringent poll provisions which enable electors to stop amalgamations. These had been relaxed in 1975 to facilitate amalgamations. The re-introduced poll provisions were suspended in 1988 to facilitate restructuring of local government;
- required all territorial authorities with a population of 70,000 or more to establish ward divisions for the 1986 triennial elections. This provision was changed in 1991 when the ward system became voluntary;
- reformed the electoral franchise by abolishing the rating qualification for property owners thus eliminating the right of corporate and absentee property owners to vote. Loan polls were determined by electors rather than ratepayers. These changes were reversed in 1991;

- reconstituted the Local Government Commission. Acting according to a 1986 ministerial referral, the Commission required all territorial authorities to address the issue of amalgamation and rationalisation. The government's objective was to achieve a comprehensive and nationwide reorganisation in time for the local government elections in 1989, and to ensure entrenchment of the reforms before the 1990 parliamentary elections;
- reorganised the structure of local government with effect from 1 November 1989. A key feature of the reorganisation was the amalgamation of local government entities and the development of regional local government for almost the entire country; and
- rationalised and modernised the powers and procedures of local government. The principles and approaches that had been applied in reforming central government were applied to local government.¹³

Some of these reforms are discussed further below.

2.2 BOUNDARIES OF THE SECTOR TODAY

Following the reorganisation of local government that took place in 1989 and, to a lesser extent, in 1992, the structure of local government is as follows:

- 12 regional councils. All areas of New Zealand, other than the Chatham Islands, fall within one of the 12 regions;
- 74 territorial authorities. They comprise 15 city councils, 58 district councils and the Chatham Islands County Council. Four unitary councils that have regional as well as territorial responsibilities are included;
- special purpose authorities. These include scenic and recreation boards, airport authorities and single purpose entities such as the Otago Museum Trust and the Auckland Regional Services Trust. There are only a handful of special purpose authorities.

¹³ For a detailed discussion of the reform process see Jansen, Ross Malcolm (1992), "New Zealand Local Government Changes in the 1980s: Reform or Restructuring?", Unpublished thesis submitted for the degree of Doctor of Philosophy in Politics, University of Waikato, Hamilton.

The Auckland Regional Services Trust is a unique authority which was established to assume the ownership of service providers and certain assets (including interests in local authority trading enterprises) and debts of the Auckland Regional Authority. The trust is charged with disposing of its assets, other than those related to bulk water supply and sewage, as soon as is prudent. The proceeds are to be used to retire debt;

- 155 community boards. Community boards are established on the initiative of a territorial authority or its electors, or as a result of a reorganisation of a territorial authority. These boards do not constitute separate local government organisations but are an element of the related territorial authority. They are primarily advocates for their community and any powers which they have are delegated by their parent territorial authority;
- Local Authority Trading Enterprises (LATEs) and other companies associated with regional and territorial authorities, including 12 of the country's 44 energy companies. The remaining energy companies are owned by community trusts or private interests. Some trading entities are formed under general legislation. There is no obligation to form LATEs, other than in respect of passenger transport operations. LATEs are required to be operated as successful businesses; and
- community trusts. A local authority may establish a community trust, primarily to receive any surplus proceeds from the sale of shares in a port company either by the authority or through a LATE. A community trust is required to hold property vested in it for purposes beneficial to the community. A community trust is not a local authority.

Local government embraces those organisations that are ultimately accountable to, and are largely funded by, local electors.¹⁴ Organisations covered by this definition have six main characteristics:

- they are created by an Act of Parliament (either special statutes or, more commonly, general legislation, particularly the Local Government Act 1974);

¹⁴ Licensing trusts that are established under the Sale of Liquor Act 1989 come within this definition. They are not discussed in this report.

- their main powers are defined in the Acts under which they are established and under general local government legislation. Some functions are conferred on local government by general legislation (for example, the Building Act 1991);
- they operate in specific districts or regions;
- they are controlled by councils or boards;
- they rely on one or more of the following main sources of funding: local taxes on property (rates); rates on other local authorities; user charges; income from the trading utilities under their control and government grants; and
- they are able to set their overall levels of expenditure and may determine their expenditure priorities.

The number of local government organisations is now smaller than before the 1989 reorganisation. In 1987, there were 828 organisations that were affected by the review of the local government sector (see box).¹⁵ The functions of most special purpose authorities were allocated to territorial and regional councils in the 1989 reorganisation. This largely accounts for the decline in the number of local government organisations.

Number of Local Authority Organisations in 1987	
Territorial Authorities (i.e. city, borough, county, town and district councils)	217
Community Councils	136
Regional and United Councils	22
Special Purpose Authorities	453
Total Number of Organisations	828

¹⁵ Source: Officials' Coordinating Committee on Local Government (1988), *Reform of Local and Regional Government: Discussion Document*, Department of Internal Affairs, Wellington. Note that the precise number of organisations is open to debate. The total number of special purpose authorities before the 1989 reorganisation has been estimated to be as high as 900.

Regional Councils

The structure of local government is characterised by two main types of government, regional and territorial councils. The number of regions has been reduced from 22 to 12. Regional councils are directly elected and are headed by a chairperson.

In 1992 the law governing regional councils was extensively amended to clarify their role as regulatory authorities concerned with resource management and related functions, including public passenger transport planning in Auckland and Wellington.¹⁶ They were no longer to provide services such as transport passenger services. Regional councils typically undertake the following functions:

- resource management at the regional level;
- civil defence at the regional level;
- transport planning;
- harbour regulation and marine pollution control;
- soil conservation and catchment activities; and
- control of pests and noxious plants.¹⁷

Territorial Councils

Territorial councils are directly elected, general purpose councils with responsibility for a wide range of functions. City councils are established in major urban areas while district councils are set up in rural areas and towns. The functions of city and district councils are the same. New districts and cities may be established. The Local Government Commission acts as an appeal authority in relation to reorganisation proposals.

16 The idea of creating regional councils as solely regulatory bodies had been canvassed and rejected before 1987.

17 Most noxious plant and animal pest control powers of regional and territorial authorities are to be replaced by provisions which are to be included in a Biosecurity Act.

Each city and district council has between seven and 24 members, and is led by an elected mayor. Community boards comprise between four and 12 members. At least four members of community boards must be elected while up to one-third of the board may be appointed from members of the city or district council who represent the relevant ward or wards within the particular community.

Territorial councils typically undertake the following functions:

- the organisation or provision of certain basic services, such as roading, drainage, sewage reticulation, treatment and disposal, refuse collection and disposal, and, at least at the retail level, water supply;
- the provision of amenities such as parks and recreational facilities at the local level, libraries and community centres;
- resource management planning at the local level;
- other regulatory activities such as health inspection, administrative aspects of the Building, Dangerous Goods, and Sale of Liquor Acts, and dog control;
- rural fire services. The New Zealand Fire Service provides fire services in urban fire districts while territorial authorities have responsibilities for the provision of fire services in rural areas; and
- civil defence at the local level.

Other Activities

Twelve energy companies that are wholly or majority owned by territorial authorities maintain electricity distribution networks, undertake design and construction services and sell electricity.

New Zealand has 13 major commercial ports. They range from the large general purpose ports, for example, those of Auckland, to specialist ports such as the Port of Marlborough, which derives most of its revenue from the Interislander ferry service. These ports are operated by companies formed under the Port Companies Act 1988. Port companies are predominantly owned by local government, although two are partly owned by private interests.

The three international airport companies are jointly owned by local and central government. The shareholdings are as follows:

- Auckland International Airport Limited: the Crown 51.6 percent; Auckland's territorial authorities 48.4 percent;
- Wellington International Airport Limited: the Crown $66\frac{2}{3}$ percent; Wellington City Council $33\frac{1}{3}$ percent; and
- Christchurch International Airport Limited: the Crown 25 percent; Christchurch City 75 percent.

The three companies have a combined asset value of \$520 million and earn a return on assets (pre tax and interest) of approximately 7 percent.

Airport companies operate five provincial airports and the Chatham Islands airport. Altogether there are 21 provincial airports which local authorities own directly or indirectly.

3 THE ROLE OF LOCAL GOVERNMENT

3.1 DEVOLUTION OF POWERS

Parliament is sovereign in New Zealand. The coercive powers of local government i.e. the power to levy rates and to regulate through bylaws, are delegated by parliament. This contrasts with federal systems of government, such as Switzerland's, in which it may be more accurate to say that central government's powers are devolved from those of local government.

Section 37(k) of the Local Government Act, which came into force in November 1989, contains the first comprehensive statutory statement of the purposes of local government. The section states:

Purposes of local government - The purposes of local government in New Zealand are to provide, at the appropriate levels of local government -

- (a) Recognition of the existence of different communities in New Zealand;
- (b) Recognition of the identities and values of those communities;
- (c) Definition and enforcement of appropriate rights within those communities;
- (d) Scope for communities to make choices between different kinds of local public facilities and services;
- (e) For the operation of trading undertakings of local authorities on a competitively neutral basis;
- (f) For the delivery of appropriate facilities and services on behalf of central government;
- (g) Recognition of communities of interest;
- (h) For the efficient and effective exercise of the functions, duties, and powers of the components of local government;
- (i) For the effective participation of local persons in local government.

Palmer assessed the significance of the foregoing section in the following terms:

From a legal perspective there is no specific priority or weight given to one objective over another. In practice each objective may require consideration depending upon the activity or function concerned [W]here the validity of any act or omission is challenged by legal proceedings or other remedy, adequate

consideration of these purposes may be relevant to the proper performance by council, committee, or officer of a power of decision.¹⁸

An important limitation on the activities of a local authority arises from the *ultra vires* principle which restricts its powers to those expressly conferred, or derived by implication as reasonably necessary or incidental to the performance of express functions and powers. As observed by Lord Templeman:

A local authority, although democratically elected and representative of the area, is not a sovereign body and can only do such things as are expressly or implicitly authorised by Parliament.¹⁹

This statement was cited in a recent case in New Zealand involving the Mackenzie District Council. In the judgment, Richardson J. added:

... a local authority such as Mackenzie has only a subordinate role in our system of government. It is a statutory creation exercising the local and special purpose functions reposed in territorial authorities by Parliament. It is not to be viewed in high policy terms as the *alter ego* of central government.²⁰

Because the powers of territorial and regional councils are defined by statute, any judicial review of council decisions involves questions of statutory interpretation. The role of the court is not to substitute its judgment for that of the council whose decision is questioned. On being satisfied that the council has not considered irrelevant matters or neglected to consider relevant matters, the courts consider whether the council has nevertheless come to a conclusion so unreasonable that no reasonable council could ever have come to it.

Local government in New Zealand is subject to less ministerial control than its counterpart in the United Kingdom.²¹ Activities that are substantially funded by central government may require the approval of the responsible minister and policies may be proscribed by legislation. Regulations relating to hazardous waste, buildings and fire safety may be subject to ministerial comment, or to standards or codes

18 Palmer, Kenneth A. (1993), *Local Government Law in New Zealand*, Law Book Company, Sydney.

19 *Hazell v Hammersmith and Fulham London Borough Council* (1991) 1 All ER 545, 548.

20 *Mackenzie DC v Electricorp* (1992) 3 NZLR 41.

21 Palmer, Kenneth A. (1993), *Local Government Law in New Zealand*, Law Book Company, Sydney.

approved by central agencies. Beyond such requirements, there is no general obligation on local authorities to obtain ministerial confirmation before bylaws become operative.

The minister of local government has a discretionary power to initiate a review of the performance of any local authority where there has been a significant failure to meet obligations, or where mismanagement of resources or deficiency in management or decision making processes has occurred. A commissioner may be appointed by order in council to exercise the functions of a council if the council wilfully refuses to perform its statutory functions.

Because local government cannot validly be viewed as an agent of central government, it is not surprising that central government has been "an undemanding and inattentive taskmaster".²² Local government can, however, be viewed from an economic perspective as agent of the citizens of its region or territory.

3.2 ECONOMIC RATIONALE FOR LOCAL DECISION MAKING

The question of the circumstances under which it would be efficient for local rather than central government to produce goods and services, or to regulate economic activity, is complex. Probably the most common such circumstances are where a degree of local knowledge is required, where the costs and benefits of government accrue locally, or where both apply.

There are many goods and services which provide benefits that do not extend significantly beyond a particular community. Library services and rubbish collection are two examples. To the extent that goods and services are supplied or organised collectively, a judgment is required as to the quantity to be produced. The local community may possess better information on the value that should be placed on such goods and services and its willingness to pay for them than a central government agency.

In addition, where the costs of government goods and services are borne locally, the local community has an incentive to make the best choices. For example, if residents of Christchurch are little affected by the actions of those of Tauranga, there is limited incentive for them to become involved in making decisions on the provision of goods

22 Bush, Graham (1990), "The Historic Reorganisation of Local Government", in Martin Holland and Jonathan Boston (eds.), *The Fourth Labour Government: Politics and Policies in New Zealand*, Oxford University Press, Auckland.

and services in Tauranga or in funding them. Similar considerations apply to the question of local regulation.

Although councils generally possess superior local information compared with central government, they may not always face better incentives to use that knowledge for the benefit of their communities. In particular, if accountability arrangements are weak, any *prima facie* advantages from devolving decision making to local government may be negated.

There are a number of reasons why the monitoring and accountability of local government might be less effective than that of central government. These include lower levels of turn-out in local elections, inadequate knowledge of candidates' positions (partly because of the lesser role of party affiliations) and less intense scrutiny of local government by the media and interest groups. In addition, the costs to individuals of monitoring the activities of local government may be large relative to expected benefits. These weaknesses are likely to be more important than the greater familiarity of local electors and the media with local government activities.

Offsetting these considerations, the accountability of local government is enhanced by the following factors, some of which arise from recent reforms:

- lower costs of information. The transfer of the functions of special purpose authorities to directly elected territorial and regional councils may have had this effect. The requirement for every local body and, where appropriate, community board to conduct its business in a manner that is comprehensible and open to the public is also important in this regard;
- increased voter turn-out in local elections. The introduction of postal voting appears to be having this effect; and
- proscribing the decisions which authorities are permitted to undertake. Examples of restrictions or influences on the financing decisions of local authorities include:
 - the requirement to provide an annual plan before each financial year. The Local Government Act requires local authorities to establish clear objectives for each of their activities and policies, and to monitor their performance against stated performance measures;

- loan polls may be initiated by ratepayers to ratify borrowing proposals;
- supplementary budgets may not be introduced part way through a financial year if they require an additional rate impost; and
- the requirement to produce an audited annual report.

3.3 ASSESSMENT

An assessment of the role of local government should focus on the comparative advantages it possesses over alternative structures. This requires consideration of the information available to local authorities and the strength of the incentives they face.

The structure of most organisations is determined by the nature of the tasks they are required to perform. Efficient organisational structures are those which enable the problems of coordinating the use of resources to be solved efficiently. Delegation of decision making powers to appropriate levels is crucial. In doing so, organisations must typically weigh the advantages of the specific knowledge gained from being closely involved in operations against related monitoring costs. These principles apply to both public and private sector organisations. The *raison d'être* of local government in this sense is that some powers appropriate to government are best delegated to the local level.

Despite differences in national characteristics and economic philosophies, local government structures in different countries have much in common. All OECD member countries have sub-national jurisdictions. Although the number of levels of government varies, control of certain functions at city or township level is common. Functions such as roading, waste disposal and town planning, for example, normally fall within the ambit of local government.

These similarities are probably not coincidental. The pattern of local government activity has evolved in different countries over a considerable period. It has been upheld by the political process, which may imply that any constituencies for change have been either too small or too weakly motivated to bring about an alternative structure. Elements of local government activity that were less efficient may have been weeded out over time.

This perspective allows the possible shortcomings of local government in New Zealand to be kept in perspective. The debate about the role of local government has frequently

arisen from specific complaints, for instance that rates have been rising in real terms, or that councils have been 'wasteful'. Such criticisms may ignore the fact that local government may be the best organisational form for certain functions. If such functions were undertaken in other ways, inferior outcomes would result.

This is not to say that all aspects of New Zealand's local government are soundly based or that typical overseas experience should be copied unthinkingly. Some features may have survived due to disenfranchisement or because their benefits are concentrated while their costs are diffuse, leading to lobbying for their retention by groups that benefit at the expense of the wider community.

Local government reform since 1987 has led to considerable improvements. The majority of the reforms, including the rationalisation of boundaries, the establishment of trading activities on a sounder commercial footing and the move to obtain some services from private operators, resulted from an awareness that the status quo was not desirable. Indeed, it is a fact of economic life that sheltered sectors, with less exposure to competitive pressures, are slower to adjust to changes in the economic environment. Local government is similar to central government in the extent to which its activities can be sheltered from competitive pressure.

4 PROVISION OF GOODS AND SERVICES

4.1 RATIONALE FOR PROVISION BY LOCAL GOVERNMENT

The case for the provision of goods and services by local government rests on two arguments:

- that certain goods and services should be supplied by the public sector; and
- that they should be undertaken by local rather than central government.

The grounds for local rather than central government provision were discussed in section 3. The principle of ensuring that where benefits are localised, costs are also borne locally, appears sound. Although a number of functions have alternated between central and local government, currently there appear to be no major disagreements in this regard. However, there is debate over the classes of goods and services that should be produced in the local government sector rather than in the private sector. Local government, like any business, faces three basic decisions about its output, namely:

- what goods and services should be produced;
- how should they be produced; and
- how should they be paid for?

The practical choices of which activities should be undertaken by local government in-house, which should be contracted out or disposed of, and what pricing or funding mechanisms are appropriate, follow from these basic decisions.

4.2 CHOICE OF ACTIVITIES

Public Goods

A 1988 officials' report suggested that local government should focus on the provision of local public goods.²³ It is widely accepted that pure public goods have two properties. First, it is impossible to exclude individuals who do not contribute to the cost of their production from enjoying their benefits. This is known as the non-excludability property. Each person has an incentive to wait for someone else to provide the goods, leading to a free-rider problem.

The second property of pure public goods arises where it is undesirable to exclude individuals from enjoying the benefits, as the enjoyment of them by one person does not detract from that of other people (the non-rivalrous property). National defence and street lighting are often cited as examples of pure public goods.

According to this traditional view, if the provision of pure public goods were left to the private sector in an otherwise unconstrained market, they would be supplied in inadequate quantities or not supplied at all. Public provision of such goods or other government action would appear to be required to ensure their optimal supply.

The traditional view of public goods has been reassessed in more recent times because non-excludability and non-rivalry properties reflect transactions costs. Non-excludability is a problem if the costs of identifying those who benefit from a particular activity are prohibitive. It is likely, for example, to be excessively costly to charge motorists directly for the use of every road even though toll bridges indicate that it is not infeasible to charge for the use of some roads.

Suppliers may also lack relevant information to exclude people who do not contribute to the costs of goods and services because consumers have incentives to understate their preferences. In the case of street lighting, some individuals might, if asked, downplay the benefits that they receive from street lighting to reduce their share of the total costs involved.

These problems may be overstated. Pure public goods are a polar case and are rarely, if ever, found. The extent to which goods and services exhibit the features of public

23 Officials' Coordinating Committee on Local Government (1988), *Reform of Local and Regional Government: Discussion Document*, Department of Internal Affairs, Wellington.

goods differs from product to product and, for given goods, through time. Technological change may affect the degree to which goods and services approximate pure public goods. The development of cable television and the scrambling of television signals have, for example, made it feasible to exclude non-subscribers from certain broadcasts.

Transactions costs are pervasive and often do not justify government intervention. Many producers face excess capacity in the short run, for instance transport operators, hotels, seasonal businesses and sport clubs, but this is not necessarily an impediment to an optimal supply of goods and services.

Voluntary arrangements may assist in overcoming the non-rivalrous property. Sports clubs may be an example. The marginal cost of allowing another person to use certain facilities, for instance an under-utilised golf course, may be very small. If people agree in advance to share the costs of the golf course, the potential problem arising from low or zero marginal costs may be reduced.

Even where substantial public good characteristics are present, it does not automatically follow that public provision of the product or service in question is desirable. The costs and benefits of intervening need to be assessed and, if government action is justified, the most appropriate instrument should be employed.

Lighthouses have traditionally been cited as an example of a pure public good which should be funded out of taxation. However, lighthouses used to be privately funded and operated in England. Fees for lighthouse services were compulsorily collected along with port charges, with port owners acting as an agent for lighthouse operators. The free-rider problem was overcome by a regulation which required shipowners to contribute to the costs of lighthouses.

The approach of tying the fee for a particular service to the charge for another is one possible solution to a non-excludability problem. Whether this is feasible depends upon the existence of a private good for which charging is possible, and whose use is sufficiently correlated with the public good in question. The funding of roading through petrol taxes is an example.

Natural Monopolies

In a decreasing cost industry (that is, where there are economies of scale) the marginal cost of production is less than the average cost. If price is set equal to marginal cost,

the producer would face a loss.²⁴ Although simplistic analysis might suggest that the government should fund such losses by way of taxation, this conclusion assumes that taxes can be raised costlessly.

A better solution may be for decreasing cost industries to adopt multi-part pricing. A set levy is charged to cover fixed costs, for example an access fee or subscription, and unit prices are set at marginal cost. Utilities often price their services on this basis. Alternatively, the firm may simply set price equal to average costs rather than marginal cost. This avoids a loss but implies some efficiency cost relative to the textbook competitive model because the price charged exceeds marginal cost. Firms in decreasing cost industries facing competition could be expected to price on this basis. Decreasing costs alone do not normally justify the provision of goods and services by the government.

A related problem concerns natural monopolies. A natural monopoly exists if one firm can supply the output of an entire industry at a lower cost than two or more independent firms. A natural monopoly can set its prices above marginal cost. However, provided that the firm faces at least potential competition, for example where the right to supply is subject to tender, the position is similar to that of a decreasing cost industry with more than one producer.

New entrants into an industry may be discouraged where high sunk costs (i.e. costs that are not recoverable if the firm leaves the industry) enable the existing producer to lower prices to reflect incremental operating costs. Furthermore, entrants will not be able to recover all their capital expenditure if they exit the industry. For these reasons, significant sunk costs afford a producer a degree of monopoly power that it would not otherwise be able to exercise.

A number of local government services are often said to constitute natural monopolies involving sunk costs, for example water, sewage and drainage systems. Parts of the roading network may also be an example of this class of monopoly. The actual demand and supply conditions of the particular industry, including the state of technology, are important in assessing whether an industry should validly be treated as a natural monopoly with sunk costs.

24 A loss arises because the price charged for the last unit supplied is less than the average cost. Efficiency is maximised in the perfectly competitive model when price is set equal to marginal cost because the value of the incremental unit of product to the consumer is equal to the opportunity cost of resources required to produce it.

Traditionally, governments have engaged in production where these conditions apply or have regulated private producers. A contemporary analysis, recognising the weak incentives for efficiency that governments face and other transactions costs, suggests that a sceptical view should be taken of whether government action is likely to generate a net benefit for the community. Furthermore, where government action is justified, there would be strong grounds for facilitating competition in the supply of services, for example through franchising or tendering of the services required.

Externalities

Another ground for examining whether public provision or funding of local goods and services is justified relates to the possibility that they may lead to significant externalities. A positive (negative) externality arises whenever an individual's action increases (reduces) the welfare of another. A person may benefit from a positive externality because a neighbour's garden is appreciated. From the community's point of view, externalities may result in sub-optimal production of goods and services because decisions on the level of production will reflect private rather than community-wide benefits. While subsidisation of the producer may appear to be warranted by positive externalities, it is also desirable to impose the cost of such subsidies on people who benefit but who would not normally contribute to the production of the relevant goods and services. The opposite situation applies in respect of negative externalities.

Most activities produce externalities and most do not justify government action. The issue for public policy is whether the marginal benefit of government action aimed at addressing externalities is likely to outweigh related costs. Even if an externality provides valid grounds for government action, the government would need to choose the optimal instrument to address the problem (for example, regulation or public funding).

While externality grounds are the apparent rationale for some local regulation (for example controls on noise and certain fire safety and building regulations), few local services appear to rest on these grounds. Some local authorities subsidise major sporting and cultural activities, libraries, art galleries and some city or town promotions in the belief that they provide wider benefits for the local community. There are, however, valid reasons for questioning the efficacy of such expenditure. Private sector promoters are able to take measures aimed at capturing many of the benefits from major sporting and cultural activities. They may, for instance, obtain sponsorship from major beneficiaries such as airlines and hotels. Moreover, local

authorities appear to impose the costs of such activities on ratepayers rather than the beneficiaries.

Merit Goods

A number of local government activities have as their rationale the notion that they involve merit goods. Goods and services that are capable of being supplied privately may be considered so meritorious that they are provided or subsidised by the government. Cultural and recreation services, libraries and art galleries are often cited as examples of local merit goods.

From an economic perspective, the concept of merit goods is controversial. Interference with individual preferences is at the heart of the concept of merit goods. Consumer choice may be restricted simply because a ruling group considers its particular set of values superior and wishes to impose them on others. Furthermore, the merit goods concept does not provide a framework for resolving questions relating to the quantities of goods that should be produced and their price. At the very least, the risk of under-consumption of merit goods needs to be weighed against the costs of overriding individual preferences.

Concluding Comment

The foregoing analysis does not offer a simple guide to the goods and services that should be provided or funded by local government. A case-by-case examination is required to determine what level of local government provision, if any, may be appropriate. A small number of local government activities are justified on local public good grounds (for example civil defence), whereas others are unambiguously of a private nature (for example forestry, off-street parking, commercial property development and quarries).

Problems relating to decreasing cost industries with high sunk costs may justify local government involvement in arranging for drainage, sewage and water supply systems but these services could be provided privately under franchises as is the case with gas reticulation and, in most cases, paid for by users. High transactions costs make it infeasible to charge for most local roads, given present technology, and justify government involvement in arranging for their funding but the work required can be undertaken by private firms.

Over recent years, public policy in a number of countries has facilitated greater private participation in the provision of local government services. This follows a more rigorous application of accepted criteria for government involvement in the economy and a greater appreciation of the costs associated with intervention.

Water supply, for example, was privatised in the United Kingdom in 1989. Sweden has contracted out certain road and park maintenance, water supply, sewage and waste collection services. A 1987 survey in the United States found that more than half of all local government solid waste collection services were supplied by contractors. A later survey suggested that 35 percent of all solid waste combustion facilities in the United States and Canada were privately owned and operated. A wide range of other local government activities, including traditional operations such as data processing, have been contracted out by some local government entities in the United States.

4.3 ALLOCATION OF GOODS AND SERVICES

In the case of privately provided goods, the price mechanism serves to signal which goods should be produced and in what quantities. However, the price mechanism alone may not provide a solution to the allocation of output produced by the public sector. A combination of prices (user charges) and administrative judgments are commonly used to determine the provision and consumption of publicly provided goods and services.

As most goods (or services) provide at least some private benefits, an extreme view is required to justify zero prices for local government output. If goods were provided on an unrestricted basis to consumers without charge, their consumption would usually be excessive from society's viewpoint. Consumers would demand goods up to the point where the marginal benefit which they receive from the goods equals the cost of acquiring them, that is, the transactions costs involved. As a result, consumption would tend to be excessive, and the burden of financing the production of the goods would fall on the community through some other means, for example taxes.

In addition to user charges, a number of non-price allocation mechanisms are prevalent in local government.²⁵ Quantity rationing is the most common such mechanism. This

²⁵ For a detailed discussion of non-price allocation see Kerr, R. L. (1991), "User Charges: Some Aspects of Their Allocative Role", in New Zealand Business Roundtable, *From Recession to Recovery*, New Zealand Business Roundtable, Wellington.

results from administrative estimation of demand and a judgment on the amount that should be supplied. The judgment would normally take account of the cost to ratepayers. Examples of quantity rationing include limits on the amount of refuse that may be collected, such as one bag a week for each household, waiting lists for local authority housing and for popular books at libraries, queuing for assistance at council offices and some form of ordeal, for example where residents are required to hold a hose to water their gardens.

Non-price allocation is normally less efficient than price allocation and can have adverse equity effects. With non-price allocation, the supplier receives little information on the value of services provided to consumers. This restricts the supplier's ability to make appropriate decisions on the quantity, type and quality of services that should be provided. It also limits competition from private providers. The consumer is unaware of the real costs of services. This lack of information impedes the balancing of supply and demand at optimal levels. Moreover, the requirement to queue, wait or undertake an ordeal represents a waste of resources as output, including leisure, which is of higher value to consumers is lost. In the private sector, significant queuing and waiting are generally indicators of a breakdown in markets (for example, queuing for food in the former communist countries).

A recent debate within one city council typifies the difficulties that may arise if demand is estimated by administrative means. The council concerned conducted market research, asking respondents how important its activities were to the community and how satisfied they were with the current provision of goods and services. Libraries scored well on both counts (important, well provided) whereas the art gallery scored poorly (unimportant, poor current service). The results provoked considerable debate within the council.

Library proponents suggested an immediate reallocation of resources away from the art gallery. The art gallery supporters, however, used the same data to draw the opposite conclusion. They interpreted the results to imply that libraries had been over-provided, to the point where marginal returns were likely to be considerably lower than those obtained from the art gallery. The only definite conclusion that can be drawn from this experience is that, in the absence of a price mechanism, administrative judgments about demand and consumer preferences may be subject to significant uncertainty.

Product degradation i.e. provision of goods and services of inferior quality, is another form of non-price allocation of goods and services employed by local government.

Consumers face a choice between accepting lower quality goods and services at below-market prices, or turning to private sector sources of supply at market prices. The lower quality of some local government-supplied housing may be an example of product degradation.

User charges should be applied where local government provides goods or services that have a private component provided that the costs of doing so (transactions costs) are not excessive. Such charges should reflect the marginal costs of production and distribution, subject to the concerns about production efficiencies noted below. Only in extreme cases should charges be set at zero. At present user charges generally account for between 23 and 36 percent of the total income of the larger local authorities. It is most unlikely that there are valid public policy reasons for such a limited reliance on user charges.

Uncertainties about the true private component of goods or services provided by local authorities need to be weighed against the drawbacks of alternative allocation and funding mechanisms. Non-price rationing relies on the judgments of administrators who may have poor information on consumer preferences. Administrative allocations are also subject to lobbying by interest groups. The potential weaknesses in local government accountability noted above may exacerbate these problems.

While user charges may not be perfect proxies for the private good component of publicly provided goods and services, alternative funding mechanisms are not ideal either. General taxes, including rates, impose a range of economic costs: they alter incentives to work, save and invest, and reduce national income. Furthermore, all feasible taxes impose significant administration and compliance costs on the community.

The small number of goods or services produced by local government that exhibit significant public good characteristics suggests that user charges should be pursued in most circumstances. The costs of user charges to the community are transparent, whereas other funding mechanisms and their consequences (e.g. the limited supply of inferior goods and services, and higher rates and debt) are less transparent to the user.

4.4 EFFICIENT SUPPLY OF GOODS AND SERVICES

Where a local authority decides to supply goods and services, it does not necessarily follow that it need produce them. This has been increasingly recognised during the past few years.

Public provision of goods and services often occurs where competition is limited. Consumers may have few alternative sources of supply, and in these circumstances incentives facing providers are particularly weak. There is also a risk that user charges may be excessive because they could be set at levels well above the prices at which a competitive market would provide comparable goods or services. Competition provides an incentive for suppliers to constrain costs, to be responsive to consumers' needs and to innovate.

To capture the full benefits of appropriate user charges, the provision of local goods and services should not normally be the exclusive preserve of a single supplier. The pricing mechanism works best when producers face actual or potential competition. This is true whether goods are produced by public or private organisations.

For many goods and services produced in the public sector, it is possible to promote competition by removing artificial barriers to entry by alternative suppliers and by establishing production units as separate trading entities, with clearly defined objectives and appropriate accountability. The separation of the provision of goods and services from other local government activities is necessary to limit the scope for cross-subsidisation and therefore to foster competition with other providers, to reduce conflicting objectives and to enhance performance measurement.

Where external competition is not possible, local authorities can foster competition by regularly tendering the right to supply goods and services. The benefits that can be reaped have been illustrated in the case of tenders for bus services by some local authorities. Christchurch City Council also reported saving \$0.9 million by tendering refuse collection services. There is scope to expand this approach, for example in the core areas of roading, drainage and sewage. Even traditional administrative tasks, such as the collection of rates, could be tendered.

Some local authorities, especially smaller or remote ones, argue that effective competition is impossible in their circumstances. There may, for example, be only one roading contractor in the area. A sceptical view of such arguments should be taken because tendering encourages the emergence of new suppliers.

In some cases it is possible that well-designed regulation may be preferable to direct provision of goods and services by local government. Moreover, subsidies for private provision, in addition to regulatory requirements, may be worth considering in certain situations. It is useful in this regard to consider the case of rubbish disposal.

The risk of disease and the unsightliness to others of rubbish on properties might be seen as an externality warranting a rubbish disposal service provided at low direct costs by local authorities.²⁶ However, this may result in a rubbish disposal service that is inflexible, for example collection once a week of a limited amount and restricted types of rubbish, with private sector provision of more flexible services being crowded out. It may also discourage the recycling of used materials. An alternative approach, involving regulation of unsanitary conditions with collection services provided privately might be more efficient.

The provision by local government of rubbish disposal services reduces the incentive to design more efficient regulations to deal with the underlying problem. For example, it may not prevent properties being littered with discarded washing machines, cars and garden rubbish, because they are not collected by the normal local government rubbish services. Beyond this, it may reduce incentives for the development of enforceable and transferable private property rights in this area.

Local authorities need not assume the role of provider of those goods and services which it wishes to fund. Where production remains within the local public sector, the introduction of competition is likely to improve operating efficiency. If this approach were followed, residual activities that could not be open to competition would probably be few.

4.5 OWNERSHIP OF COMMERCIAL ENTERPRISES

The commercial enterprises of local government may be defined broadly as those which supply goods and services that do not meet the criteria for public provision. The arguments against local government participating in such activities are similar to those that led central government to withdraw from a number of comparable activities over recent years.

Publicly owned enterprises are generally less efficient than privately owned businesses. There are several reasons for this:

- public enterprises often enjoy competitive advantages. They may, for example, use public funds to subsidise their activities and competition may be impeded or

²⁶ As argued above, an externality would not normally suggest that a service should be provided free of charge.

prohibited in other ways. The absence of competition leads to higher costs, slower rates of innovation and an inadequate focus on the needs of the customer;

- public enterprises benefit from an implicit government guarantee which reduces the sanctions associated with the threat of commercial failure and discourages monitoring by financial market participants;
- public sector managers may be protected from the transfer of ownership (for example, takeover), which impairs performance;
- public enterprises are managed by directors or employees who do not have an ownership interest in the business whereas private firms are generally managed by directors with a stake in ensuring the performance of the business;
- politicians may interfere with commercial decisions of public enterprises resulting in over-staffing, excessive non-staff input costs, under-capitalisation and inappropriate plant location and size.

There is substantial evidence that these factors lead to large inefficiencies.²⁷ This is the key reason why governments of all political persuasions in many countries have undertaken privatisation programmes.

While a more widespread application of user charges and the facilitation of competition may be beneficial, they will not maximise the efficiency of local government commercial activities. This will require local government operations to face the same pressures to perform and satisfy consumer requirements as private sector operations.

Because of monitoring difficulties, the ownership of commercial businesses by local government tends to result in a number of undesirable consequences:

- costs tend to be excessive. The competitive processes found in product and capital markets and the market for corporate control tend not to be harnessed sufficiently to reduce costs. Government businesses are often charged an inappropriate cost of capital, they may be subsidised in other ways, and they may enjoy an actual or *de facto* monopoly by virtue of being subsidised;

27 See, for example, John Nellis (1994), "Is Privatisation Necessary?", *FPD Note*, The World Bank, No. 7 (May) pp. 1-4.

- consumer choice may be reduced. The absence of competition prevents consumers from choosing among a wider array of services. This is especially the case where public providers are implicitly or explicitly subsidised. The incentive to innovate is also reduced; and
- significant business risk is borne by ratepayers. All business operations involve risks. These are accentuated where businesses are poorly managed. There have been some well-publicised examples of local government commercial operations encountering financial difficulties.

The corporatisation of many trading activities is a step in the right direction. It should lead to better pricing of output and pave the way for the emergence of greater private sector competition. However, the process has three major weaknesses:

- there is no statutory obligation for corporatised businesses to be charged an economic cost of capital i.e. to achieve a realistic return on equity;
- only a few trading enterprises are required to be corporatised. Others, such as the professional services provided by local authorities and their housing and property activities, need not be; and
- corporatisation will not remove business risk and overcome the inherent weaknesses in public ownership of businesses.

As a result, corporatisation will not eliminate all the problems that arise from local government ownership of commercial businesses. This would require the privatisation of businesses owned by local authorities.

4.6 INCOME AND WEALTH REDISTRIBUTION

The provision of goods and services by local government necessarily implies a degree of income and wealth redistribution. Some redistribution involves subsidies from ratepayers to consumers of certain services (or vice versa) if user charges do not reflect the marginal costs of production and distribution. Other forms of redistribution involve explicit subsidies to groups that may also be assisted by central government's welfare system. The provision of subsidised housing, and the granting of subsidies to beneficiaries for various services supplied by local government such as transport, are examples.

To the extent that particular communities have different preferences about the degree and form of redistribution they wish to achieve, local initiatives could in principle be better than central government schemes. However, the 1988 officials' report on local government saw no explicit role for local government in income and wealth redistribution.²⁸ The report suggested that explicit redistribution should remain the sole preserve of central government. According to Scott (1977), the general consensus on the appropriate distribution of functions between national and sub-national agencies is that redistribution should be a central government function.²⁹ The officials' report acknowledged that local government could be involved in the delivery of social services.

Some local government activities that assist certain groups would not satisfy generally accepted efficiency or equity criteria. Moreover, given the size and scope of central government's redistributive policies at present, it is difficult to conceive of an explicit role for additional local government policies of this type.

Taking housing as an example, pensioners are often identified as a group worthy of assistance. At least one city council provides housing close to its central business district on the basis that its tenants would not otherwise have access to accommodation in that area. The council may not fully recognise the costs of its policy. The opportunity costs of the resources employed are likely to be high because a greater quantity of housing could be obtained in alternative locations.

As central government housing subsidies now take account of rent paid, subsidised council rents may effectively transfer the costs of housing assistance from central to local government. In addition, the grounds upon which redistribution is taking place may be far from clear to the electorate. The annual plan of the city council concerned only sets out the operating cost of providing the housing, together with a general assertion that a social need is being fulfilled. Whether an adequate mandate from the electorate exists, given the limited transparency in the policy, is uncertain.

28 Officials' Coordinating Committee on Local Government (1988), *Reform of Local and Regional Government: Discussion Document*, Department of Internal Affairs, Wellington.

29 Scott, Claudia D. (1977), *Local and Regional Government in New Zealand: Function and Finance*, George Allen & Unwin, Auckland.

Local government redistributive policies are most likely to be beneficial where it can be shown that the local community has preferences that are not being recognised by central government policies. It is also necessary to show that the benefits of local policies outweigh the costs involved. In the event that these conditions are met, the form and the costs of redistribution should be fully disclosed. Many existing local government redistributive activities may not fulfil these criteria.

4.7 PROPOSALS RELATING TO THE PROVISION OF GOODS AND SERVICES

The main functions of local authorities may be broadly grouped into four categories:

- commercial goods or services that should be provided privately;
- goods or services where there may be a public good element, but where user charges should be applied;
- goods or services where charges could be tied to another form of revenue collection; and
- goods or services which are largely public goods.

Commercial Goods and Services that Should be Privately Provided

Commercial or private goods and services have none of the characteristics that might warrant government action. Accordingly, local government provision of commercial goods and services or ownership of entities that produce them is difficult to justify. Airports, ports, commercial forestry, refuse collection and transfer stations, off-street parking, rental housing, commercial property development and quarries clearly fall into this category. Any outstanding regulatory issues should be resolved at the local or national level. It would then be desirable on economic grounds for the production of commercial goods and services to take place in the private sector and for local authority businesses engaged in such activities to be transferred into private ownership.

Some of these issues have been or are being addressed by local authorities. Although not legislatively required to do so, a number of councils have sold, or are intending to sell their equity holdings in port companies. Negotiations for the sale of equity holdings in airport companies are proceeding. The Auckland and Wellington City

Councils have disposed of their abattoirs. Despite these developments, withdrawal from commercial activities and avoidance of associated business risks are not yet universally accepted objectives of local authorities. Indeed the Christchurch City Council has moved in the opposite direction with its investment, through Southpower, in the energy company Enerco. To date Christchurch ratepayers have borne a substantial loss as a result of this investment.

Services for Which User Charges Should be Applied

Swimming pools, dedicated sports facilities, libraries, art galleries, water supply and regulation are examples of activities that should be largely funded by user charges. As noted above, there appear to be few grounds for providing services free or at minimal cost if they contain a large private good component.

There is no all-encompassing method to determine the appropriate extent of user charges for such activities. The distribution of public and private benefits must be judged on a case-by-case basis where the onus is on councils to establish the grounds for any subsidisation. Two examples illustrate the potential for more efficient and equitable outcomes through a greater reliance on user charges. The costs of operating libraries and swimming pools are heavily subsidised by most councils. It is difficult to conclude that the public good element of these services, i.e. the benefits of the services to non-users, are of the magnitude suggested by the level of subsidies.

Taking the Auckland City Council as an example, the gross operating costs of its library network are projected to be \$14.8 million in 1994/1995 which will mainly benefit 170,000 registered patrons (around 56 percent of the resident population). Budgeted revenue amounts to around 7 percent of gross costs. The average net subsidy is expected to be about \$80 per patron. (This is a somewhat arbitrary statistic as all patrons may not use the library during the year while some non-patrons may do so.) The 1994/1995 annual plan indicates that around 4 million books are expected to be borrowed during the year. A combination of an annual membership fee together with a small charge per book could potentially fund most library costs, although it should be noted that the Local Government Act prohibits membership fees for libraries.³⁰ This difficulty could be overcome by an appropriate amendment to the Act.

30 The University of Auckland, which provides some services in competition with the City library, charges approved borrowers from its library (other than students and staff) a fee of \$88 a year.

Similarly, the existence of privately operated swimming pools raises doubts as to the extent of the public good component of swimming pools. To the extent that local government has some social objectives (e.g. learning to swim), these could be subsidised directly without the need for it to own the facilities and to price all admissions below marginal costs.

Parks and playing fields need to be assessed on a case-by-case basis. At one extreme, facilities such as Wellington's botanical gardens may have a large public goods element. In contrast, some sports facilities that are dedicated to particular groups of users on a near-permanent basis have a substantial private good element. At least the direct costs of meeting their requirements, such as preparing cricket pitches, could be charged to the relevant sporting bodies.

Services for Which Tied Fees Should Apply

Transactions costs prevent direct charging for some services. However, as discussed earlier, alternative revenue bases may exist which are closely correlated with consumption of the services concerned. The central issue is whether user charges levied through alternative bases would be more efficient and equitable than funding through rates. Sewage and possibly local roading appear to be the main candidates for levying user charges by this means.

There appears to be scope for a separate sewage charge based on the consumption of water. This is only practical where water meters are in place. While metering involves installation costs, the benefits in terms of equity (charging according to consumption) and efficiency (reducing excessive consumption) may be greater than related costs. A number of councils are installing water meters (for example, Auckland and Christchurch Cities).³¹ The introduction of user charges for water is reported to have reduced demand by 20 percent in some instances.

Charging for the use of local roads may also be possible on an analogous basis. Local authorities own almost 82,000 kilometres of formed roads (including streets) compared with around 10,400 kilometres of state highways and motorways. At present, funding for local roading is jointly provided by Transit New Zealand (largely funded by road user charges and excise duties) and local authorities. Transit New Zealand's contribution to the costs of local authority roading in 1992/1993 was about

31 Water meters were installed at most properties in the district of the former Auckland City Council. Metering is now being extended to the areas which have been brought within Auckland City and to those areas which were not previously subject to metering.

\$230 million. While the level of funding directly provided by ratepayers is not known, it could be \$200-300 million a year.

The grounds for local authority funding appear to be that:

- the benefits are to some extent localised and therefore some of the costs should be borne by local communities; and
- some benefits accrue to property owners, in terms of access, and therefore rates may be an appropriate basis upon which to fund roading.

The argument that localised benefits should be accompanied by localised funding follows from the rationale for local government. However, it does not follow that general taxation (either rates or any alternative) is the appropriate revenue base. Empirical support for the use of rates is lacking. While property owners derive some benefits from roading, in most instances the users of the roads are likely to be the more direct beneficiaries.

The recent introduction of regional petrol taxes highlights the potential to shift the funding for local roads away from rates. Much of the public debate regarding these taxes has centred on the weakness of the rationale provided for their introduction. While the extent to which existing indirect taxes on petrol cannot be justified on normal taxation criteria needs to be taken into account, the basic notion that indirect taxes need not be uniform nationally appears reasonable. The land transport pricing study that is currently underway at the central government level may shed further light on this issue.

Goods and Services Which Should be Mainly Tax-Funded

Residual local government activities for which user charging is inappropriate need to be funded from rates. Most parks, street lighting, civil defence and the administration of democratic processes (elections and elected councillors) are examples of such activities. Some regulatory functions of local government may also belong in this category. Although current funding policies of councils imply that public goods account for a large part of local government, it is likely that a rigorous analysis of local government activities would not support this view.

4.8 ASSESSMENT

The local government reforms of the past three years have made progress in rationalising the supply of goods and services by local authorities. There is scope to take the process much further.

Councils should focus on local activities with high public good characteristics. These are the traditional functions of local government. Where operations replicate functions undertaken commercially, the case for local government involvement appears weak. Such operations should be sold.

Where activities should remain in the local government sector, there is scope for introducing or expanding user charges. Many goods and services produced by local government have at least some characteristics of private goods and can be thought of as publicly provided private goods. In these cases, the degree of subsidy through rates requires close scrutiny.

In some cases, tying charges to those of related goods would improve the efficiency with which resources are used, by making users more aware of the true costs involved. It would also produce an outcome which is more equitable than funding through rates. Roothing and sewage may be two cases in which this approach could be pursued. Given the significance of roading and sewage, this type of charging has considerable potential to reduce pressure on the rating base. A number of city councils are contemplating instituting charging for water and sewage services.

There is also scope to improve the means by which local authority goods and services are provided. Competition in the provision of goods and services should be pursued wherever possible. A number of local authorities have demonstrated the gains that are possible from contracting out the provision of services.

5 LOCAL GOVERNMENT FINANCING

5.1 GENERAL ISSUES

The financing requirements of local government depend on where the boundaries of its activities are drawn and on the extent to which user charges are applied. This section concentrates on the funding of that portion of local government expenditure for which user charges are inappropriate.

Rates are the primary source of funding for local government. The 50 largest local bodies raised \$1.3 billion through rates in 1993/1994. Rates account for more than 50 percent of local authority revenue. A 1988 Officials' report concluded that rating should continue as the primary source of local government revenue.³² Submissions on the report from local authorities generally argued that rates provided an excessively narrow revenue base. They supported alternative sources of income such as local income or consumption taxes rather than higher user charges.

The narrowness of rates as a revenue base would be less of a problem if local government spending were subject to proper scrutiny and if appropriate pricing of goods and services were more rigorously pursued. However, even if the utmost were achieved in this regard, a residual set of activities would remain which would need to be financed from taxes.

In addition to the general level of rates, the distribution of the rates burden, especially as between business and residential ratepayers, remains controversial. The distribution depends on the basis chosen for rating and the manner in which differential rates are set.

There appears to be little consensus on the degree to which rates should be regarded as taxes or as charges for services. Two recent court rulings in which the Electricity Corporation of New Zealand (ECNZ) has successfully appealed against rates levied on its assets have highlighted this issue. The greater the extent that rates are considered to be charges for services, the less logical would it be to consider ability-to-pay as a criterion for setting rates.

³² Officials' Coordinating Committee on Local Government (1988), *Reform of Local Government - Funding Issues: Discussion Document*, Department of Internal Affairs, Wellington.

Any examination of local government financing needs to address debt raising. Unlike central government, there are a number of statutory limits on local government borrowing. The appropriateness of debt as a source of funds, together with the conditions under which local government may raise debt, requires appraisal.

There are a number of methods of financing services provided by local government. The main sources of the funds currently employed fall into three broad categories (excepting user charges and income from trading enterprises):

- taxation (including rates) and fines;
- transfers from central government; and
- debt.

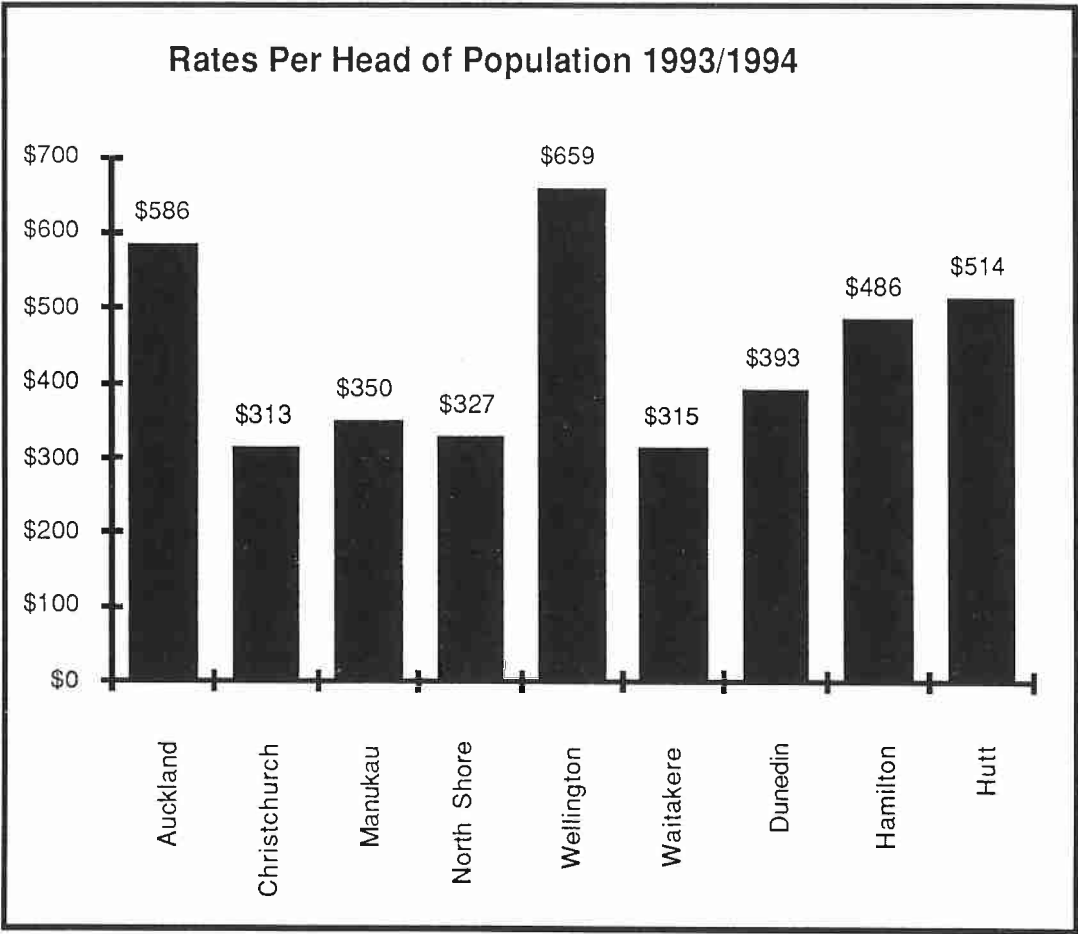
The preferred mix of funding sources should reflect the relative economic cost of each source. The choices faced by local government in this regard broadly mirror those available to central government, with two exceptions. First, local authorities do not have the option of borrowing from the Reserve Bank. Secondly, some local authority activities may be funded by grants from central government.

5.2 TAXATION AND FINES

Rates

Rates are the major source of funds for local authorities. The following bar chart shows the average per capita rate for the nine largest territorial authorities measured by their permanent populations. Around half of New Zealand's population resides in the nine cities. Where a separate water rate is charged it is included but regional rates are excluded. The information presented in the graph is based on a survey by *Management*.³³

33 Management (1994), "New Zealand's Top 50 Local Bodies", *Management*, April, pp. 29-53.



The average rate burden varies considerably with Wellington ratepayers paying more than twice the amount paid by their counterparts in Christchurch. A number of factors could account for variations in the level of rates, including the range of services provided, the relative efficiency of local authorities, the extent of alternative means of funding (such as user charges) and contrasting geography and territorial size, as well as differences in community preferences. In general rates are well below the maximum 1.25 percent of capital value allowed under the Rating Powers Act.

Rates provide a financial base for local government which is independent of central government, relatively cheap to administer and capable of being adapted to suit local circumstances. In the absence of local funding, the provision of goods and services could be less equitable (as a result of cross-subsidisation among local communities) and less efficient (because differences in consumer preferences would be less likely to be taken into account accurately).

Rates have many of the properties of a tax, both in their distributional effects and in the economic costs they impose. Viewed against normal economic criteria, they are far

from an ideal tax. They are collected from a narrow base comprising rural, residential, commercial and industrial land and/or buildings. Such property is one input used in the production of housing services and a wide range of other outputs. A tax on this specific input may distort production decisions and lower national income. The economic costs of raising revenue from such a base should be borne in mind when making decisions as to the appropriate level of user charges.

Types of Rating Systems

The statutory authority to levy rates is contained in the Rating Powers Act 1988.³⁴ Territorial authorities may levy general rates on every separate rateable property within their district. Property is rateable unless it is exempt. A separate rate, for example a water rate, may be levied to undertake or contribute to any specified function or work, or to provide any specified service, for the benefit of all or part of the district.

Since 1982, territorial authorities have had power to levy a uniform annual general charge. The rationale for the charge is that every occupier should contribute a minimum amount toward the general revenue of the council. The extent to which councils may rely on such a charge to fund their activities is limited. Councils may also impose a separate annual charge instead of, or in addition to, an annual general charge.

The mechanics of rating for regional and territorial authorities differ. In general, regional councils levy rates on property in districts or cities within their regions. Regional councils may collect their rates directly from property owners (for instance, Southland) or indirectly by way of a rate payable by territorial authorities that are located in the region (for example, Auckland).

The Rating Act authorises four rating systems:

- annual value. Rates are levied on the annual value (equivalent rental value) of property;
- capital value. Rates are levied on the combined value of land and capital improvements;

34 The discussion draws on a commentary on the Rating Powers Act 1988 prepared by Alan Dormer and contained in *McVeagh's Local Government Law in New Zealand*, Brooker & Friend, Wellington.

- land value. Rates are levied on land value only; and
- area. Rates are levied according to the size of the property. This system may only be used for land drainage and water rate purposes.

A regional council may generally adopt the rating system of its choice. However, where a regional council intends to enter into an agreement with a territorial authority for the collection of a regional rate on its behalf, the regional council's choices are constrained. Where the region comprises two or more territorial authorities that use a common rating system, that system must be adopted by the regional council. Where there is no common system, the regional council may adopt one of the systems used by territorial authorities in its region. Even in these cases, however, a regional council may choose a separate rating system if it intends to apply a differential rate.

The land value system is predominant, although the trend is in favour of the capital value system. No single system offers unambiguous advantages in all circumstances. The main argument in favour of the annual value system is that rent may be a better predictor of income than capital value. However, the income generated by a property and its capital value are related.

Differential Rates

The power to apply a differential rate was granted to counties on a restricted basis in 1969 and extended to boroughs in 1975. This power is unique to New Zealand and South Australia.³⁵ Differential rates are often struck between commercial/industrial and residential properties, usually in favour of the latter properties. This may reflect the electoral dominance of residential ratepayers. A differential rate may also be weighted in favour of the rural sector, perhaps to reflect the relatively high value of rural land and the low use of services by rural ratepayers. Differential rating is more widespread under the land value system.

Differential rating was introduced because the application of a uniform rate was said to be inequitable. There were concerns that farm land located within urban areas would be excessively taxed if a uniform rate were applied. Tensions apparent in rating disputes may thus be symptoms of a deeper underlying problem. Increased reliance on appropriate user charges would help overcome the problem of inequitable

35 Palmer, Kenneth A. (1993), *Local Government Law in New Zealand*, Law Book Company, Sydney.

rates. In the case of rural-urban differentials, there may be a need for more appropriate boundaries to be drawn.

One rationale advanced for making the commercial and industrial sector bear a larger share of total rates than homeowners is that it consumes a disproportionate share of local government services. Roading, refuse collection and sewage reticulation and disposal are frequently cited as examples. There do not appear to be empirical studies that would justify most differential rates. Moreover, direct charges can be employed to impose the costs of most services on firms and other users.

An alternative rationale for differential rating is that rates are a tax deductible expense to businesses but not to households. This argument does not withstand close scrutiny, despite its acceptance as a relevant factor by the courts. Income earned by firms is generally subject to income tax. Because firms are taxed on a net rather than a gross basis, a deduction for expenditure on rates is permitted. This does not place firms in a favourable position relative to residents.

Residents receive a deduction for rates if their gross income is taxed, for example, where property is rented. However, where gross income is not taxed, for instance the implicit rents that accrue in respect of owner-occupied housing, a tax deduction for related costs including rates is disallowed. Owner occupiers are, if anything, relatively advantaged because they do not pay tax on the net income that arises from their investment in housing. It is incorrect to conclude that firms gain an advantage over residents because they can deduct rates for income tax purposes.

A related argument that has been advanced for imposing higher rates on businesses is that some businesses can claim an input tax credit for GST paid in respect of rates. This is also said to confer an advantage on businesses. However, GST was designed to impose tax on final consumption spending. For this reason, firms (but not final consumers) generally receive a deduction for GST paid on inputs. This deduction is intended to avoid a cascade effect where the amount of tax is affected by the number of traders involved in the production and distribution of goods and services. Business firms, other than those supplying exempt services, pay GST on their net value added.

While firms may appear to recover GST on outputs from their customers, their ability to do so is affected by the sensitivity of the demand for the particular goods and services to changes in their price. Where small changes in price lead to a large reduction in the demand, GST is unlikely to be fully passed on to consumers. It is

simplistic to assume that GST is passed on in full to final consumers. Businesses should not be discriminated against in rating policy decisions on these grounds.

Many local authorities have shown a reluctance to live with the full consequences of differential rating. A number of city councils have been concerned at the decline of retailing in their highly rated central business districts (CBDs). Various devices have been used in an attempt to reverse this trend. Wellington City Council has set aside \$0.5 million to provide relief from rates for some city businesses. Some local authorities have used their regulatory powers to support inner city developments and to disadvantage competing projects located elsewhere. Other examples include subsidies for cultural or sporting festivals on the basis that they attract patronage to the locality concerned.

An analysis of differential rating should take account of its dynamic effects. Property values change to reflect the impact on net income of differential rating. The 1994 general revaluation has reduced the rateable value of property located in Wellington City's CBD. To meet the Council's objective of obtaining 67 percent of rate revenue from the commercial/industrial sector and 33 percent from the residential sector, it will be necessary to increase rates on commercial properties in the suburbs and on the fringe of the CBD by up to 150 percent compared with 65 percent in the CBD. If these increases proceed the value of affected properties will fall.

The costs of imposing additional rates on businesses are usually not transparent. They can influence a number of decisions, such as the pricing of products, where firms locate and which activities are sited in particular areas. In general, rates are only one of a range of factors influencing these decisions, and therefore their specific influence is difficult to isolate. To illustrate this point, in one urban area a territorial authority was adamant that lower rates for central city businesses were influential in attracting firms to locate within its boundaries. The neighbouring territorial authority was equally convinced that the higher rates it imposed did not discourage businesses from locating within its boundaries. The latter conclusion would be dubious for marginal decisions where the disparity is other than trivial.

Competition among local authorities is likely to constrain their ability to impose excessive rates on businesses or residents. Some businesses and residents are likely to relocate to other centres if excessive rates are imposed.

Differential rating which is not justified by demonstrable differences in services provided has drawbacks from an economic efficiency perspective:

- it has allowed unpredictable and large shifts in the incidence of rates to occur with adverse effects on investment;
- it has driven large tax wedges between the economic (pre-tax) and market (post-tax) value of properties; and
- it has led to large and unnecessary costs associated with the setting of differentials and subsequent negotiation, amelioration and, in some cases, litigation.

From an equity perspective it is far from clear that the differential rating has led to better outcomes given the availability of other means of promoting equity such as user charges and separate and special rates. Moreover, for reasons set out earlier in this study, local government has limitations as a redistributive agent. It is also necessary to show that the benefits of any local redistributive policy outweigh the costs involved. Differential rating does not appear to have satisfied this test. This analysis leads to the conclusion that the use of the differential rating powers in the rating legislation, beyond that which can be justified by demonstrated additional costs, should be progressively abandoned.

Legal Challenges to Rating Decisions

The courts have examined many rating issues. Parliament has conferred on local authorities the power to determine the rating system to be chosen, the differentials (if any) to be applied and the amount of the rate to be struck. For the court to intervene in that process would be to take upon itself powers which parliament has devolved to local government. As Gallen J. put it:

... it is not part of the Court's function to consider the merits of rival systems of rating. That is a matter of determination by the appropriate elected local authority The local authority has the obligation of recognising the particular requirements of the district it is obliged to administer and must be regarded as the only judge of what is appropriate.³⁶

The most successful challenges involve cases in which rating decisions have been invalidated on procedural grounds. In a judicial review, the applicants are obliged to demonstrate that a council has erred in law in order to secure relief. However, if the

36 Barton v Masterton District Council (1992) 1 NZLR 232, 237.

procedural errors are merely matters of form rather than substance, the court will refrain from overturning the local authority's decision.

Two other areas of potential challenge arise: the taking into account of irrelevant factors and the failure to take into account all relevant factors. It is very difficult for plaintiffs to point to evidence showing that decision makers have omitted to consider a relevant issue or have given weight to irrelevant factors. To overcome this difficulty the courts have developed an unreasonableness test. Gallen J. expressed the test as follows:

... a decision to be impugned on such grounds would have to be so devoid of any plausible justification that no reasonable body of persons could have reached it ... [and] ... it would have to be so outrageous in its defiance of logic or of accepted moral standards that no sensible person who had applied his mind to the question to be decided could have arrived at it ...³⁷

The law relating to judicial review of administrative decisions was recently summarised in the following terms:

What is plain beyond argument is that neither under the head of unfairness nor under any other head of judicial review can there be disturbance of an administrative decision which on an objective consideration is seen to have been fairly, reasonably and lawfully open on the facts and to have been reached after a fair procedure.³⁸

The above principles are relevant in examining three recent court judgments which focused on the duties of councils in setting rates. The first two arose from objections by ECNZ to rating decisions which, ECNZ argued, had the effect of seeking contributions from it that significantly exceeded the benefits received. The third judgment concerned the powers of a city council to apply differential rates.

The cases may be summarised as follows:

- in *The Mackenzie District Council v Electricity Corporation of New Zealand*, ECNZ objected to standard rates based on capital value. The assets of ECNZ, which had become rateable because they were no longer owned by a government department, amounted to around 85 percent of the rateable value in the district.

37 *Barton v Masterton District Council* (1992) 1 NZLR 232, 237.

38 *Cooke, P., Thames Valley Electric Power Board, Want and others v NZFP Pulp and Paper Limited and others* (1994) CA 270/93.

Application of standard rates would have resulted in ECNZ paying \$3 million in rates, compared with total rate collections of \$0.8 million in the previous year;

- in *Electricity Corporation of New Zealand v the Waimate District Council*, ECNZ objected to a rate differential of 137 times the standard rate under a land value rating system;
- in *Howick Engineering Ltd v Manukau City Council*, Howick Engineering Ltd objected to a complex differential rating system which required certain ratepayers, especially owners of industrial property, to pay a differential rate that was on average 3.5 and, in extreme cases, 6 times the rate faced by residential ratepayers.

An important issue is whether rates should be regarded as charges for local government services or as taxes. In the Mackenzie case, Richardson J., whilst not directly addressing the issue of whether rates were taxes, stated unequivocally that benefits derived must be taken into account in setting rates:

... the legislation presupposes that a local authority proposing to make a general rate will address its attention to both possibilities. And the availability of a differential basis of rating recognises that in some circumstances a uniform rate will be unfair to particular classes of ratepayers;

and:

In determining the quantum of rates to be raised, what rating system should be adopted and whether the rate should be on a uniform or a differential basis, a local authority, which is essentially engaged in supplying services for its district, must have regard to the levels of services provided to taxpayers and categories of ratepayers.

Tipping J. in the Waimate case reached a similar conclusion:

It seems to me that Parliament in introducing the power to rate on a differential basis must have intended that the differential be struck on some rational basis. Parliament cannot have intended to give territorial authorities carte blanche to introduce whatever differential system they liked.

Both judgments concerning ECNZ stress that not only can a local authority consider a differential rate if a uniform basis would be inequitable, but it must do so. Richardson J. stated:

The stance adopted by Mackenzie may well have flowed from the emphasis given by the chairman to treating Electricorp like any other ratepayer. But Electricorp was not like any other ratepayer and to ignore its special interests

was to breach the fiduciary duty that Mackenzie had to its ratepayers and to Electricorp in particular.

A feature of these judgments was that the court did not specify what level of rates was reasonable, nor how a reasonable rate should be established. This was left to be negotiated between the parties.

The Manukau City Council case involved a more complex situation than either of the ECNZ cases. Manukau City had been substantially increased in size by the 1989 reform. It had inherited different rating systems and had a widely varied rating base. It eventually adopted a rating system which applied differentials in its former districts but also included further differentials targeted at particular categories of property (industrial and commercial). This had the effect of imposing higher rates on highly valued industrial property.

The plaintiff challenged the differentials on the grounds that the council had not followed the required procedures and that the differentials were unreasonable. The plaintiff succeeded on the first ground only. The judgment is important for its qualified recognition that councils have the power, when considering rating matters:

- to take into account general policy considerations, in this case neither to encourage indefinite holding of undeveloped land through rates being too low nor to discourage activity through rates being too high. The judge commented: "I am unable to understand the contention that in selecting an appropriate rating system a local authority must disregard the effect of that system on its general and proper objectives and must relate the form of the system solely to rating matters"; and
- to rate on the basis of ability to pay as opposed to payment for services. The judgment noted that "it was a proper matter for Manukau to consider that if movements in values were directly translated into rates, residential ratepayers might be called upon to carry a burden which was beyond their reasonable capacity to meet The extent of ... smoothing or levelling exercises, and of the protection of the less well off, must be reasonable."

The Manukau case was not an unfettered endorsement of the council's actions. The judge did not, however, view the council's actions as so unreasonable that the court should intervene.

Petrol Tax

A petroleum tax is levied on the total amount of motor spirits and diesel that is used for transport purposes and delivered by a wholesaler in a local authority area. The tax was introduced in 1971. The revenue, which is small at \$21 million in 1991/92, is distributed among territorial authorities in the region. Territorial authorities are reluctant to dispense with the tax. A separate petrol tax may be applied to fund passenger transport services in certain regions. The issue of local petrol taxes was discussed earlier along with user charges for local roads.

Alternative Taxation Options

Rates are not the only possible revenue base for local government. Local consumption and income taxes are common overseas. There is no *a priori* reason why such taxes could not replace rates. However, the costs of imposing local income or consumption taxes are likely to be large relative to the amount of revenue collected. Compliance and administration costs may be expected to be of a similar scale to those associated with comparable central government taxes, whereas the revenue collected would be substantially less.³⁹ It is doubtful that such tax bases would prove to be cost effective.

To the extent that wealth is identified as a desired tax base, it would generally be preferable to tax all forms of wealth equally. This does not seem to be feasible in New Zealand for the foreseeable future because little information is currently collected on wealth.

An alternative approach would be to transfer to local government part of the revenue collected by central government. This would alleviate some of the administrative problems and costs that arise with new local taxes. However, it would eliminate the direct linkage between the level of expenditure in each locality and the burden of funding it, which is a key accountability mechanism.

Whatever the merits of the arguments for alternative tax bases, they are secondary to the main issue of determining the level of local expenditure that should be funded from

³⁹ Sandford and Hasseldine estimated the compliance costs of collecting business income tax in New Zealand to be \$1.2 billion or 19.6 percent of revenue collected in 1990/1991. This compares with \$195 million or 1.9 percent of revenue for PAYE and \$453 million or 7.3 percent of revenue for GST. See Sandford, Cedric and Hasseldine, John (1992), *The Compliance Costs of Business Taxes in New Zealand*, Institute of Policy Studies, Wellington.

taxation. If the range of activities funded from rates is straining the system, the preferred solution is to curtail spending, transfer commercial activities from local authorities to the private sector and apply user charges where appropriate. As noted in the previous section, the scope for such rationalisation remains considerable. If this approach were adopted, the existing rates base would be more than sufficient to fund remaining activities.

Fines

Local authorities are able to impose fines. They provide a minor source of income. Fines should generally be set to encourage optimal compliance with council bylaws. Councils need to be careful not to use their regulatory powers to impose excessive fines and fees. From an economic perspective, excessive fines and charges amount to a highly selective tax. They are among the most distorting taxes. On the other hand, a too lenient approach to fines encourages excessive non-compliance.

These principles may be illustrated by examining street parking. If the cost of parking is set too low, there will be excess demand for parking spaces, the council may earn a poor return on its investment and private provision of parking may be discouraged. Central city businesses and shoppers may be subsidised at the expense of other businesses and residences. On the other hand, excessive parking fees could result in substantial under-utilisation of parking and penalise central city businesses and shoppers. If the expected cost of a parking infringement is low because the probability of being caught is small, the resulting fine is low, or both, motorists will be encouraged to park without paying. Councils face a trade-off between the price of parking, the level of fines and the intensity with which parking bylaws are enforced.

5.3 TRANSFERS FROM CENTRAL GOVERNMENT

Property owned by central government is not subject to local authority rates. However, local government receives grants from central government which are equivalent to rates. There seems to be little reason to change this arrangement. Privatisation and corporatisation have reduced the amount of Crown property that is not subject to rates.

Local authorities receive subsidies from Transit New Zealand for local roading and public passenger transport. The future of this arrangement is linked to the review of land transport. A discussion paper suggests that funding for roads should flow

directly from the land transport fund to transport (roading) agencies.⁴⁰ The level of funding would be more directly related to the amount and characteristics of traffic activity over the parts of the roading network for which each agency is responsible. This proposal would reduce the influence of Transit New Zealand in determining roading priorities. Funding arrangements would be more automatic and similar to those that apply to regional health authorities.

Total government grants, subsidies and levies paid to local government amounted to \$302.7 million (11 percent of the total income of local authorities) in 1991/1992.

5.4 BORROWING

Local authorities borrow directly from financial markets. The Controller and Auditor-General recently reported that the long-term debt (that is debt maturing after more than a year and net of sinking funds held to repay debt) of territorial and regional councils amounted to \$1.7 billion in June 1993.⁴¹ A further \$0.5 billion was reported as short-term debt. Total debt was equivalent to \$650 per head of population and 134 percent of annual rates.

At present only the Auckland Regional Council and the Christchurch and Dunedin City Councils have formal credit ratings. Their long-term domestic debt is rated at AA compared with central government's domestic debt rating of AAA.⁴² The ARC's debt trades in the secondary market at around 0.75 percentage points above the equivalent central government bonds. The debt of local authorities with weaker financial records typically trades at a margin of around 0.9 percentage points. The narrow margins may reflect the difficulty that financial market participants have in assessing the credit-worthiness of local authorities, the demand for local authority debt, and uncertainties relating to the extent of any implicit central government guarantee of local authority debt.

40 Ministry of Transport (1994), *Land Transport Strategies and Network Funding*, Ministry of Transport, Wellington.

41 Chapman, J T (1994), *Report of the Controller and Auditor-General on the Financial Condition of Regional and Territorial Local Authorities*, The Audit Office, Wellington. The amounts presented included unpublished data supplied by the Audit Office.

42 Central government international debt rating is AA minus which is the relevant rating for most international comparisons.

Present Borrowing Powers

Local authorities are subject to the annual financing principle. The assumption is that present ratepayers should finance current expenditure (including interest) only, and should not generally be required to fund past debts and liabilities. Similarly, present ratepayers are not required to fund future expenditure. The annual funding principle is reflected in the Local Authorities Loans Act 1956 which states that every local authority shall provide for its ordinary obligations in any year out of revenue for that year. The Act requires expenditure relating to works that extend over more than a year to be funded by borrowing.

The Act provides for short-term overdrafts for general and emergency purposes and for long-term borrowing to finance capital expenditure, including the refinancing of existing loans. A local authority may borrow, subject to prescribed limits, in anticipation of its revenue. Borrowing for an emergency requires the prior approval of the Local Authority Loans Board. Where a local authority maintains a separate bank account for trading activities, it may borrow, with the consent of the Local Authority Loans Board, in anticipation of its trading revenue. The limits that apply to borrowing for activities other than trading do not apply to such borrowing but the Board may impose conditions. These provisions do not apply to LATEs and other entities which have a separate legal status.

Local authorities wishing to borrow on a long-term basis are required to obtain the prior approval of the Local Authority Loans Board, except for renewal and redemption loans, and loans up to \$15 million and \$50 million for authorities with a population of under or over 20,000 respectively. As most lending falls within these limits the Board's role in approving specific loan proposals is now not extensive.

All long-term borrowing is required to comply with conditions relating to the term of the loan, methods of repayment, underwriting fees and brokerage rates set by the Board. Long-term borrowing must be repaid within the life of the capital asset being funded, and can only be used for the purpose for which it is raised. Borrowing in foreign currency is prohibited. A special rate, which is deemed to be struck, provides security for long-term loans and can be applied by the lender should a local authority default. The Board may approve an application or require the prior consent of the ratepayers. Ratepayers have certain rights to demand a poll. Illegal borrowing by a local authority may result in the imposition of fines on members of local authorities who consent to such borrowing.

Changes to Borrowing Powers Proposed by the Government

The borrowing powers of local authorities have been under intermittent review since 1987. Borrowing constraints imposed under existing arrangements appear to have been successful in preventing most local authorities from encountering severe financial difficulties. This has been achieved, however, at a cost. More efficient methods of borrowing and managing risk that have evolved since 1926 are prohibited. The role of the Loans Board, which has diminished over recent years, reduces the accountability of councils and their managements for borrowing and is inconsistent with the more decentralised approach to public sector management that has been adopted.

The following main arguments have been advanced for reform of local authority borrowing:

- present arrangements are unduly restrictive and costly for local authorities. The form of borrowing is highly constrained (for example, a local authority may borrow by way of an overdraft or debenture but not by issuing bills of exchange). A separate account is required for each loan, thereby limiting the ability of a local authority to manage its debt on a portfolio basis. Present arrangements are well out of step with contemporary financial management practices; and
- more appropriate accountability mechanisms are now in place. The Local Authority Loans Board gives the appearance of greater central control of local authority borrowing than is actually the case.

A 1993 discussion document and draft Bill proposed that the Local Authority Loans Act be replaced by new borrowing powers that would be included in the Local Government Act 1974.⁴³ The proposal was based on the principle of transparent management by local authorities rather than central control. Following submissions on the discussion document and on a revised draft Bill, the government has introduced a Bill for select committee study. The Bill is intended to:

- give local authorities the power and flexibility to obtain debt finance on the best terms and conditions available. Local authorities would not, however, be able to borrow in foreign currency or on-lend to LATEs. Borrowing for the purposes of subscribing for equity in a LATE would be permitted;

⁴³ Department of Internal Affairs (1993), *Local Authority Borrowing: Proposed New Local Authority Borrowing Powers*, Department of Internal Affairs, Wellington.

- enable local authorities to manage financial costs and risks. Local authorities would be able to adopt a portfolio approach and they would be permitted to hedge their financial risks;
- require local authorities to maintain debt at prudent levels and to assess the cost and benefits of borrowing options before entering into commitments;
- enable local authorities to pledge a wider range of forms of security for loans;
- improve the value of charges given by local authorities by providing for their registration and priority;
- establish clearly that local authority loans or "incidental arrangements" such as hedging contracts are not guaranteed by central government unless an explicit guarantee is provided in terms of the Public Finance Act 1989;
- prescribe certain enforcement powers and duties of receivers. The terms and conditions relating to the appointment of receivers by the court are to take into account the interests of secured and unsecured creditors and the local authority, the requirement of the local authority to provide services which are essential for the maintenance of minimum public health and safety, and the interests of ratepayers with property and the general public living within the area;
- require disclosure of proposed and actual borrowing programmes in the annual plans and reports of local authorities. Loan polls would be retained; and
- require borrowing decisions to be taken in the context of new provisions relating to the financial management of local authorities, including the application of the principles of the Fiscal Responsibility Act 1994 to local government. These broader provisions are examined later.

Discussion of Principles

The two major issues with respect to local government borrowing are:

- the circumstances in which borrowing is appropriate; and

- the limitations, if any, that should be placed on the ability of local government to borrow.

The first issue is an extension of the question of the funding mix between taxation, user charges and debt. From an economic perspective, this issue is primarily one of the timing of the imposition of the taxation burden. Debt must be serviced and ultimately repaid from future revenues. The question of the amount of borrowing, if any, that should be undertaken thus becomes a choice between current and future taxation. The circumstances in which future taxation is a superior option appear limited.

The case for debt funding rests on considerations of fairness. Some local government expenditure provides benefits that are realised over a long period, and it is reasonable for the costs to be spread over time. This argument is weakened if the benefits are enjoyed continuously by the same population. However, because the composition of the population is constantly changing, spreading expenditure that provides future benefits is generally equitable among generations.

Another justification for borrowing is to smooth the level of rates over time. Highly variable rate levels would arise if capital and current outlays were funded solely by rates. Because changes in rates are reflected in asset prices, highly variable rates could disturb asset and other prices and thereby increase uncertainty faced by investors. Rate changes are also relatively costly to implement. Borrowing to finance lumpy projects that provide future benefits would enable rates to be smoothed through time and could reduce these costs.

There are, however, grounds for continuing to constrain the powers of local authorities to borrow. These include the following:

- local authorities are subject to relatively weak monitoring arrangements leading to a divergence between the interests of the principals (ratepayers) and their agents (councils). Unlike private sector directors, elected officers do not have a direct stake in the residual assets of the entities that they manage. Ratepayers can vote a council out of office at the next election and a commissioner, receiver or both could be appointed. However, most council operations are protected from competition, are largely funded by mandatory rates and fees, and elected officers and their managers are not subject to the threat of takeover. Monitoring by lenders is weakened because the main security for borrowing is the right to

levy a special rate. In the event of default, lenders probably assume that there is at least the possibility that central government would assist;

- pressures for excessive spending and borrowing can arise where benefits are highly concentrated among ratepayers while costs are spread thinly over a diffuse majority. This tends to create a free-rider problem because it is not worthwhile for any small group of voters to incur the expense involved in mobilising the majority. In addition, the self-interest of elected officers and management may favour excessive spending and debt because it increases their power and perquisites of office; and
- excessive debt may be incurred if present voters and elected officers put self-interest ahead of the interests of future generations.

Reforms of local and central government have generally sought to provide organisations with the scope to act independently on a more business-like basis but subject to improved transparency and accountability arrangements. The borrowing and financial management proposals are intended to bring these aspects of local government administration into conformity with other local government reforms.

Principal and agency issues are the key ones that need to be addressed. As with the Fiscal Responsibility Act 1994, the main elements of an appropriate response to such issues are as follows:

- specification of desirable financial criteria for local government;
- a requirement for local authorities to nominate each year their objectives for total spending, rates and borrowing for a period of years; and
- a requirement for local authorities to account explicitly for deviations from their targets.

The Bill that is now before parliament largely reflects this approach but it also contains some rules which prohibit local authorities from taking certain actions, such as borrowing in foreign currency, which are inconsistent with it. In addition, there are aspects of the proposals and possible ways of strengthening them, which are discussed below, that should be examined further.

Mandatory Credit Rating or Other External Monitoring

A requirement on local authorities to be rated by a recognised and independent credit rating agency should be examined. Credit ratings could provide useful information in a summarised form for ratepayers and lenders on the relative financial strengths of local authorities. More importantly, they would provide strong incentives for management to act prudently. One possibility would be to require local authorities to maintain a minimum rating, say, no more than two or three steps below that of central government.

Compulsory credit rating may be too costly for some authorities. Another possibility would be to require local authorities to inform their ratepayers whether they are rated with reasons for their decision. A further possibility would be to require local authorities to specify their intended credit standing. This might be described as the interest rate margin at which their benchmark debt would trade over central government debt. An independent report assessing whether the intended credit standing had been achieved during the year could be included in each authority's annual report. Another possibility would be to require large spending, taxing or borrowing proposals to be subject to independent investigation with the report being available to ratepayers.

These suggestions are aimed at strengthening external monitoring of local authorities. One difficulty is that local authorities do not generally have a largely independent internal monitoring agency like the Treasury to review and comment on large spending, taxing and borrowing proposals. The possibility of strengthening the fiscal responsibility aspects of the Bill by incorporating additional external monitoring should be examined.

Obligation to Reduce Excessive Debt

The proposals provide no guidance on the steps that are to be taken if a local authority's debt reaches an imprudent level. While a commissioner, receiver or both may be appointed, there are grounds for an intermediate step that requires elected officers to reduce debt. This might oblige the authority to cut expenditure, dispose of non-essential assets and take other steps to reduce debt to a prudent level as a matter of urgency.

Borrowing for On-lending to LATEs

The proposals seek to prevent any local authority from borrowing on behalf of a LATE or for the purposes of on-lending to a LATE. This provision appears to be aimed at preventing LATEs from obtaining a competitive advantage over private firms by borrowing on the security of a local authority's taxing powers. This objective is endorsed.

The local authority could, however, borrow to increase its equity stake in a LATE or it could dress up on-lending as quasi-equity. Regulatory measures, including tax rules and statutory reporting requirements, have led to hybrid instruments that are designed to avoid the intent of provisions such as those proposed. Hybrid instruments contain features of equity and debt. If these provisions were likely to be readily circumvented, it may be necessary to consider alternative or supplementary provisions to achieve the desired aim, such as a requirement for any on-lending to be at commercial rates.

Loan Polls

The proposals provide for loan polls to be held where a special rate is to provide security for a loan. While a more transparent approach to local authority borrowing and broader accountability mechanisms are the key to constraining excessive spending and borrowing by local authorities, there may be some advantage in retaining loan polls if mandatory credit ratings or similar forms of external monitoring are not adopted. They enable ratepayers to object to a potential rise in their future tax burden and act as a constraint on excessive borrowing by local authorities.

Liability of Members for Reckless Borrowing

A proposal to hold a member of a local authority personally liable for up to \$10,000 where a court decides that the member acted recklessly in approving loans has been deleted from the Bill. There are good grounds for imposing sanctions on elected officers who act recklessly as this encourages them to take their responsibilities seriously. The test that was proposed was not a high one. The thrust of the provision should be reinstated.

Registration of Local Government Stock

The Reserve Bank of New Zealand currently has a monopoly on registry services in relation to local government stock. There are no valid grounds for its preferred position. Registry services should be contestable with each issuer free to use the

registry of its choice. This aspect of local authority borrowing arrangements should be addressed in the Bill.

5.5 ASSESSMENT

Local government financing needs to be evaluated in the context of the role of local government. To the extent that its role involves the provision of services, financing should be viewed primarily as a matter of determining appropriate direct and indirect charges for goods and services. Insofar as local government is involved in the provision of public goods, its financing (other than borrowing) should be seen and evaluated as taxation.

Viewed in this light, there are considerable inefficiencies in the current structure of local government financing. Standard economic arguments suggest that prices should normally reflect the opportunity costs of goods and services that are provided.⁴⁴ However, local authorities frequently do not charge economic prices for private goods and services. Usually, they undercharge (e.g. libraries) and sometimes they appear to overcharge (e.g. water for commercial enterprises). In addition to explicit subsidies, it is doubtful whether local authorities always make an appropriate allowance for the cost of capital.

A more appropriate application of economic charges would reduce the reliance of local authorities on rates. A move in this direction should be the first financing priority. At that point, consideration should be given to whether present forms of rating are appropriate as a form of financing for services that could not be charged for in a more efficient way.

To the extent that local government financing cannot be linked to goods or services provided, it should be regarded as taxation. Local authority taxes should be designed in the context of New Zealand's overall taxation system, to minimise its distortionary effects and related administrative and compliance costs. Local retail sales taxes, GSTs or income taxes would appear to involve excessive administrative and compliance costs in relation to the revenue required.

For practical purposes, attempting to determine definitively whether general rates are charges for services rather than taxes and, if so, what differentials appropriately

44 Opportunity costs measure resources committed to the production and distribution of goods and services at the amount which they would earn in their next most valued use.

reflect the differing consumption of services, is impossible. The presumption that businesses consume more services than their portion of rateable values would suggest remains unproven. The apparent biasing of rates against businesses may to some extent be a reflection of weaknesses in accountability mechanisms.

The preferred approach should be to pursue user charges, wherever possible, instead of differential rates. The activities identified in the previous section as possibilities in this regard, such as roading, sewage and refuse activities, are those that businesses probably consume disproportionately. If these activities were correctly priced, the case for differential rates for the business sector would fall away.

With respect to local government borrowing, the recent Bill proposes some desirable reforms, in particular the requirement that local authorities borrow within an explicit and comprehensive up-to-date debt management framework. There are grounds for strengthening the transparency of local authority borrowing arrangements and for going somewhat further in removing remaining constraints that are of doubtful merit, for example on borrowing in foreign currency.

6 REGULATORY ISSUES

6.1 PURPOSE OF REGULATION

The main purposes of regulation are to further efficiency and equity objectives. A primary function of central government is to establish the general framework within which individuals and firms may enter into voluntary arrangements that affect all aspects of their lives. This includes the establishment of property rights and procedures for their enforcement. Beyond this role, central and local government may be able to promote community welfare by specific regulations aimed at reducing transactions costs to an optimal amount.

Transactions costs make it inappropriate to define property rights fully. Thus regulation may be required to assist in deciding among competing rights, for example the right of a factory to discharge wastes into the atmosphere and the rights of affected people and firms to clean air. Inadequately defined property rights and transactions costs help to explain the need for resource management and similar laws. Some regulation of building standards may be justified on the grounds that it would be too costly for the public to assess whether the buildings that they frequent provide at least a minimum standard of safety. Externalities may arise if a fire extends from one property to another. Building regulations may be aimed at reducing these costs and associated risks.

The overall aim of the government should be to provide a regulatory environment that enables total output to be maximised. This requires that the costs and benefits of regulatory proposals be carefully examined. In some instances the overall harm produced by a regulation may be greater than the the problem it seeks to overcome. In addition, perceived problems may be better addressed by modifying or clarifying property rights, or by introducing subsidies or taxes. Thus the full range of instruments available to local government should be examined.

The second possible ground for regulation is equity. Regulations may be used to ensure that undesirable outcomes, in terms of social opportunities and wealth and income distribution, are minimised. The interests of present and future generations may need to be examined in addition to those of different groups of present citizens. Undue emphasis on current use of community resources could, for example, benefit present citizens to the detriment of future citizens.

The role of local regulation is influenced by the following factors:

- local knowledge. The effectiveness of some regulatory activities depends on local knowledge. This may be particularly relevant for day-to-day administration of regulation. Central government may not possess local knowledge to the same extent as regional or territorial authorities, mainly because of its focus on national issues;
- local accountability. Regulatory activities should be undertaken by local government where it is appropriate for regulators to be accountable to local rather than national electorates. This is especially the case where a balance is required to be struck between competing local interests. On the other hand, local representatives may give inadequate attention to national interests. In this case, there are grounds for issues of national importance to be decided by representatives who are accountable to national electorates; and
- history. Some regulatory activities are undertaken by local or central government for somewhat arbitrary historical reasons. If they were originated today they would be undertaken at a different level of government. The costs of changing regulatory responsibility after the event may, however, be too high to warrant this action.

One consequence of these influences is that it is sometimes difficult to prescribe which regulatory activities should be undertaken by local government and which by central government. Each instance needs to be considered on a case-by-case basis in terms of the above criteria.

6.2 REGULATORY FUNCTIONS OF LOCAL GOVERNMENT

Local government undertakes extensive regulatory functions. It administers aspects of numerous statutes and statutory regulations. Local government is also empowered to make and enforce bylaws affecting many activities. The main regulatory functions of local government are discussed below.

Resource Management

The Resource Management Act 1991 is the key legislation governing the use of natural and physical resources including rivers, lakes, coastal and geothermal areas; land; the air; and buildings, bridges and other structures. The purpose of the Act is to promote the sustainable management of these resources. Sustainable management is defined as development that meets the needs of the present generation without compromising the ability of future generations to satisfy their needs. Instead of prescribing activities that may be permitted, the Act places emphasis on the effect that a proposed activity may have on the environment.

Regional councils play a pivotal role in resource management. They have primary responsibility for the management of water, soil, geothermal resources and pollution control. Regional councils also have responsibility for natural hazard mitigation, soil conservation and hazardous substances. They share responsibility with the minister of conservation for resource management issues that affect coastal marine areas.

Each regional council is required to prepare a policy statement that sets out its objectives for managing all natural and physical resources of the region in an integrated manner. Regional plans, which are not mandatory, may address specific resource management issues in the region.

The following matters, which are declared to be of national importance, must be recognised and provided for in regional policy statements, and in regional and district plans:

- the preservation of the national character of the coastal environment, wetlands, lakes and rivers, and their protection from inappropriate subdivision, use and development;
- the protection of outstanding natural features and landscapes from inappropriate subdivision, use and development;
- the protection of areas of significant indigenous vegetation and fauna;
- the maintenance and enhancement of public access to, and along, coastal marine areas, lakes and rivers; and

- the relationship of Maori, and their culture and traditions, with their ancestral lands, water, sites, waahi tapu and other taonga.

Territorial authorities have primary responsibility for land use management and they complement the role of regional councils on issues such as natural hazard mitigation and hazardous substances. They are required to prepare district plans that are consistent with any national policy statement or regional plan.

A resource consent gives a person or organisation permission to develop a natural or physical resource, the right to carry out an activity that affects the environment, or both. There are five types of consents that are issued by district or regional councils as indicated below:

- land use consent (granted by district and sometimes regional councils);
- subdivision consent (district council);
- water permit (regional council);
- discharge permit (regional council); and
- coastal permit (regional council).

An applicant is required to provide the district or regional council with an assessment of the effects on the environment of his or her proposal. The obligation on applicants to provide environmental assessments has greatly increased information available to councils.

The New Zealand Business Roundtable has prepared a separate report that assesses experience to date with the Resource Management Act.⁴⁵ The report recommends a number of amendments aimed at improving the operation to the Act. It contains the following observations:

- the Act has heightened consciousness on the part of developers to the need to give greater weight to environmental concerns;

45 Dormer, Alan (1994), *Resource Management Act 1994: The Transition and Business*, New Zealand Business Roundtable, Wellington.

- it has motivated many local authorities to undertake studies aimed at assessing the extent of pollution caused by their activities (for example, landfill operations) and determining the steps that can be taken to mitigate their effects. Many local authority activities were not previously required to obtain consents and were not subject to penalties for environmental damage;
- the enforcement procedures of the Act are better than those provided by previous legislation;
- the intended benefits of moving from a prescribed use to an effects approach have not yet been realised. Plans and policy statements are too restrictive, especially in respect of matters of marginal relevance in terms of environmental effects. Councils appear to be having considerable difficulty in developing controls which focus on environmental effects as intended by the advocates of the present law;
- the provision for joint hearings has provided councils with the opportunity to take an integrated approach to environmental considerations and makes it possible for major projects to be approved within time frames that could rarely have been obtained under the previous legislation. On the other hand, the time required to prepare an application for a consent has increased. Councils have not performed as well as was hoped in complying with specified time limits for taking decisions; and
- the cost to applicants of obtaining consents has increased. The information requirements of councils and poor administration are contributing factors.

The Act makes very limited provision for economic instruments to be employed to address resource management issues. No provision is made for resource rentals, the voluntary transfer of discharge permits between unrelated businesses or the transfer of water permits. Where economic instruments can be employed, there has been limited use of them. These weaknesses are a major concern from an economic perspective. Greater reliance on economic instruments rather than regulatory decisions is desirable because it would increase efficiency. A value would, for instance, be placed on environmental safeguards and mitigation activities. This would assist in judging whether the balance between development and environmental protection is appropriate. The incentive for firms to find cost effective solutions to environmental problems would also be improved.

Building Controls

The Building Act 1991 is the main statute that affects building standards. The purposes of the Act are to provide for:

- necessary controls relating to building work and the use of buildings, and for ensuring that buildings are safe and sanitary, and have means of escape from fire; and
- the coordination of these controls with other controls relating to building use and the management of natural and physical resources.

The Building Act requires the Building Industry Authority (BIA), which was formed under the Act, to prescribe a building code. New buildings, alterations to buildings and the operation of certain buildings are required to comply with the code.

The Act is intended to be less prescriptive and more flexible than the previous legislation, thereby promoting greater innovation and efficiency. The building code specifies the objective to be achieved, the functional requirement and the performance expected. These matters are commonly expressed in qualitative terms.

The BIA has published non-mandatory approved documents that specify in greater detail how the provisions of the code may be met. Building owners are free to meet the requirements of the code in alternative ways but the burden of proof is on the owner.

Building standards were determined at the local level before the Building Act came into force. The highly prescriptive nature of the previous regulations and the varying requirements of different local authorities are believed to have substantially increased building costs, and reduced the real incomes of building owners and the productivity of the nation's resources. The regulations unduly limited:

- innovation in building methods and choice of building materials;
- building configurations; and
- competition among builders.

The government decided that these costs could be reduced by establishing a national building code.

Responsibility for day-to-day administration and enforcement of the Building Act rests with territorial authorities. The construction, alteration or demolition of buildings cannot generally be carried out without first obtaining a building consent from the relevant territorial authority. An owner must advise his or her local authority that building work has been completed to the extent required. This may entail the submission of a compliance certificate issued by an approved building certifier.

Unlike previous legislation, the Act requires the owners of certain new and existing buildings to demonstrate annually that their buildings comply with the requirements of the Act. They are required to obtain a compliance schedule. This provision does not apply to a building used as a single residential dwelling or to buildings other than those that contain lifts, automatic doors and alarms, and similar systems.

The compliance schedule is issued by city and district councils. It is required to specify the inspection, maintenance and reporting procedures to be followed by independent qualified persons (IQPs) in respect of certain systems. Owners of buildings for which a compliance schedule is necessary are obliged to supply to the local authority an annual warrant of fitness. Before the owner can submit a warrant of fitness, an IQP must inspect the relevant systems and verify that they meet the requirements of the compliance schedule.

A building owner must advise the council if the owner proposes to change the use of a building or to extend its life and if alterations are required to bring the building into compliance with the building code. The use of a building cannot be changed unless the territorial authority is satisfied on reasonable grounds that, in its new use, the building will comply with the provisions of the building code. The building is required to continue to comply with other provisions of the building code to at least the same extent as before the change of use.

A territorial authority may prohibit the use of unsafe buildings and it can require that work be undertaken to reduce or remove the danger. Non-compliance with the Act may also result in fines. The penalties have been described as severe by barristers and solicitors Chapman Tripp Sheffield Young.

Some building regulation aimed at promoting health and safety is likely to be desirable. The transactions costs incurred by the public in establishing that buildings that they frequent meet at least a minimum level of safety, for example, is likely to be larger than the costs of prescribing and enforcing minimum requirements. A focus on buildings

that are frequented by the public and where large numbers of people are potentially affected, as in the Building Act, is also desirable.

It is too early to judge the overall effectiveness of the Building Act. It is unlikely, however, that the current law is optimal. Increased processing costs and major increases in paperwork in complying with the Act have been reported. Parts of the building code are inconsistent, technically complex and lack clarity. The range of building types and the associated differences in the costs and benefits of particular preventive measures are such that it would be remarkable if existing rules were appropriate in all or even most circumstances. It is difficult for policymakers to make the necessary judgments on the value of marginal increases in safety. Finally, the code is unlikely to reflect changes in relative prices quickly (for example, those that occur in response to technological developments) which alter the costs and benefits of particular trade-offs. As a result of the complexities and a lack of administrative expertise, it has been reported that many local authority staff are retreating to known solutions and not embracing change.

The Building Act broke new ground in permitting IQPs rather than council officers to undertake certification functions, although vehicle inspection certificates (formerly motor vehicle warrants of fitness) have been issued by private providers for many years. This approach, which facilitates competition in the delivery of local regulatory services, is desirable in principle and could be extended to other regulatory activities of local and central government. However, the Building Act requires certifiers to comply with stringent requirements which in practice are onerous and risky. Most companies and individuals with the necessary qualifications have been unable to obtain insurance cover for the liabilities involved. Consequently the option of choosing a quicker, more efficient procedure for obtaining building consents has not yet materialised.

The possibility of introducing transferable rights to adopt a different standard of safety from that implied by the Building Act should be examined. This would enable lower standards to be adopted in those circumstances where the costs of compliance are highest. It would also permit the marginal value of such regulations to be quantified thereby facilitating an evaluation of their costs and benefits. A similar approach to pollution has been adopted in a number of instances in other countries.

Experience with the Building Act should be reviewed to ensure that intended benefits are being achieved. The review should include an assessment of the Act's administration by local authorities. Any shortcomings that are found should be addressed.

Other Regulatory Functions

Additional regulatory functions undertaken by local authorities include the following:

- environmental health. A territorial authority is under a duty to appoint one or more environmental health officers for the purposes of enforcing statutory duties and bylaws. The officers are required to examine any nuisance (seventeen are specifically identified in the legislation) or condition which is likely to be offensive or injurious to health. Environmental health officers may also carry out inspections aimed at enforcing regulations relating to food labelling;
- food premises. Premises that manufacture, prepare, pack or store food for sale are required to be registered with territorial authorities. Extensive regulations establish minimum health standards for the conduct and maintenance of food premises. The work practices of staff engaged in the food industry are also regulated. Territorial councils carry out inspections to enforce compliance with the regulations;
- liquor sales. Every territorial council is constituted as a district licensing authority under the Sale of Liquor Act 1989;
- dangerous goods. Every city or district council is the licensing authority for dangerous goods purposes;
- fencing of swimming pools. Territorial councils are responsible for the enforcement of regulations that require swimming and spa pool areas to be fenced to promote the safety of children;
- road, rail and water passenger transport services. All passenger services must be licensed by the Secretary of Transport. Holders of licences are also required to register with their regional council. The main purpose of this requirement is to facilitate passenger transport planning. However, regional councils have some rights to decline registration and unregistered services are not permitted to operate;
- billiard rooms, and shooting and amusement galleries. These businesses are licensed by local authorities. The grounds for specific regulation of at least some of these activities may no longer be valid;

- entertainment on Sundays, Good Friday or Christmas Day. Outside of retail and wholesale shopping arenas, a territorial council has wide powers under the Local Government Act to limit the provision of entertainment on certain prescribed days;
- noxious plants. Every regional and territorial council is required to perform the function of a district noxious plants authority.⁴⁶ The authority's general duties are to eradicate declared noxious plants within the region, city or district;
- dog registration and hydatids control. Every territorial authority is required to register dogs and to prepare a hydatids control plan for approval by the Ministry of Agriculture and Fisheries and to treat dogs. General dog control is also a function of territorial authorities; and
- other bylaws. Local authorities have considerable powers to make bylaws, for example, to prohibit the obstruction of footpaths and to control litter, animals and processions. Four elements are essential to the validity of a bylaw. It must be *intra vires* the powers of the local authority, it should not be repugnant to the general laws of the land, it should be certain and it should be reasonable.

An indication of the significance of regulatory functions in the case of larger city councils can be obtained from selected city plans. Auckland City, for example, intends to spend \$12 million on regulatory activities in 1994/1995, 68 percent of which is to be funded by fees. Planning activities, which are to be funded entirely from rates, will absorb another \$4.3 million. Christchurch City plans to spend \$5.6 million on public health and safety and a further \$9.4 million on environmental planning. Public health and safety in Christchurch City involves 85 staff. Spending on regulatory activities under-estimates their overall importance to the community because it fails to take into account the overall effect of regulations on resource use and wealth creation.

6.3 ASSESSMENT

The following recommendations arise from a review of the regulatory functions of local government:

46 Most noxious plant and animal pest control powers of regional and territorial authorities are to be replaced by provisions which are to be included in a Biosecurity Act. The development of plans and service delivery is to be contestable.

- regulations should be reviewed from time to time on a first principles basis. It is unlikely that all existing regulation would withstand such scrutiny. The review should examine (among other things) whether any regulations that are justified should be the function of central or local government;
- voluntary arrangements should be encouraged, as far as practicable, to address perceived regulatory problems. This could involve a more precise specification of property rights; greater reliance on economic instruments such as taxes, subsidies and transferable rights; and increased provision for private agreements with affected parties. This approach is likely to provide more efficient solutions to at least some regulatory issues because better incentives would apply. Regulations tend to be blunt instruments which have little regard to particular circumstances and they provide strong incentives for lobbying;
- the question of whether local regulatory functions should be undertaken by separate local government entities from those that carry out other functions should be re-examined. At present, there is potential for conflicts of interest between the service delivery interests of councils and their regulatory functions, despite internal separation of such functions. Most public sector reforms have involved the complete separation of these roles and this is benefiting the community. In 1988 officials raised the issue of whether a similar approach should be applied in the local government sector.⁴⁷ The divestment of service delivery functions by regional councils, internal separation and the establishment of LATEs by territorial councils are steps in the desired direction but they do not go far enough. In most cases the establishment of a LATE is voluntary.

One possibility would be for all regulatory activities to be undertaken by regional councils. Another option would be to establish directly elected regulatory entities to service cities and districts and for existing territorial councils to provide only services other than regulatory services;

- the effectiveness of local government administration of regulation should be subject to ongoing review. Most councils have not yet developed adequate performance measures for their regulatory activities. Such measures would offer

⁴⁷ Officials' Coordinating Committee on Local Government (1988), *Reform of Local and Regional Government: Discussion Document*, Department of Internal Affairs, Wellington.

an avenue for improved monitoring by ratepayers and other interested groups but they should be supplemented by periodic external review;

- provision should be made for greater contracting out of regulatory functions similar to the certification function of independent qualified persons under the Building Act. This would encourage regulatory agencies to increase efficiency; and
- councils should examine carefully their policies on charging for regulatory services. There are valid grounds for charging the beneficiaries of most regulatory services for the costs involved. On the other hand, councils generally have monopoly rights to provide such services and they should not take advantage of their preferred position to impose excessive user charges on individuals or firms.

These proposals build on the progress that has been made by recent reforms of local government and the regulations which local authorities administer. They would contribute to a more dynamic economy and would increase the welfare of all citizens.

7.1 RECENT REFORMS

Changes in the financial accountability and management of local government were a key aspect of the reforms introduced since 1987. They were intended to improve the transparency of local authority activities and finances, and to facilitate better monitoring by external parties.

The Local Government Act 1974 now provides that in conducting its affairs every local authority and, where appropriate, every community board is to ensure that:

- its business is conducted in a manner that is comprehensible and open to the public;
- clear objectives are established for each of its activities and policies;
- conflicting objectives and conflicts of interest are resolved in a clear and proper manner;
- so far as is practicable, its regulatory functions are separated from other functions;
- its performance is regularly measured in relation to its stated objectives and is capable of being assessed by interested persons and organisations;
- its local communities, and where appropriate, central government, are adequately informed about the activities of the local authority;
- so far as is practicable, where a committee of a local authority has responsibility for regulatory functions, that committee is not to undertake other functions; and
- so far as is practicable, its management structure reflects and reinforces the clear separation of regulatory and other functions and is capable of delivering adequate advice to the local authority to facilitate the explicit resolution of conflicting objectives.

Annual Plan and Report

Every local authority, LATE or other organisation that is controlled by the local authority and any entity in which a local authority has a significant interest is required to prepare an annual plan. The plan is required to contain the following information in detail for the financial year to which the report relates and in general terms for the following two financial years:

- the intended significant policies and objectives of the local authority, LATE or other organisation;
- the nature and scope of significant activities that are to be undertaken;
- the targets and other measures by which performance may be judged in relation to its objectives;
- indicative costs of its activities, including an allowance for depreciation and a return on capital employed;
- the source of funds; and
- the rating policy of the local authority.

The last three items are required in total and separately for each significant activity of the local authority. The plan must also explain any significant changes between the policies, objectives, activities and performance targets specified for the relevant year in the last annual plan.

The plan is to be adopted within the first three months of the relevant financial year and is to be made available to the public free of charge or for a reasonable fee. Copies of the plan are to be sent to the Secretary for Internal Affairs, the Controller and Auditor-General and the parliamentary library. At least a month is to be available for public submissions.

A local authority is required to prepare and adopt an annual report that assesses its actual performance against its plan. The report is to contain the following:

- audited financial statements for the local authority comprising a statement of financial position (balance sheet);

- an overall operating statement and an operating statement for each significant activity;
- a cash flow statement; and
- such other statements as may be necessary to reflect fairly the financial position of the local authority, the resources available to it and the financial results of its operations.

Consolidated financial accounts are generally required where an authority holds equity or otherwise has a financial interest in other organisations, including a LATE. The financial statements are to be audited. The Controller and Auditor-General, the auditor of local authorities, is required to comment on the actual performance of the local authority compared with its targets. The annual report is to be distributed on a similar basis to the annual plan.

Local authorities are required to adopt financial systems and reporting and record keeping procedures that are consistent with generally accepted accounting practices recognised by the New Zealand accounting profession as appropriate and relevant to the public sector. Their systems and procedures must, among other things:

- include, for each significant activity, an allowance for depreciation and the cost of capital;
- enable the financial position of the local authority to be determined with reasonable accuracy at any time;
- enable a true and fair view of the state of affairs of the local authority to be presented at the end of the financial year; and
- show in a "full and complete manner" all income and expenditure and all assets and liabilities.

A LATE is under an independent duty to prepare an annual statement of corporate intent presenting its objectives for the financial year and the two following years, setting out the scope of its activities and its equity ratio, accounting policies, performance targets and profit estimates. A LATE is required to submit an interim financial report on its activities during the first half of each year. At the end of each

year a full report, including audited financial statements, has to be submitted to shareholders and made available to the public.

7.2 PROPOSED STRENGTHENING

As part of the move to free up specific constraints on local authority borrowing, the government proposes to strengthen provisions relating to financial management. A Bill, referred to in section 5, is currently before the House. The proposals are based on the following principles:

- all revenues, expenditure, assets and liabilities are to be managed prudently and only for lawful purposes;
- in determining the long-term financial strategy, revenue and borrowing policies, and in making decisions with significant financial consequences, local authorities are to consider the costs and benefits of different options;
- adequate and effective provision shall be made for income to meet the expenditure needs of the local authority;
- sources of funding (whether rates, user charges or borrowing) are to be appropriate to the benefits provided by related expenditure; and
- annual operating revenues are generally to be adequate to meet all identified operating expenses.

The apparent requirement to prepare a detailed ten year financial plan every three years may be excessive. Uncertainty over such a long period will limit the usefulness of such plans. Moreover, local authorities may be inclined to repeat the same estimates each year for at least the last five years of the plan. Possibly only the key aggregates such as total spending, rates, other revenue, the surplus or deficit, borrowing and net worth should be forecast for a period up to ten years.

The main concern should be to identify any foreseeable build-up in capital expenditure and debt repayment obligations. Beyond these, explicit policy statements on expenditure, rates, user charges and debt, and a discussion of the steps that are to be taken to achieve specified policies, would be more useful to external monitors than formal estimates. There are some elements of these ideas in the Bill but a policy

statement on the steps which local authorities plan to take to attain their policies seems to be an omission.

7.3 REVIEW BY THE AUDIT OFFICE

The Controller and Auditor-General has recently released reports on the financial condition of regional and territorial local authorities, and the governance of local authority trading activities.⁴⁸ The former report, which was based on a review of all regional and territorial councils in the first half of 1993, examined three main aspects:

- the financial condition of each authority and how well the council monitored this;
- whether the authorities determined and monitored the condition of their physical assets; and
- the extent of long-term planning by each council.

The key findings of the review were:

- the introduction of accrual accounting provides local authorities with a more rigorous framework to assess their financial state. Authorities are generally managing their finances prudently and conservatively. They are capable of meeting short-term financial obligations and servicing their debt;
- a serious weakness is the lack of reliable information on infrastructural assets, other than roading. Most councils have no reliable information on the condition of assets such as sewage and water systems, and few councils have adopted formal procedures to monitor infrastructural assets. (The exception of roading may reflect the influence of Transit New Zealand.);
- strategic planning in local government is in its formative stages. Only a quarter of all councils had prepared long-term strategic plans;

48 Chapman, J T (1994), *Report of the Controller and Auditor-General on the Financial Condition of Regional and Territorial Local Authorities*, The Audit Office, Wellington and Chapman, J T (1994), *Report of the Controller and Auditor-General on Governance of Local Authority Trading Activities*, The Audit Office, Wellington.

- because of the last two points noted, the Controller and Auditor-General was unable to give a positive assurance that local authorities' financial condition is secure in the longer term; and
- the challenge for local authorities is to extend their management into new and difficult areas, in particular the planning and maintenance of their infrastructural assets.

The report commented that it would not have been possible to carry out a similar review without the changes that had been implemented. It should be noted that local authorities have been responsible for the management of infrastructural assets, such as water supply systems, from the inception of local government in New Zealand.

The review of the governance of local authority trading activities was limited. It involved six territorial and two regional councils. A total of 21 companies, four joint venture businesses and nine business units were investigated. The review focused on two key aspects of accountability:

- the respective roles of the local authority shareholder and the company, and the process for the appointment of a board of directors to oversee the management of the business and add value to the shareholder's investment; and
- the way in which local authority shareholders monitor the performance of companies in which they have an interest.

The review found that:

- councillors who act as nominee directors face a conflict between their responsibilities to council companies and their role as members of shareholding local authorities;
- nominee directors are not a substitute for a formal monitoring relationship between council companies and shareholding local authorities;
- local authorities should specify to boards the role and responsibilities of councillors who are also directors;
- chief executives should not be put in a position of conflict between their roles as advisors to the council and their obligations as directors of council companies;

- local authorities should institute a process whereby they select people with appropriate skills to be directors of their companies and they should seek applicants as widely as possible;
- councils had generally separated their purchase and ownership responsibilities but further steps are required by some councils to make the separation transparent;
- in many cases, local authorities are not scrutinising statements of corporate intent in a rigorous fashion. Councils should review the rationale for their involvement as shareholders and their intentions for businesses against their overall objectives when negotiating annual statements of intent. They should set out clearly their expectations for company performance;
- not all shareholding local authorities have recognised the importance of obtaining complete and regular information on the performance of their companies. Minimum reporting requirements aimed at correcting this deficiency were recommended;
- some councillors are not adequately informed about the performance of council investments. Councils need to specify explicitly the information which they require from holding companies or council committees. Local authority shareholders should obtain advice from council staff or professionals to enable them to analyse company performance; and
- councils are exercising adequate control over the operations of their business units but they are not entirely clear about the role and functions of council activities structured as business units. Councils are not always sufficiently aware of conflicts facing business units arising from the need for a balance between council control and management autonomy, and the desire to manage those tensions in a manner which makes the unit accountable.

7.4 ASSESSMENT

Considerable improvements in the financial management performance of local government have been made. Local authorities are reported to be positive about the changes, which contrasts with their strong resistance to earlier reform efforts. They are still adjusting to the reforms and their full effects are not yet apparent. There can be

little doubt, however, that greater transparency of local authority activities has facilitated monitoring by external parties and is increasing pressure on local authorities to improve their performance.

The Controller and Auditor-General's reports suggest that there is considerable room for better financial management practices, particularly in respect of core services such as drainage, sewage and water supply, and in the management of trading activities. These comments illustrate arguments advanced earlier in this report that government agencies often face weak incentives. While better financial management practices may help, privatisation of commercial activities is the best solution.

A review of some larger city councils which was undertaken by the New Zealand Business Roundtable suggests that the development of performance indicators which meet the intent of the legislation has not yet been generally achieved. Some councils, for example Christchurch, have made more progress than others, for instance Auckland. The quality of annual plans varies markedly.

The first priority for the future is to ensure that the financial reforms are fully implemented. Their progress should be monitored. In due course a detailed study should be undertaken to assess whether any further changes should be implemented.