LOCAL GOVERNMENT FORUM

Submission on the Wellington City Council's Draft Annual Plan 2005/06

May 2005

1. Introduction

1.1 This submission on the Wellington City Council's (the Council's) *Draft Annual Plan 2005-06* (the draft Plan) is made by the Local Government Forum (the Forum). The Forum was established in 1994 to promote greater efficiency in the local government sector and to contribute to debate on policy issues affecting the sector. The Forum comprises business organisations that have a vital interest in local government. Their members are among the Council's largest ratepayers. A list of Forum members is attached as Appendix 1.

1.2 The Forum has long argued that the main contribution the Council can make to the advancement of the overall welfare of the citizens of Wellington City is to minimise the rates and regulatory burdens that it imposes. It could achieve this by focusing on funding genuine local public goods and services, facilitating the efficient provision of necessary infrastructure and exiting from non-core activities. This argument is in line with standard economic analysis.

1.3 Overall, the Forum's view is that the Council is not doing enough to reduce its spending, which we believe is an essential step towards making Wellington a more attractive place for business. In turn, a strong business sector can underpin and sustain the general welfare of the community. This broader perspective is the one we adopt in our advocacy; we are not a lobby group for the narrower interests of business (as our opposition to selective business assistance – see section 4 below – indicates).

2. Economic growth

2.1 For many years, the Forum and other business organisations have been urging the Council to focus on its core functions, because this is likely to be the best way of improving Wellington's economic performance. Generally speaking, the Council has not accepted this advice. Its involvement in some non-core areas, eg housing, goes well beyond that of most councils.

2.2 The draft Plan celebrates the strong growth in the local economy, but ignores the fact that increases in the public sector, the health sector and the community services sector are largely responsible.[1] This growth is largely unaffected by actions taken by the Council and is vulnerable to changing political fortunes.

2.3 At the same time, as we observed in last year's submission, a marked decline has occurred in both enterprises and employment in wealth-generating sectors such as the primary industries and manufacturing, as well as in supporting services such as transport and storage, communications, wholesale trade, and finance and insurance. The exodus from Wellington of the head offices of many of our member companies has continued. The Forum's view is that the Council's poor performance in the areas that matter to business is likely to be a factor in this outcome.

3. Subsidisation of events and 'attractions'

3.1 A significant focus of the draft Plan is on subsidising events, 'attractions' and sports facilities. The Council's case for this expenditure is not supported by rigorous economic analysis. The poor standard of the Council's analysis makes it impossible to determine whether any of the Council's current and proposed expenditures on events would create net benefits for Wellington ratepayers.

3.2 Of particular concern is the Council's continued reliance on multiplier analysis to justify expenditure on major events aimed at attracting visitors to the region. The analysis used by the Council and its consultants is deeply flawed and does not provide a sound basis for expenditure decisions.[2]

3.3 McDermott Miller's analysis for the Council (and the Council's adoption of their findings) of the 'benefits' of the V8 supercar

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1 See Local Government Forum, Submission on the Wellington City Council's Draft Annual Plan 2004/05, 21 May 2004, pp 5-7.

2 The problems with this analytical approach are examined in detail the report prepared by Professor Tyler Cowen of George Mason University for the New Zealand Business Roundtable in 1999, *Should Governments Subsidise Stadiums and Events*? The report can be downloaded from the New Zealand Business Roundtable's website.

championship series to Wellington is a recent example of flawed analysis. The Forum's submission on the V8 series outlined in detail our concerns with that particular proposal.[3] In a response to similar criticisms by Professor Martin Lally of Victoria University, McDermott Miller made the remarkable admission that they undertook no formal analysis to support their multipliers (which contribute almost 50% of the alleged benefits). In the absence of more competent analysis we are pleased that the project is no longer being considered. Expenditures associated with it should be dropped from the Council's budget. Nevertheless, we are dismayed that in a press release of 13 May 2005, the mayor continued to use a figure of "22.9 million of new spend" as an indicator of "economic benefit" from the race, even though our critique of the McDermott Miller report and that of Professor Lally showed it to be spurious (and even McDermott Miller did not claim this was a proper indicator of economic benefit). We are at a loss to know how to get straightforward matters of economic analysis across to the Council (see also section 9 below). This has been a recurring problem going back to the Council's erroneous views on the income tax and GST treatment of rates, which was finally resolved by a working party that included the Audit Office. We suggest the Council should instigate a review of how it was misled on the economics of the race proposal, and establish a process for future exercises to be the subject of an independent audit.

3.4 We also note with concern the high costs to the Council of the Wellington Convention Centre and the Wellington Events Centre. We urge the Council to continue to explore options for reducing ratepayers' exposure to the costs and risks of these projects.

3.5 While it is possible that some events or attractions might justify Council involvement, the case for subsidisation cannot be made without a thorough and robust cost benefit analysis. The Council has not undertaken (or presented) such analysis for any of the new activities that it is proposing to support. In its absence the Forum

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[3] Local Government Forum, *Submission on Proposal that Wellington City Council Subsidise the V8 Supercar Championship Series*, April 2005.

does not support ratepayer funding of a new indoor sports stadium or an aquarium.

3.6 The Council's continued expansion into non-core areas is of major concern to the Forum. Its approach reinforces our general concern with the lack of constraints on local authorities under the current legislative framework.

4. Subsidisation of favoured industries

4.1 The Council proposes continuing its strategy of providing favourable treatment through Positively Wellington Business to particular industries such as film, creative manufacturing, biotechnology, professional services and information technology. It also supports Positively Wellington Tourism to "market Wellington as a visitor destination".

4.2 The idea that councils and governments can pick winners has long since been discredited. Comparative advantage is discovered by entrepreneurs through trial and error, not by governments or councils. Taxing all businesses to selectively benefit a few will not increase economic activity in Wellington. Competing firms will be unfairly disadvantaged and others will lose skilled labour and resources to the privileged businesses. As a result, the local economy will be weakened overall. Economic and empirical evidence indicates that such interventions are welfare-destroying.

4.3 We again urge the Council to drop or substantially reduce the allocations of funding to Positively Wellington Business and Positively Wellington Tourism. Firms that benefit from such activities should pay for them. Instead of imposing a high rating burden on all businesses and then selectively subsidising a few, the overall rating burden and the business rate differential should be reduced.

5. Infrastructure activities

5.1 The Council has prepared an assessment of Wellington City water and sanitary services, which is focused on the achievement of public health standards, as well as a liquid waste management plan. Both are required under the Local Government Act 2002 and are subject to a separate consultation process.

5.2 The Forum has not considered the associated discussion documents in any detail, but supports regular assessments of the Council's infrastructure to ensure the Council provides ratepayers with the quality of service they prefer and are prepared to pay for. We believe the Council should be more vigorously exploring options for putting water and wastewater services on a more commercial basis, including moves to more economic charging and greater use of private enterprise.

5.3 The Forum notes that it would be useful if the Council were to provide more detail in the draft Plan on the performance of the Council in providing infrastructure. For example, it is of general interest that water losses from the reticulated system stand at 21% compared to a target of 10-15%.[4] Information on key matters such as this, and what the Council intends to do to remedy them, could ensure ratepayers were better informed as to the Council's performance.

5.4 In respect of roading, we are pleased that the inner-city bypass is proceeding and that the Council is engaged in discussions with Transit on other roading projects. We are concerned at the signs of increasing congestion problems in the city and greater Wellington, and we question whether the Council is acting vigorously enough to anticipate and deal with them. The outcome indicators provided in the Transport section of the draft Plan do not include information on past and projected changes in vehicle speeds or other measures of congestion. Nor is information (such as benefit cost ratios) provided on potential capital expenditure projects. As with water, we favour moves towards more commercial structures in road operation, including more efficient road pricing. The Council has talked about this in the past but little seems to have happened. We think more

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[4] Capacity, Wellington Water Management Limited, *Draft assessment of water and sanitary services*, 2005, p 29.

Council time and energy should be devoted to basic infrastructure issues and less to things such as ‘attractions’ and business welfare. This effort should include joining with the private sector in pushing for changes to the Resource Management Act to facilitate infrastructure provision and other commercial and residential development.

6. Non-core assets

6.1 The Forum continues to take the view that the Council should divest itself of non-core assets, particularly its shares in Wellington International Airport Limited. Studies have shown that public ownership of commercial enterprises is, on average and over time, less efficient than private ownership.[5] Most major airports in Australia are now in private ownership.

6.2 We continue to believe that the Council should divest most of its housing stock. The private market is able to supply accommodation for most people, including low-income individuals. Concerns about the affordability of housing are better addressed through income supplements or other housing policies which are the responsibility of central government. The government is increasing housing assistance in its Working for Families package. The provision of emergency housing might be an exception that could justify a limited Council involvement in the housing market.

6.3 The Forum notes that at least 40% of the Council’s tenants do not meet the Council’s criteria for housing needs (p 57), underlining our concern that the Council’s involvement is excessive.

7. Club goods

7.1 The Forum notes the Council’s proposed modest increases in the charges levied on ‘club’ goods, such as swimming pools, recreation centres and the libraries. While these minor changes are in the right direction, the Forum continues to believe that those who benefit from these services should pay most, if not all, of the associated costs.

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5 See, for example, the major review article by W Megginson and J Netter (2001) ‘From State to Market: A survey of empirical studies on privatization’, *Journal of Economic Literature*, 34, pp 321-389.

Generally speaking, they are in the nature of private goods – users can be charged for the services – and those who use them are the primary beneficiaries.

8. Funding the Council's activities

8.1 The Draft Annual Plan reflects the Council's lack of focus on elements that are of key interest to ratepayers, particularly the level of rates. As was the case last year, the overall increase in rates is mentioned only in the chief executive's message, and the change in rates is not mentioned in the discussion of 'Setting the Scene' and 'What's New'?

8.2 Further, the chief executive presents the large and unacceptable increase in rates of 7.88% as an achievement (p 3), because, he claims, it is below the level forecast in the 2004/05 Annual Plan. Last year's Annual Plan forecast a rates increase of 7.9% for 2005/06.[6] This compares with a 9.5% forecast increase in the Financial Statements in this year's draft Plan (p 141). This is a significant increase rather than a decrease compared with last year's Annual Plan. Thus, it appears that the Council's so-called "rigorous approach to financial management" (p 3) has achieved nothing. It is also not clear how the 7.88% increase quoted by the chief executive relates to the 9.5% in the Financial Statements. It is possible that the chief executive's number has been adjusted for the expected growth in the ratepayer base of 1.7% (p 183) and therefore reflects the average increase per ratepayer, even though the chief executive's statement refers to "the overall rates take". If so, the statement is misleading.

8.3 Whatever the reason for the discrepancy in the figures, the implication that a rates increase far in excess of the rate of inflation could be considered an achievement resulting from rigorous financial management is indicative of a Council that is seriously out of touch with the concerns of its ratepayers. Neither the mayor nor most councillors campaigned on the basis of such an increase in last year's election. Some councils in the country are commendably proposing zero rate increases this year. Spending increases of the order

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6 Wellington City Council, *Annual Plan 2004/05*, p 173.

proposed by the Council exceed any likely rate of growth of the regional economy, indicating that the Council is taking an increasing share of it. Because the private sector is essentially the productive sector of the economy, this means that the Council is reducing the potential for regional economic growth and higher living standards for citizens. The Council's level of per capita spending is already one of the highest in the country. It needs to curb its big-spending habits.

8.4 Curbing spending is the desirable means of reducing the business rate differential without unduly affecting residential ratepayers. The speed at which the differential is being reduced is too slow. A faster rate of reduction is preferable to selective handouts to businesses. The aim should be the elimination of the differential in the medium term.

9. Cost of capital

9.1 Following our discussions with the Council last year, The Forum remains concerned that the Council is not appropriately considering its cost of capital when deciding whether to obtain outputs from the private sector or to invest to produce them in-house.[7] A flawed understanding of the cost of capital could lead to wrong investment decisions.

9.2 The key concept underlying our argument is that the use of capital by the Council has an 'opportunity cost' and that opportunity cost should be used in assessing alternative options. (Moreover, funds have an opportunity cost regardless of whether or not provision has been made in Council budgets; some of the discussion of the V8 car race seemed to overlook this point.)

9.3 Funds used to finance a particular investment project could have been invested in other projects to earn a return. The alternative return is the opportunity cost, or cost of capital. There is an opportunity cost to any investment regardless of whether the project is undertaken in

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7 An example of the Council's misunderstanding of this issue is the statement in *Rates News*, August 2004, that "Leased assets are more expensive than purchased assets because the Council has a low cost of borrowing."

the public or private sector, or funded by borrowing, rates or reserves. Conventionally, the cost of capital is estimated by considering the return that could be earned by projects with a similar risk to the one under consideration. The riskiness of a project is not affected by whether it is financed by the Council or privately. The Council's borrowing rate only appears to be lower than that of private enterprises because its loans are backed by its coercive ability to levy rates. Given that project risk is unaffected, this is not a justification for Council financing. It if were, it would make sense for councils (and central government) to take over private enterprises generally.

9.4 Financing projects from reserves does not reduce the cost of capital either. The reserves could have been used to reduce rates. The opportunity cost of using ratepayers' money is the value that ratepayers would have derived if they had been able to spend the money for themselves, plus the costs to society which arise from the way rates distort behaviour at the margin. Taking account of these deadweight costs, council financing is actually more expensive than private financing from a social point of view.

9.5 The failure to recognise the cost of capital may create the illusion that an uneconomic project is attractive. If ignored in assessing a project, it can make investments appear successful and well managed. In the private sector, businesses report their net profits along with funds invested so that investors can assess the adequacy of the reported rate of return.

9.6 Requiring an adequate return on capital is essential to ensure that councils (and any other investors) make sensible investment decisions. Ignoring the benefits that could be generated by alternative uses of ratepayers' money biases decisions in three ways.

9.7 First, local government projects may displace private investment that would generate greater benefits to society. Given the choice, ratepayers might prefer to put the extra money towards paying off their mortgages, expanding their businesses or simply putting the money in the bank.

9.8 Second, the Council may conclude that it is cheaper to invest to produce inputs in-house rather than to contract for their provision from outside organisations.

9.9 Third, ignoring the fact that forgone profit is a cost may prevent the Council from realising that an investment is uneconomic (ie the benefits do not exceed the costs). If the net benefits of a project are assessed using a cost of capital that is too low, projects will appear to satisfy investment criteria – such as having a positive net present value – before they really do.

9.10 We recommend that the Council review its policy in this area with the assistance of outside professional advice. The point is well understood by central government, which does not follow the Council's practice. A Treasury Handbook *Estimating the Cost of Capital for Crown Entities and State-Owned Enterprises* (available on the Treasury's website) elaborates on the points we have made. In order to pursue this issue, we would be grateful for a written response to the points made in this section of our submission. We have also asked the Office of the Auditor-General to look into the Council's practice.

10. The Council's overall performance

10.1 The Forum has long supported the benchmarking of councils' performances notwithstanding the associated difficulties.

10.2 The Forum reported last year on its 'Hot Councils' awards which ranked different councils on the basis of rates and expenditure, consent processing, democracy and audit reports. Wellington was one of the poorer-performing councils and the lowest-performing of the metropolitan councils.

10.3 *Consumer* recently surveyed its subscribers' views on the performance of councils.[8] *Consumer* reported that although Wellington City Council was one of the most asset-rich councils in the country, its performance was 'very average'. The Council's performance in the provision of household services, community services, community facilities and public relations was rated as average, while its staff were rated as significantly worse than for the average council.

10.4 *Consumer* noted that over the past six years, household spending on rates and water charges had increased by 26%, around twice the rate of inflation. Despite the increase in rates, people were less happy with council performance than they had been when last surveyed by *Consumer* in 1999.

10.5 Findings such as these reinforce our concerns that much of the spending of the Council is directed at low-return activities that do not provide clear benefits for ratepayers.

11. Conclusion

11.1 We remain of the view that the Council needs to make a much bigger effort to restrict itself to activities where it has a comparative advantage, ie providing local public goods and administering justified local regulations. The efficient provision of infrastructure is also important while such assets remain in Council ownership.

11.2 The proposed increases in spending and rates in the draft Plan are far too high, and the Council's debt is projected to grow at an alarming rate. A number of the public good expenditure items proposed would be assets for the city, at least in the eyes of some interest groups. However, households cannot have all the things they want at the same time. They have to prioritise and spread their spending over a period in which it is affordable. The Council should do the same.

8 Consumer, *Growing Pains*, January/February 2005, pp 19-23. The survey was conducted in October 2004. Subscribers were asked to rate their councils on five overall measures: household services (eg rubbish collection, building permits); community services (eg water, sewerage, roads, street lighting); community facilities (eg sports fields, parks, gardens, libraries); staff and public relations (eg consultation, handling complaints).

11.3 The Council should exit from the provision of private goods and review its involvement in the provision of club goods. Proposals for the funding of major events should be subject to rigorous economic analysis and only be accepted if the benefits clearly outweigh the costs, the outputs are local public goods, private funding is not available, and ratepayers support ratepayer funding.

11.4 We commend the specific suggestions made by the Wellington Regional Chamber of Commerce for reducing Council expenditure.

11.5 We welcome the planned reduction in the business rating differential but believe the speed of change is too slow. There is no general case for a business rate differential. The Council should be aiming to phase it out completely over 3-5 years. We do not believe this would necessitate an increase in residential rates. If the Council were to focus on its core activities, it could substantially cut both its expenditure and rates, which we believe would make Wellington a more attractive place both for business and for the wider community.

Appendix 1

The Local Government Forum

Member organisations include:

- Business New Zealand
- Electricity Networks Association
- Federated Farmers of New Zealand
- New Zealand Business Roundtable
- New Zealand Forest Owners' Association
- Property Council of New Zealand