

Future funding of local government activities

Report to Local Government New Zealand

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NZIER

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HIGHLIGHTS

The purpose of this report is to consider whether there is a need for a supplementary source of funding for local government in New Zealand, and if so, identify the best option for such a source.

In addressing these questions we held workshops with selected local authorities and discussions with central government officials, as well as undertaking a “desktop” assessment.

Is there a need for a supplementary source of funding?

Our study finds that some local authorities are facing real funding pressure. This pressure appears to be caused by a range of factors, which impact differently on individual local authorities, including:

- problems of scale and physical conditions in providing infrastructure services to small communities;
- increasing demands from central government that local government activities meet minimum national standards, such as water standards;
- increasing responsibilities, arising from:
 - devolution of functions by central government to local authorities without associated funding, such as developing local pest management strategies under the Biosecurity Act 1993;
 - withdrawal of central government from some services, leaving a vacuum which communities often want local government to fill;
 - demands of local communities and central government for their local authorities to be active in non-traditional areas. Giving local authorities a power of general competence is likely to reinforce this trend;
- differences in wealth and income.

There is evidence to suggest that local governments in some regions are approaching the limits of rates as the best source of additional income.

Possible solutions

Our assessment of alternative local taxes concludes that a new local tax is undesirable. In particular the introduction of a new local tax to supplement property rates would be likely to involve substantial administrative and compliance costs.

However, there are several pragmatic options that, taken together, could go some way towards relieving current funding pressure on councils. These include:

- **bringing third parties fully into the picture:**
 - *removal of existing rating exemptions or Crown compensation for their cost* to reflect the fact that exemptions, particularly those for Crown and Maori customary land, are generally provided for national priorities and obligations (the exception is rating exemptions for land used for religious or charitable purposes, which seem likely to have local benefits);
 - *financial contributions from developers;*

- *utility rentals* including giving local authorities the equivalent of the normal powers of landlords to enforce compliance with the terms on which access was permitted; and
- *differential rating of visitor facilities* in some areas, to recover some of the costs of local government services attributable to visitors;
- **establishment of a protocol between central and local government**, covering:
 - respective responsibilities in economic, social, cultural and economic areas;
 - where the interests of each level of government lie; and
 - agreement as to which level of government should ultimately fund different services;
- **central government grants** toward the cost of meeting the national public or merit good component of health and environmental standards for services such as sewerage, refuse disposal and drinking water, and allowing for regional differences in costs and the local community's ability to pay;
- **extension of the central government's fuel excise tax** to supplement local government funding of roading costs. An increase in the level of fuel excise tax in the order of 8 cents/litre would be sufficient to meet total local government expenditure on roading maintenance nation-wide;
- **better communication to ratepayers and local communities** of the purposes to which local government expenditure is directed and the benefits that result.

RECOMMENDATIONS

Recommendations regarding local authorities' ability to pay

We conclude that revenue sharing for general revenue assistance would involve a number of risks for local government and, in particular, could lead to a loss of local autonomy and accountability. We do not recommend revenue sharing in general. Instead we have identified a number of pragmatic changes which we consider would mitigate funding pressures on individual councils.

We recommend that existing exemptions from rates, particularly in relation to Crown land and certain Maori land, and land used for essentially commercial activities, be removed, or local authorities be compensated by the Crown:

- the Crown should directly meet the cost of rates for currently exempt Maori land, as well as accepting an obligation to make up the shortfall from non-payment of rates on Maori freehold land; and
- rating exemptions for land used for religious and charitable purposes could be retained, to reflect the associated local benefits.

Recommendations on individuals' ability to pay

We recommend that:

- the rates rebates scheme be reviewed;
- on the assumption that the change proposed in the Local Government (Rating) Bill passes into legislation, local authorities consider adopting open ended postponement policies, subject to the ratepayers concerned meeting the full costs (including interest, administration and a provision for risk) and the local authority being satisfied, in any particular case, that there is adequate security to ensure ultimate payment.

Recommendations on perceptions of value for money

We recommend that:

- the Local Government (Rating) Bill, should be amended to allow local authorities to send separate rates bills for significant activities that are branded as bills rather than rate demands, subject to them first assessing the compliance cost implications of more than one bill; and
- local authorities consider presenting their recreational and cultural expenditures as a portfolio of opportunities, with the funding focus on the cost of the portfolio as a whole and the activity focus on establishing a range of opportunities to meet all significant preferences within the community.

Recommendations on who should pay

We recommend that:

... for national public goods provided by local government:

- Local Government New Zealand investigate the possibility of establishing a protocol between central government and local government covering:

- respective responsibilities in economic, social, cultural and economic areas;
- where the interests of each level of government lie; and
- agreement as to which level of government should ultimately fund different services;
- building on the Ministry of Health’s current work on a sewerage subsidy, consideration be given to the introduction of central government grants toward the cost of meeting the national public or merit good component of health and environmental standards for services such as sewerage and drinking water, and allowing for regional differences in costs and the local community’s ability to pay;

... for utilities:

- further consideration be given to the option of a local government power to charge utility rentals, and that local authorities have the equivalent of the normal powers of landlords to enforce compliance with the terms on which access was permitted. However, further work is required on the likely economic incidence of utility rentals in the New Zealand context;

... for costs imposed by third parties:

- a specific provision be included in the new LGA to provide for developer contributions;
- councils whose districts have high visitor numbers be encouraged to consider the use of differential rates, and targeted rates once they become available, to recover some of the costs of local government services attributable to visitors.

Recommendations on funding tools

Options for general revenue:

We recommend against the introduction of a new local government taxation mechanism. A new local tax is likely to have significant administrative and compliance costs. Local income taxes and GST are likely to only be feasible if implemented as a form of revenue sharing with central government.

Supplementary sources of funding:

We recommend that

- consideration be given to extending the current national fuel excise, with the additional revenue applied to local government funding of roading costs (the effect of this would be to free up an equivalent amount of local government revenue either for other expenditure or for rates reductions). A useful contribution might require an increase of approximately 8 cents/litre;
- funding of individual projects continue to be through Transfund in order to ensure consistency;
- consideration be given to the appropriate allocation formula for revenue raised under this proposal, if it is to redress, and not exaggerate, differences in councils' ability to fund local government services;

Specific rating issues:

We recommend that:

- the requirement to fully fund depreciation from annual operating revenues be retained, but:
 - local authorities be given the ability to waive this requirement where they do not intend to replace the asset concerned, subject to this being spelt out in the Long Term Financial Strategy;
 - Local Government New Zealand give priority to seeking a more appropriate definition of depreciation for infrastructure assets;
- a clear legal provision for councils to levy charges for water, sewerage and trade wastes on a full cost recovery basis be introduced.

GLOSSARY

Capital goods – Capital assets, such as buildings and information technology, that are required for the production of products and services.

Contestable markets, contestability of supply – A market for the supply of a product or service where there is freedom of entry and where exit is inexpensive. Even if there is only a single current supplier, its prices and profits will be constrained by the threat of new entrants.

Cross-subsidies – Subsidising losses on the provision of some products and services from the profits of other goods and services, or subsidising the provision of services to one group with revenue raised from another.

Efficiency, allocative – The maximisation of community surplus from the provision of (in this case) local government products and services. That is, scarce resources are allocated to provide the level and standard of products or services that yields greatest benefit to the local community. Allocative efficiency is promoted by ensuring consumers face the cost consequences of their decisions.

Efficiency, operational – The supply costs of the products or services provided by local authorities are minimised over the short term, and over the long term when capital costs are significant.

Efficiency, dynamic – Efficiency improvements over time as new ways to lower costs are discovered and products and services are supplied by their most appropriate providers.

Efficiency, transaction cost – Administration and compliance costs are minimised, and evasion is at acceptable levels.

Elasticity – The percentage change in either the demand for, or supply of, a product or service resulting from a percentage change in a variable that influences demand or supply decisions, usually price.

Equity, ability to pay principle – the principle that taxes should be levied in relation to the ability to pay of the taxpayers.

Equity, benefit principle – the principle that taxes should be levied in relation to the benefits received.

Equity, contemporary – Dealing equitably with those who benefit from the products or services, those whose actions give rise to the need for such products or services, and ratepayers.

Equity, horizontal – Equal treatment of equals, for example similar tax treatment for those on similar incomes.

Equity, intergenerational – Dealing equitably with current and future beneficiaries, risk exacerbators, and ratepayers.

Equity, vertical – Unequal treatment of unequals, for example different tax treatment of those who have different incomes.

Evasion – The deliberate non-payment of charges, rates or taxes, or the avoidance of other obligations.

Exemptions – Provisions within the Rating Powers Act (or the new Local Government (Rating) Act once it comes into force) to exempt various types of land from rates. Exempt properties are still required to pay separate rates and other charges made in respect of water supply, waste collection, and sewage disposal.

Externality – The unintended effects on a third party of a transaction or event that is not included in the price of the original transaction or event.

Goods, club – Products or services for which people can be excluded from their benefits at low cost, but their use by one person does not detract from their use by others.

Goods, merit – Products or services for which the community as a whole desires a higher use of the good than would be likely if it were charged at full cost.

Goods, mixed – Products or services that have the properties of a mix of economic goods, such as both public and private good characteristics.

Goods, private – Products or services for which people can be excluded from their benefits at low cost, and use by one person conflicts with use by another.

Goods, public – Products or services where excluding people from their benefits is either difficult or costly, and use by one person does not detract from use by another. Reliance on the market would lead to underprovision.

Incidence, economic – The person or firm that finally bears the cost of paying a tax, for example where rates are passed through in rental prices, the economic incidence falls on the person renting a property, not the property owner who is legally liable.

Incidence, legal – The person or firm that is legally liable to pay a tax.

Internalise – The action of incorporating externality costs or benefits into the primary transaction.

LATEs – Local Authority Trading Enterprises.

LGA – Local Government Act 1974.

LGNZ – Local Government New Zealand.

Local authorities – Territorial authorities and regional councils.

LTFS – The long-term financial strategy prepared by local authorities under Part VIIA of the Local Government Act.

Marginal cost – The cost of producing an additional unit of a product or service.

Marginal revenue – The revenue from an additional unit supplied.

Market failure – The market fails to deliver the socially desirable levels of goods or services. Reasons for failure may include the presence of externalities, public good characteristics of a product or service, or monopoly power.

Part VIIA – Part VIIA of the Local Government Act. The financial management provisions.

Postponement – Delayed payment of rates.

Rates – A tax charged by local authorities on property.

Rates rebate – A reduction in residential ratepayers’ rates by up to \$200, available from councils and reimbursed by central government, but subject to very restricted eligibility conditions.

RPA – Rating Powers Act 1988.

Taxes – Compulsory, unrequited payments to the government (central or local) - unrequited meaning that the benefits are not normally in proportion to the payments.

Taxes, progressive – Tax as a proportion of income increases as income increases.

Taxes, proportional - Tax as a proportion of income remains constant as income increases or decreases.

Taxes, regressive – Tax as a proportion of income increases as income decreases.

TLAs – Territorial local authorities.

UACs – Uniform Annual Charges levied under the Rating Powers Act and related to specific services.

UAGCs- Uniform Annual General Charges levied under the Rating Powers Act and not related to specific services.

User charges - Revenues recovered in situations where there is a clear connection between payment and the cost of the good or service provided, or the benefit received.

Waiver – The reduction or cancellation of rates that have been levied on a property.

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1. INTRODUCTION

Local authorities provide a wide range of products and services to the communities they represent. The reasons why they provide these are nearly as varied as the products and services themselves. There may be a perceived market failure, central government may have devolved some of its functions down to local government level, or there may be non-economic reasons for intervention that fall within the range of purposes specified in the Local Government Act 1974 (LGA). The outcome of the current review of the LGA could widen the purposes and grant local authorities a power of general competence. That is, they would be free to undertake a wider range of functions if demanded by their local communities.

Local government activities are funded primarily from property taxes in the form of rates. Local Government New Zealand (LGNZ), the representative body for local government, has raised concerns regarding the efficiency and sustainability of the heavy reliance on this one funding mechanism. From an efficiency perspective, property taxes are unlikely to be the best means of funding expenditure in all circumstances. From a sustainability perspective, both the ability to pay and the tolerance of ratepayers are issues.

Accordingly, LGNZ has contracted the New Zealand Institute of Economic Research (NZIER) and McKinlay Douglas Limited to undertake this project on future sources of funding for community needs.

1.1 Methodology

This report considers the questions

Is there a need for a supplementary source of funding for local government in New Zealand? If so, what should it be?

In order to answer these questions we:

- undertook a desktop assessment of the current situation, focusing on both qualitative and quantitative data;
- held discussions with central government officials involved in local government policy;
- held workshops with local authorities selected to provide a cross-section of views on the issues;
- reviewed past policy proposals and research; and
- reviewed selected overseas experience.

1.2 Outline of the report

The questions addressed by this report raise a number of distinct but closely related issues or problem areas:

- *affordability*: Are councils able to adequately fund the services required by their communities?¹ Are rates unduly burdensome to low-income ratepayers?
- *willingness to pay*: The high visibility of rates as a form of tax increases the likelihood that ratepayers will object to increases.
- *who should pay*: The benefits of many local government services accrue nationally, or to parties outside the relevant district. In some cases, the level of service is mandated by central government. Who should bear the cost of service provision in such cases?
- *range of funding tools*: Do councils have access to a full range of funding instruments to meet their needs?

The main body of the report addresses each of these issues in turn, to identify the nature of any problems with existing arrangements and possible solutions. First we provide a brief overview of developments in relation to the overarching regulatory environment for local government (Section 2) and briefly discuss principles for funding local government activities (Section 3).

¹ It is important here to distinguish between the ability to fund the full range of services communities may *wish* to have, and the ability to fund services that are generally considered to be *essential*. Policy concerns regarding the ability of councils to fund services centre around the latter, based on equity considerations.

2. LEGISLATIVE POLICY DIRECTIONS

The government is currently reviewing the Local Government Act 1974. A discussion document on broader changes to the legislative environment for local government was released on 14 June. Submissions closed at the end of August, with policy decisions expected by the end of the year. Concurrently, the government is implementing changes to local government rating powers. The Local Government (Rating) Bill was introduced to Parliament on 8 August 2001, and is currently before the Local Government and Environment Select Committee. The Bill incorporates decisions arising from the funding powers review. Submissions on the Bill closed on 26 September, with the Committee due to report back to Parliament on 15 November.

2.1 General policy direction

The policy direction underpinning both these reviews represents a major shift for the local government sector. Three key themes underpin the government's proposals in this area:

- ***a significant increase in local government discretion:*** The government proposes to implement a power of general competence for local government. This will apply to regional councils as well as territorial authorities.²

In addition, the proposed changes to local government's funding powers will significantly reduce the amount of detailed prescription of rating and other powers, with greater emphasis on council policies, developed in consultation with the community, to address issues such as waivers and postponements, and targeted rates.

- ***an increased emphasis on local representative democracy:*** This increased discretion is in the context of a greater emphasis on local government's relationship with the local community, and accountability to the community in determining which functions local government should undertake and how these should be provided and funded. The proposed over-arching purpose for local government encapsulates this emphasis as follows:

To enable local decision-making by and on behalf of citizens in their local communities to promote their social, economic, cultural and environmental well-being in the present and for the future.

- ***an increased emphasis on partnership between central and local government:*** The government is placing increased emphasis on partnership between central and local government, but has not proposed any specific mechanisms to achieve it. This, combined with the increased discretion discussed above, has both upside and downside potential. On the upside, this increases the ability for both levels of government to work together to address community needs that have both a local and national element. Indeed, anecdotally, we understand there is a marked increase in the willingness of central government agencies to work with local

² However, when a regional council wishes to take on a new activity of regional scope it will be required to consult with the affected territorial authorities and central government.

government. The downside risk is that this emphasis could over time lead to greater devolution of functions to local government without necessarily being accompanied by appropriate funding provisions.

Both the Local Government (Rating) Bill and the Local Government Act review are based on the premise that rating will continue to be the primary source of funding for local government for the foreseeable future.

2.2 Specific policy proposals

Some of the specific proposals arising from these reviews are directly relevant to this report. We discuss these here.

2.2.1 Funding Powers Review

Key decisions reflected in the Local Government (Rating) Bill include:

- **general rates:** will continue to be the primary revenue raising mechanism for local authorities. Statutory limits on revenue from general rates will be removed;
- **differential rating / uniform annual charges:** Local authorities will retain powers for differential rating and/or uniform annual (general) charges. The process for adoption of differential rates will be streamlined by relying solely on the normal local government funding decision processes (i.e. the annual plan). The 30% cap on uniform annual general charges and uniform annual charges (UAGCs/UACs) as a proportion of rates revenue (other than for water and sewerage) will be retained;
- **targeted rates:** The government proposes a flexible targeted rating power for local authorities to fund specific functions and activities as an extension of current separate rating powers. Councils will be able to set targeted rates for specific functions with reference to one or more of a set of property characteristics from a list specified in the legislation, provided that the function is identified in the annual plan as one for which a targeted rate may be set;
- **regional council rating:** Regional councils will have access to the same range of funding mechanisms as territorial local authorities, and will generally be required to follow the same procedures;
- **rates collection:** Local authorities may co-operate in collecting rates, through the joint appointment of a rates collector.
- **early payment of rates:** Local authorities will be able to adopt policies to allow for early payment of rates, to accommodate ratepayer preferences;
- **rates remissions and postponements:** Current legislative tests for remissions and postponements will be replaced with council policies, contained in the relevant annual plan. This will provide considerably more discretion than is currently available to councils to develop flexible approaches, taking into account the socio-economic characteristics of their ratepayers. For example this could include the ability to postpone rates until the sale of the property concerned or the death of the owner, with appropriate allowance for interest. Under the proposed provisions, rates remissions (or any interest reductions in relation to postponements) will be recorded as local authority expenditure against the relevant objective in the remission or postponement policy, to enhance transparency. Remissions and postponements in relation to Maori freehold land will be subject to separate (optional) rates relief policies for Maori freehold land;

- **rating exemptions:** The ten existing categories of rating exemptions will remain.³ A key issue here is the exemption for Crown land, which includes extensive conservation estates in some parts of the country. The Labour Party manifesto contains a commitment to “progressively work towards establishing a fairly assessed compensation regime for loss of rates on significant holdings of government and other publicly owned land”. In light of this, the government is still considering whether or not the Crown should make a contribution to local government, for land exempt from rates, and if so, how such a contribution should be implemented;
- **mandatory remissions:** Council owned land subject to a mandatory 50% remission will become exempt.⁴ Current provisions for mandatory 50% remissions for recreational and public access land owned by societies or other groups will be removed. Decisions on whether such properties should continue to benefit from remissions will be a matter of local discretion.

2.2.2 Local Government Act Review

As already discussed above, the government proposes the introduction of a general power of competence for local government. In conjunction with this, changes to accountability and financial management requirements are proposed:

- **accountability:** amended accountability arrangements are proposed, based on an expanded long term plan and a more targeted annual plan. We understand the government’s intention is that the long term plan will integrate the decision-making process by bringing together decisions on social, environmental, cultural and economic activities. The plan will be reviewed on a three yearly basis. The annual plan will focus on budget and funding issues, and will identify any departures from the long term plan. Statutory accountability requirements are proposed for council-controlled organisations, including trusts where local authorities effectively have control;
- **financial management:** A revised financial management process is proposed, which aims to ensure a broad range of community objectives is addressed in making funding decisions, as well as purely economic considerations;
- **depreciation:** The government proposes to retain the existing requirement that councils set operating revenues at a level that recovers full operating expenses, including depreciation;
- **developer contributions:** Under current provisions some councils have sought to use powers under the Resource Management Act to charge developers financial contributions towards the costs of associated infrastructure. The government’s proposed changes would allow such contributions to be levied either through the

³ These categories are: protection of natural, historic or cultural heritage values; education; health; religious; cemeteries; Maori burial ground, reservation, marae meeting ground and customary land; transport; public access, public open space and recreation; defence; and other.

⁴ This change has little real effect on local government funding. The payment of rates on council owned land is simply an internal transfer within an individual council’s accounts, and has a zero net effect on council income. The only exception to this case is regional council owned property such as regional reserves. However, if this became rateable the resulting reduction in the level of TLA rates would be offset by an increase regional council rates, paid by broadly the same people.

Resource Management Act, supplemented by fees and charges, or through a specific power in the new legislation.

2.3 Tax Review

The Tax Review 2001 was convened in October 2000 to report at the end of September 2001. The Review's final report is now due to be released on 24 October.⁵ An Issues Paper, canvassing a range of central government taxation issues, was released on 20 June for public comment. Submissions closed on 1 August. Key relevant proposals include a centralised tax on owner occupied housing, based on the property value (net of all debt secured on the property) multiplied by the risk-free rate of return. The risk-free rate of return would be set by IRD based on the inflation-adjusted rate of return on a one-year government bond. The yield on this tax would be used to reduce income taxes. This proposal would clearly have implications for the local government sector, arising from the overlap with the rating base. If implemented, this proposal would have the effect of reducing the capacity for future rates increases. However, the property tax proposal appears unlikely to go ahead. Both the Prime Minister and Minister of Revenue have ruled it out as an option in the media.⁶

The Review does not appear to have considered the fact that owner occupied housing is already subject to property rates at a local government level. Indeed, one of the key justifications behind the proposal is that the absence of a tax on owner-occupied housing induces over-investment in housing relative to other assets that generate taxable returns.

The Review favours GST over income tax as a revenue raising mechanism, on economic efficiency and compliance cost grounds. In particular, GST's comprehensive tax base minimises efficiency impacts. If the government needs to increase revenue in the future this should therefore come first from GST. Any future tax reductions should come from income tax. Similarly, the Issues Paper finds that revenue raising is not a sufficient rationale for excise taxes where GST is available.

The Tax Review considers the road transport externalities identified in the Land Transport Pricing Study are too speculative to provide a rational basis for the 21 cents/litre general revenue excise on petrol.

Unfortunately, the Issues Paper fails to consider the taxation implications of the relationship between central and local government, and in particular the issue of how national public goods that are provided by local government should be funded. This is an issue that we address further in this report.

⁵ The final report was released on 24 October. The report did not recommend that the government take proposals for a tax on housing further at this time, due to the level of opposition. The Review Team considered that existing high levels of excise taxes are difficult to justify on revenue raising grounds, given the availability of GST as an excellent broad based, low rate, alternative. Current levels of excise taxes in New Zealand were also not considered to be justifiable on externality grounds. The Review Team therefore recommended that the general revenue component of excise taxes on alcoholic beverages, tobacco, gaming, and petrol be replaced by an increase in GST. At a minimum, the Review Team recommended that the many anomalies in this area of the tax system should be subject to further review. If the Government took up this recommendation, this might have implications for the relative merits of the petrol excise as a source of supplementary funding for local government, and therefore could impact on our findings in this area.

⁶ www.stuff.co.nz, "Clark blasts tax team's ideas", 24 June 2001.

3. A FRAMEWORK FOR LOCAL GOVERNMENT FUNDING DECISIONS

This chapter develops a framework for funding decisions. It considers the wider context in which local government operates, develops a set of funding principles, and suggests how to apply those principles to the analysis of local government funding issues.

3.1 Roles and functions of local government

The 1996 changes to local government financial management requirements placed a strong emphasis on the principle of “beneficiary pays” in local government funding, and sought to encourage greater application of this approach. Without detracting from the importance of this principle in determining how to charge for a service, funding policies need to be considered in the context of the community’s wider objectives.

Local government is based on representative democracy. It is a vehicle through which local communities can collectively make decisions about the provision of a range of local services and how they should be funded. In general, these are services the community wants, but which would not be provided to the desired level by the market. In economic terms, most local government services have elements of one or more of:

- public goods;
- club goods;
- merit goods.

3.1.1 Public goods

Public goods have two distinguishing characteristics:

- they are non-rivalrous, i.e. one person’s consumption of the good does not reduce the ability of others to consume the good. The corollary of this is that the marginal cost of supplying to an additional consumer is zero; and
- they are non-excludable: i.e. it is not possible to prevent people from consuming the good. As a result, it is not practical to recover the cost of supplying public goods through user charges as it is not possible to prevent someone who chooses not to pay from consuming the good anyway.

Local or central governments are better placed to enable the provision of public goods to efficient levels than the private sector, as they can recover the costs of provision through taxation. In general, open democratic processes should ensure that public sector enabling of the provision of public goods reflects broad community priorities.⁷

While these characteristics of public goods are undisputed, in practice it is often difficult to reach agreement on the *degree* to which particular services are public goods.

⁷ While this holds true as a general principle, in practice community priorities 1) are not homogeneous (different interest groups within a community tend to have divergent preferences); and 2) are in any case difficult to ascertain.

Under the Local Government Act, this judgement is left to individual councils on behalf of their communities.

3.1.2 Club goods

Club goods share the “non-rivalrous” aspect of public goods, but non-payers can be excluded from their benefits. Examples include network services such as electricity, telecommunications, water and sewerage.⁸ It is possible, and consistent with economic efficiency, to identify and charge users for the provision of these goods. In some cases, club goods may have wider benefits, or “positive externalities”. For example, an adequate supply of drinking water and the treatment and disposal of sewage can benefit more people than the immediate users. In such cases it may be appropriate to spread costs more widely.

3.1.3 Merit goods

These are goods that the community as a whole considers desirable, and wants to encourage. A prominent example at the local level is library services. There are readily available market alternatives for virtually all of the services libraries provide yet they are regarded by almost all New Zealand communities as an essential local “public service”. The conclusion is virtually inescapable that there is a strong commitment to ensuring that access to these services should be facilitated by providing them at less than full cost – in other words, as communities, we want to ensure a higher level of provision (consumption) than we believe would result from relying solely on the market. Another example might be recreational facilities, if the community wishes to encourage fitness and exercise. As in the case of public goods, it is in practice a matter of community judgement as to which services might fall in this category.

3.1.4 Where do the benefits fall?

Public goods may impact at a national or local level, or indeed both at the same time. Similarly, decisions on the provision of merit goods may be made nationally or locally. If a decision were made nationally that a certain public good or merit good service must be provided to the community (at some specified level) at the expense of the local community, there is a risk of a clash with some local bodies’ ability to pay.⁹ Because it will not usually be clear where the national dictum has regional support and where it does not,¹⁰ it can only be presumed that the support is spread nationally and carries with it a willingness to subsidise hard pressed regions. This implies that, where a service provided by local government is meeting a national standard that may not accord with local preferences, the level of provision should be agreed with central

⁸ In practice, these services are only non-rivalrous up to long-term capacity constraints, after which additional users may impact on the quality of service experienced by others, or even their ability to use the service.

⁹ There is also a risk that the level set nationally may not accurately reflect the correct balance between local enthusiasm for the service and the marginal costs of provision in each locality. This is a good reason why the provision of any public and merit goods should probably be determined at the local level. National standards may be required where there are strong interdependencies between the level of services in one region and prosperity in others, e.g. environmental quality in one region affecting the whole country’s tourism industry.

¹⁰ And local authorities will not have an incentive to admit support.

government and a commensurate proportion of its costs should be met by central government.

Within a given district there will be distinct sub-groups of individuals who benefit from particular services. The mix of funding for those services should reflect the benefit to these groups, taking into account any wider indirect benefits that may flow to the district as a whole.

3.1.5 Redistributive impacts

A number of past reviews of local government funding have expressed the concern that redistributive functions should be primarily the responsibility of central government. However, it is inevitable that local government functions will have redistributive elements. This is a corollary of the collective nature of local government referred to above. Where a community groups together to share resources in order to provide particular services some redistribution between members of the community will result.

The key distinction here is between *income* redistribution, which is and should remain primarily the responsibility of central government, and redistribution in terms of the *provision of access to services*. The latter is an important role of local as well as central government. There are numerous examples of such activities from provision of infrastructure services fully or part funded through rates, to subsidised entry to libraries and swimming pools.

3.1.6 Positive externalities

The wider community may benefit from the provision of a service that directly benefits a smaller group who would not be able to afford the service by itself. For example, the extension of a stormwater system to a small rural community directly benefits the members of that community, but will also benefit residents in the wider district due to improved mobility in poor weather and reduced risk of civil defence emergencies. There will be an economic case for the wider community contributing to the cost where this ensures the optimal level of provision. There may also be equity arguments for wider community funding..

These benefits were referred to as “redistributive externalities” by the NZ Local Government Association Funding Working Party in its “Green Book”, and occur:

where the wider community receives benefit from redistributing the opportunity to individuals or groups to access services in a manner and price that would not be available from a private market.¹¹

The policy thrust of proposed reforms to the Local Government Act emphasises local government’s role as a representative democracy with the objective of promoting social, economic, cultural and environmental well-being. This direction supports the provision of local merit goods by local government, with associated redistributive impacts.

¹¹ New Zealand Local Government Association Inc. Funding Working Party, *Principles and Guidelines for Local Government Revenue Systems*, December 1992, page 16.

3.2 Key questions for funding local government activities

Two key questions in determining how to fund local government are:

- who should pay; and
- what funding mechanism is most appropriate.

Answering these questions underpins the analysis in this report.

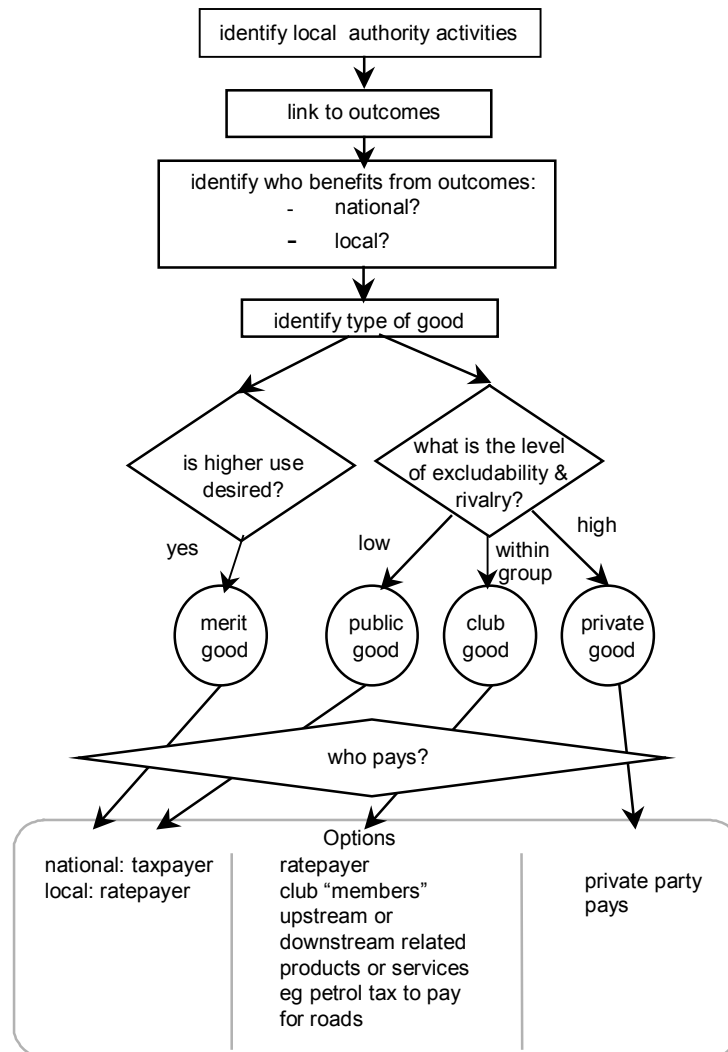
3.2.1 Who should pay?

The economic characteristics of the local government service in question largely determine who should fund its provision. Figure 1 suggests the flow of logic that should apply when deciding who should pay. The key points illustrated here are:

- where the service in question has either merit or public good characteristics, and benefits accrue nationally, central government should fund the national benefit component;
- where the service in question has either merit or public good characteristics, and the benefits accrue to the local community, local government should fund the local benefit component using local taxes;
- where there are identifiable sub-groups or individuals within the community who benefit from the service, and it is possible to exclude people from using the service in question, user charges are appropriate.

Note that most services provided by local government give rise to a mix of private, local public or merit and, occasionally, national public or merit goods thus justifying the use of a mix of funding instruments.

Figure 1 Deciding who should pay



3.2.2 What funding mechanism?

A range of different funding mechanisms are currently available to councils to fund their various activities, including various forms of property tax (general rates, separate rates, UAGCs and UACs) and user charges. In this paper we consider these mechanisms and assess a range of other potential sources of funding. Our assessment of these mechanisms is based on the following set of principles.

Table 1 Funding principles

| | |
|------------------------------------|---|
| Effectiveness | The outcomes desired by local authorities are complemented or advanced. |
| Allocative efficiency | Scarce resources are allocated to provide the level and standard of products or services that yields greatest value to the local community. |
| Operational efficiency | Supply costs are minimised over the short term, and over the long term when capital costs are significant. |
| Transaction cost efficiency | Administrative and compliance costs are minimised, and evasion is at acceptable levels. |
| Dynamic efficiency | Efficiency improves over time, by looking for new ways to lower costs and finding appropriate providers. |
| Contemporary equity | Dealing equitably with those who benefit from the products or services, those whose actions give rise to the need for such products and services and ratepayers, taking into account the level of benefit received, and ability to pay. |
| Intergenerational equity | Dealing equitably with current and future beneficiaries, risk exacerbators, and ratepayers. |
| Financial | Reducing reliance on funding from general rates. |

The above principles are drawn from a number of places:

- Part VIIA of the Local Government Act 1976;
- the consultation document on *A Future Direction for Local Government Funding Powers*;
- associated policy papers;
- central government's *Guidelines for Setting Prices in the Public Sector*;
- overseas frameworks; and
- the implicit funding rationale of local authorities.

In applying these principles to the questions addressed by this report, we also take into account the broader roles of local government, discussed earlier in this section, and its relationship with central government. Also relevant to this analysis is consideration of the Treaty of Waitangi and its impact on local government. We discuss this briefly now.

3.3 The Treaty of Waitangi and local government

The current review of the LGA is giving specific consideration to the relationship of Maori and the Treaty of Waitangi to local government. At present there is no coherent understanding of how the Treaty should impact on local government, and the respective roles and obligations of central government and councils under the Treaty.

Given the focus of this report, our key concern is on the current treatment of Maori land with respect to rating. The current Rating Powers Act distinguishes between two categories of Maori land:

- *Maori freehold land* is rateable, however rates often cannot be collected in practice as a result of often complex multiple-ownership arrangements. Local authorities are constrained in their ability to recover unpaid rates. For example, to prevent further alienation of Maori freehold land, local authorities are not permitted to force a land sale to recover rates;
- *Maori burial ground, reservation, marae or meeting ground and customary land* is exempt from paying rates (although it is liable for user-charges for specific local government services). This exemption recognises the special significance of specific areas of land for Maori.

Some Maori have questioned the validity of charging local government rates on Maori land under the Treaty.

It is outside the scope of this report to comment on whether or not Maori land should be rateable, or on the reasonableness of the protections noted above under the Treaty of Waitangi. We do note however that the Treaty of Waitangi is an agreement between the Crown (i.e. central government) and Maori. Local government and ratepayers are not party to the agreement, and therefore should not be required to bear the costs. If the costs are imposed on local authorities (as is the case where land is rates exempt), the impact will vary from region to region. In contrast, if the costs associated with the Treaty are borne at a national level, they will be spread evenly across all New Zealanders, which better reflects the nature of the agreement. The same argument should apply in respect of Maori freehold land which is rateable but whose owners often do not pay rates (sometimes because they have difficulty affording them, especially on non-productive land, sometimes out of principle). Local authorities do not have a power of sale for non-payment over Maori land and nor is it appropriate that they should be drawn in to what is essentially an issue between the Crown and Maori.

The issues surrounding the status of Maori land with respect to local government need to be worked through in a comprehensive manner between the Crown, Maori and local government.

4. LOCAL AUTHORITIES' ABILITY TO PAY

In this chapter we address the ability of local authorities to meet the costs of providing the basics to their local communities. We are not concerned in this section with the ability of individual ratepayers to pay. Individual ratepayers may struggle to pay, but if they represent only a small pocket of the local community, they are not likely to impact significantly on their local authority's ability to pay. The problem of individuals' ability to pay is picked up in chapter 5.

The data used in this section should be read as illustrative only. Much of the data used in this section is sourced from Local Government New Zealand's Local Authorities Financial Database, and so is only as accurate as the database itself.

4.1 Problem definition and issues

The belief that some local authorities are underfunded is widespread. Anecdotal evidence that particular local authorities are feeling the pinch is provided in Appendix A.

The reasons that have been put forward in a variety of contexts as to why some local authorities struggle to pay more than others include:

- some districts and regions are simply more deprived than others;
- some local authorities are simply too small to be cost effective;
- the increasing demands on local authorities generally;
- the requirement to fund infrastructure coupled with rising environmental and public health standards;
- an inability to derive revenue due to rates exemptions; and
- some local authorities were transferred commercial assets in the past, while others were not.

We address these issues in turn.

4.1.1 Deprivation

Some areas in New Zealand are more deprived than others as demonstrated by the index of deprivation developed by the Heath Services Research Centre. The index combines nine variables from the 1996 census which reflect aspects of material and social deprivation to give a deprivation score for meshblocks in New Zealand.¹² The highest ranking 10% of areas have an index scale of 1. The next 10% have an index

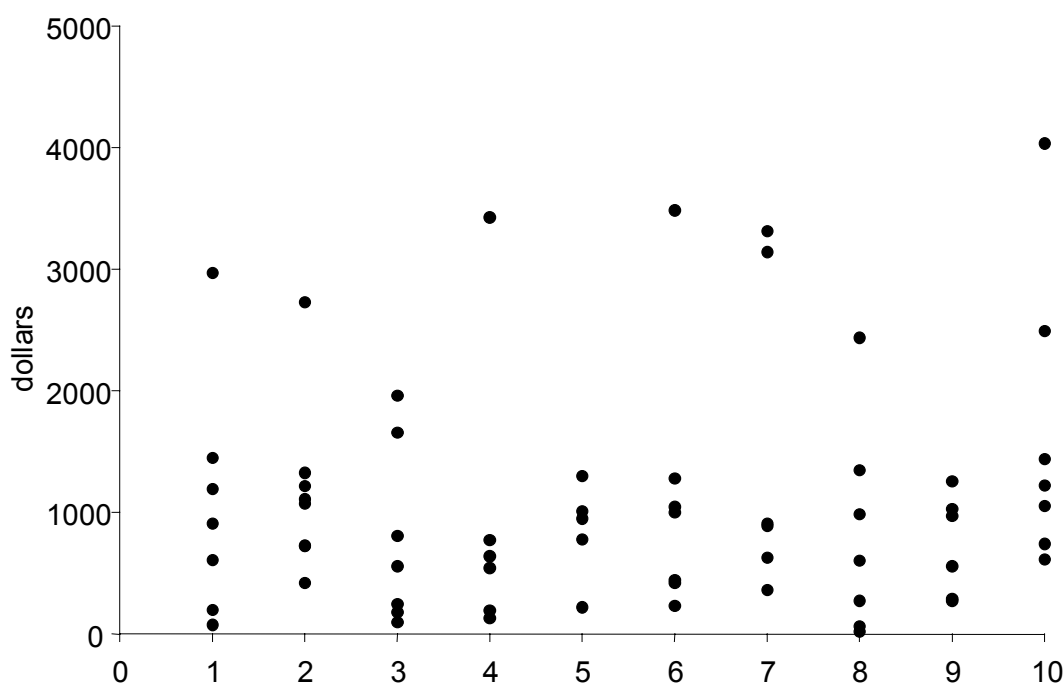
¹² The nine variables are, in order of decreasing weight in the index:

| | |
|-------------------|--|
| 1. Communication | People with no access to a telephone. |
| 2. Income | People aged 18-59 receiving a means tested benefit. |
| 3. Employment | People aged 18-59 unemployed. |
| 4. Income | People living in households with equivalised income below an income threshold. |
| 5. Transport | People without access to a car. |
| 6. Support | People aged less than 60 living in a single parent family. |
| 7. Qualifications | People aged 18-59 without any qualifications. |
| 8. Owned home | People not living in own home. |
| 9. Living space | People living in households below equivalised bedroom occupancy threshold. |

value of 2 and so on. Level 1 represents the least deprived areas and level 10 the most deprived areas. A value of 10, for example, indicates the area is one of the most deprived 10% of areas in New Zealand. These indices are combined to derive index values at the territorial authority and regional levels.

Figure 2 plots local authorities by average rates per capita and deprivation index value. The individual councils are not identified for reasons of confidentiality. People in high deprivation areas are required to fund broadly the same range of core services. The impact of rates on ratepayers in these districts is more onerous in relation to available resources.

Figure 2 Rates and deprivation¹³



By territorial authority. X-axis: deprivation index. Y-axis: rates per capita. 1999 figures.

Note: Outlying councils (very high rates per capita) have been omitted.

Sources: Local Government New Zealand; Statistics New Zealand; Health Services Research Centre.

It is possible that rates are reaching an affordability ceiling in deprived areas. A recent study undertaken for the Wanganui District Council found rates increases would be likely to increase hardship for low income households, and could reduce discretionary spending on health related items. If this conclusion is transferable to councils with an equivalent (or greater) level of deprivation, then the 16 territorial local authorities scoring a 9 or greater on the deprivation index may have reached the limit of their ability to increase rates.

¹³ The data on rates levels in this and other figures in this section gives an average level of total rates per head of population for each district. In practice, councils spread rates across the residential and business sectors, and utilise a mix of general rates and other rating instruments. As a result, this chart should not be taken as an indication of actual residential rates in each district.

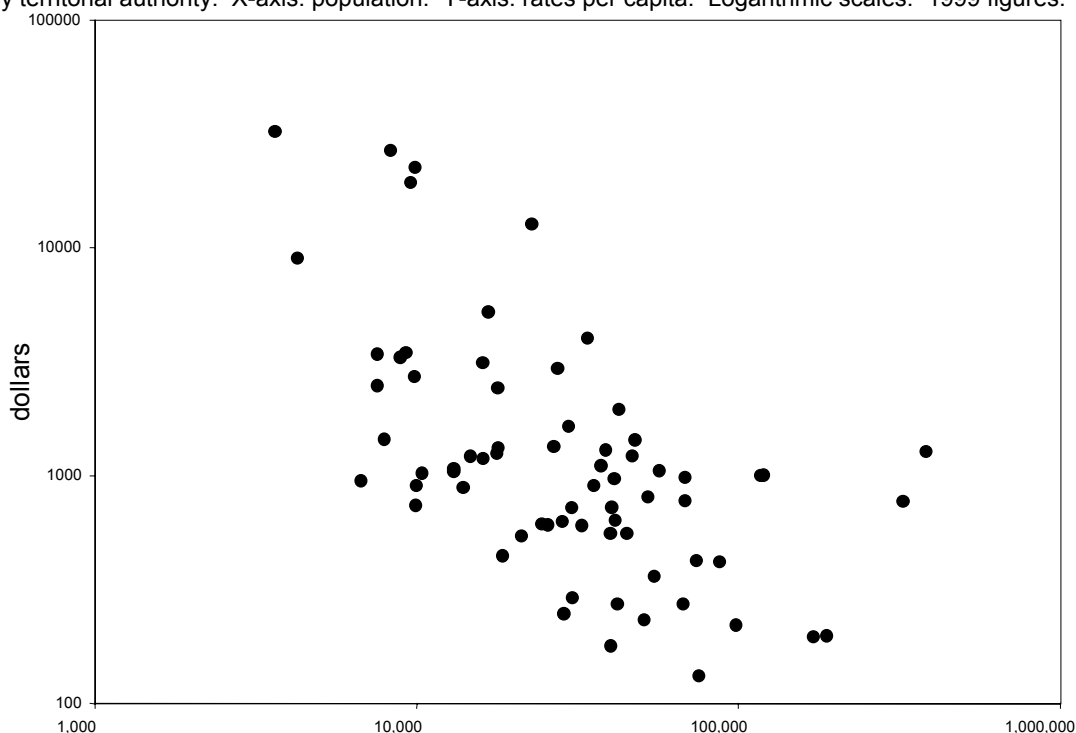
4.1.2 Scale

Some local authorities may simply be too small to be cost effective. Just as a large territorial authority must fund its water and wastewater activities, for example, so too does a small authority. The difference is that the considerable fixed cost component of such activities can be spread thinly over the many ratepayers in a large city whereas the fixed costs of the same operations in a small district has to be shouldered by its few ratepayers. This dynamic is borne out by the data (refer Figure 3 below).

This problem is exacerbated in respect of already small districts, such as Kawerau and Buller, that are getting progressively smaller.

Figure 3 Rates in differently populated areas

By territorial authority. X-axis: population. Y-axis: rates per capita. Logarithmic scales. 1999 figures.



Sources: Local Government New Zealand: Statistics New Zealand.

It should be noted that economies of scale can be as much an issue within the district of a single local authority -- that is between different communities -- as it can be between different local authorities. This may be particularly the case for rural or provincial authorities with a number of small communities each of which requires its own water and wastewater services.

4.1.3 Increasing demands

Rates paid per capita and per dwelling have been increasing steadily year on year, reflecting the increasing demand for revenues by local authorities to fund their expanding activities.

Figure 4 Growth in rates bills

Rates per capita



Rates per dwelling



Inflation adjusted, June 2000 dollars

Source: Statistics New Zealand.

The sources of pressure include:

- population growth;
- devolution of functions by central government to local authorities without associated funding, such as developing local pest management strategies under the Biosecurity Act 1993;
- increasing demands of central government that local government activities meet minimum national standards, such as water standards;
- the requirement and necessity to fund infrastructure including renewal and upgrades (refer below);
- demands of local communities and central government for their local authorities to be active in non-traditional areas.¹⁴ Granting local authorities a power of general competence is likely to reinforce this trend.

4.1.4 Funding infrastructure

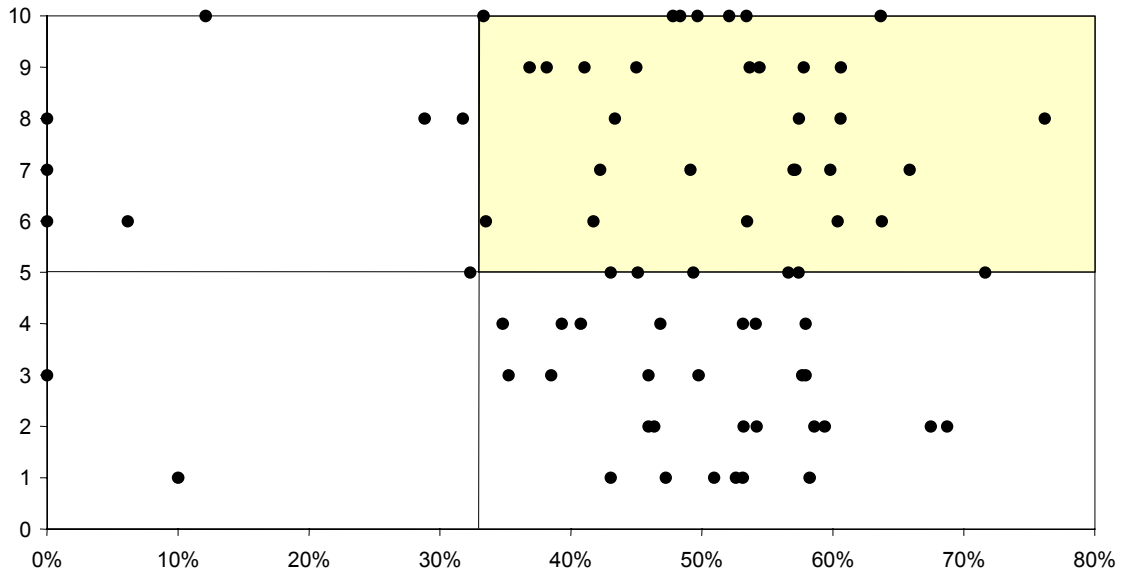
On average almost a quarter of all local authorities' funding requirements arises from the need to fund infrastructure. If regional councils are excluded, this proportion rises to a third.¹⁵ However, as Figure 5 illustrates, it is the handful of territorial authorities that incur no or low infrastructural costs that is dragging this average down. The reality is that for most territorial authorities, the proportion of funding requirements attributable to infrastructure lies between a third and 80%. Of these territorial authorities, about half could be classified as more deprived than average (refer the top right hand quadrant of Figure 5). In their cases, spending on infrastructure may be particularly burdensome and may be crowding out other expenditure.

¹⁴ In principle, given effective governance and accountability arrangements, extension of local government services in response to additional demands should reflect community preferences and willingness to pay for those demands. However, demands for local authorities to take on non-traditional activities may raise the following issues: 1) whether rates increases are the most appropriate funding source for such activities; and 2) whether differences in the ability of councils to fund additional demands justifies new redistributive measures.

¹⁵ The latter figure for territorial local authorities only is more relevant. Infrastructure services are more a function of territorial authorities than of regional councils.

Figure 5 Infrastructure and deprivation

By territorial authority. X-axis: infrastructure's share of total funding in 1999. Y-axis: deprivation index.

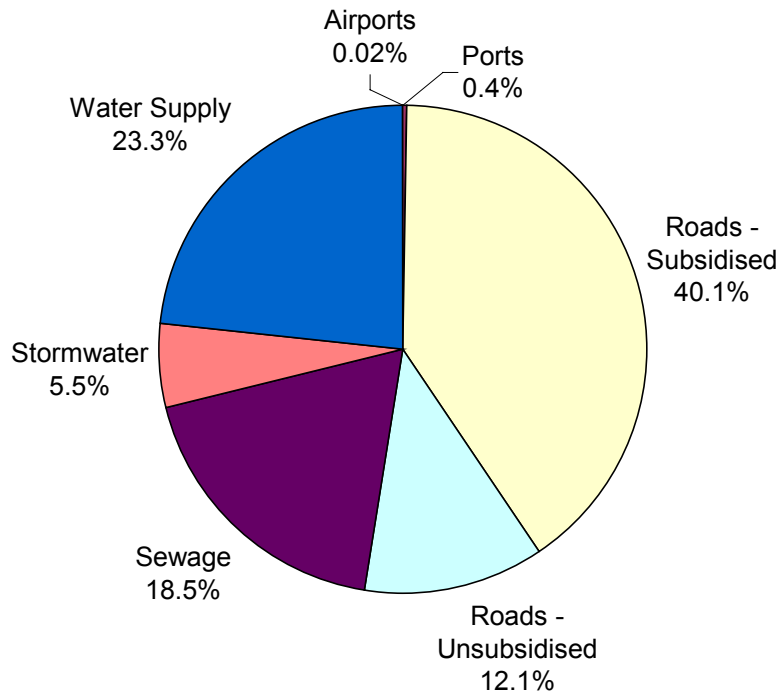


Sources: Local Government New Zealand; Health Services Research Centre.

More than half the infrastructural funding requirements arise from roading. Much of the rest arises from the need to fund water and wastewater (refer Figure 6 below).

Figure 6 Infrastructure funding by activity

Shares in 1999. All regional and territorial authorities.



Source: Local Government New Zealand.

4.1.5 Rates exemptions

The Rating Powers Act 1988 currently provides for the exemption of a variety of types of land from rates. In general these exemptions relate to land used for public and community purposes. Some of these exemptions relate to land owned by the Crown or Crown entities, and others relate to land in private or community (including religious and charitable) ownership.

'Exempt' properties do not currently enjoy a total exemption from local authority rates and charges. They are liable for any separate rates and other charges which are made in respect of water supply, waste collection, and sewage disposal. However legislation currently before the house will, if passed, limit the obligation on schools and not for profit preschools to pay pan charge for their sewerage costs. The charge will be subject to a cap calculated on 20% of the minimum number of pans required to service the rolls of each institution.

Some local authorities are characterised by the presence of very substantial areas of Crown land. It is a persistent complaint, for example, from West Coast local authorities that about 90% of their land is locked up in national parks and Department of Conservation land. Even though the services they provide may be relatively minimal (but including some roading) they are unable to recover costs.

Table 2 details what Crown and other land is exempt.

Table 2 What is exempt

| Crown Land | |
|--|---|
| Nature of Ownership or Interest | Provision |
| Land for Vice Regal residences and Parliament | s4, 1 st schedule, cl. 1, s6 |
| Crown-owned land formed and used for road (i.e. most of the state highway network) | s4, 1 st schedule, cl 2, s6 |
| National parks | s4, 1 st schedule, cl 3, s6 |
| Protected areas under various legislation: Reserves Act, Conservation Act, Wildlife Act (i.e. much of the conservation estate) | s4, 1 st schedule, cl 4, s6 |
| Hospitals, schools and university hostels, child welfare homes | s4, 1 st schedule, cl 5, s6 |
| Land owned and occupied by the Crown used for certain operational elements of airports | s4, 1 st schedule, cl 6, s6 |
| Land occupied by New Zealand Railways Corporation for certain operation elements of railways | s4, 1 st schedule, cl 6, s6 |
| Defence land | s10 |

| Land Regarded as Crown Land | |
|---|--------|
| <i>(this exemption applies whether or not the underlying ownership is actually vested in the Crown)</i> | |
| Land for the purposes of any education authority under the Education Act | s5, s6 |
| Integrated schools | s5, s6 |
| Universities | s5, s6 |
| Hospital and health service land | s5, s6 |
| This exemption can be caused to expire by Order-in-Council | s5(5) |

Table 2 continued over ...

Table 2 continued

| Non-Crown Rates Exemptions | |
|-----------------------------------|--|
| Educational Institutions | |
| Full Exemption: | Kindergartens; playcentres; schools (not operated for pecuniary profit) - up to 1.62ha. |
| Religious Institutions | |
| Full Exemption: | Theological colleges - up to 1.62ha; churches, chapels, mosques and other premises used principally for religious worship; Sunday or Sabbath schools (not for private pecuniary profit). |
| Charitable | |
| Full Exemption: | For free maintenance or relief of orphans, the aged, infirm, physically or mentally disabled, sick or needy - up to 1.62ha. |
| Health | |
| Full Exemption: | Children's health camps, Royal NZ Foundation for the Blind. |
| Others | |
| Full Exemption: | Cemeteries and crematoria (not for private pecuniary profit or vested in a local authority); machinery; Catchment Board or Commission land for soil conservation and rivers control; land exempted under other acts. |
| Māori Purposes | |
| Full Exemption: | Marae - up to 2.03ha; Māori customary land; Māori burial ground - up to 2.03ha. |
| 50% Mandatory Remission: | Māori Reserves. |

| Non-Crown Rates Exemptions continued ... | |
|---|---|
| Heritage and Conservation | |
| Full Exemption: | NZ Historic Places Trust; Queen Elizabeth II National Trust; Museum of NZ Te Papa Tongarewa Board. |
| Community¹⁶ | |
| 50% Mandatory Remission: | Local authority land used for: <ul style="list-style-type: none"> • public gardens; • sports grounds (other than race courses); • public halls; • libraries; • cemeteries or crematoria; • public baths, swimming baths, bathhouses and sanitary conveniences. Land occupied by Agricultural and Pastoral Societies for showgrounds. Land occupied by a trust, society or association not used for the private pecuniary gain of any members, for the purposes of: <ul style="list-style-type: none"> • public gardens; • sports grounds (other than race courses); • public halls; • libraries; • cemeteries or crematoria; • public baths, swimming baths, bathhouses and sanitary conveniences. Land occupied by a trust, society or association not used for private pecuniary profit for the purposes of conservation and preservation providing general public access. |

Source: Department of Internal Affairs.

Local authorities have argued that rates exemptions have contributed to the need for higher rates and that this has been burdensome, particularly in respect of high deprivation areas. We are aware of one provincial local authority, itself facing a very real problem of affordability, that has estimated it could reduce its business rates by 8% and its residential rates by 5% if the Crown exemptions were removed.

¹⁶ The Government proposes to remove the 50% mandatory remissions on land for public access, public open space, and recreation owned by Trusts or associations.

4.1.6 Transfer of commercial assets

Economic reform of the mid 1980s through to the 1990s resulted in a number of local authorities becoming owners or part owners of valuable commercial businesses. These included ports, airports and electricity undertakings. In some cases this was as a result of the dis-establishment of predecessor special purpose authorities (e.g. harbour boards). In the case of electricity it resulted from the compulsory corporatisation of what had been local authority owned Municipal Electricity undertakings, the value of which increased enormously as a result of accompanying regulatory changes. There was a considerable element of arbitrariness about who got what. Whether electricity undertakings were owned by local authorities or by electric power boards was very much an accident of history and there was certainly no contemplation at the time these decisions were taken that they would ultimately have very significant wealth implications. Local authorities have argued that these processes have served to inequitably increase the wealth and income of some local authorities relative to others with major implications for their abilities to fund local activity.

4.2 Options

The options to address the problem of local authorities' ability to pay and the related issues are:

- revenue sharing with central government;
- amalgamating councils, services or funds;
- introducing other supplementary sources of funds;
- removal of rating exemptions on Crown land; and
- borrowing.

4.3 Analysis of options

Funding mechanisms that facilitate revenue sharing, such as a local income tax or local GST, are analysed in the chapter on funding mechanisms. To avoid repetition, we do not discuss the specific mechanisms here. Instead, in this section, we explore at a higher level the pros and cons of revenue sharing.

A discussion on other supplementary funding tools, such as payroll taxes, poll taxes, utilities rentals and petrol taxes, can also be found in the chapter on funding mechanisms. Again we do not repeat the detail of the discussion below. Here we are more concerned with the higher level discussion of the need for supplementary funding tools.

With these caveats in mind, we analyse below each of the options identified above.

4.3.1 Revenue sharing for general local government expenditure

In this section we discuss revenue sharing as a potential source of supplementary income for general local government expenditure.

For the purposes of this discussion we define "revenue sharing" as any form of central government funding for local government expenditure purposes by way of a grant. This essentially includes any central government funding except funds provided under a contract for services. This funding may come from general taxation revenue, or from a tagged revenue source such as a specified proportion of GST. It could be notionally

tied to specific functions, or untied. In this discussion we are focussing on revenue sharing for general expenditure purposes (i.e. funding from central government that is not tied to any specific local government activities). As we discuss in Section 8 of this report, the most feasible option for implementing a local income tax or GST (the most commonly suggested forms of alternative local tax) is as a form of revenue sharing, where the tax is set uniformly across the country, collected by central government on behalf of local government and distributed to councils on some basis. Revenue sharing has been considered in this context in past reviews of local government funding.

Revenue sharing to provide general revenue assistance to local government was implemented in New Zealand in October 1986 on an interim basis. \$14 million was allocated for General Revenue Assistance under this scheme, over the period October 1986 to March 1987¹⁷. These funds were distributed to local authorities based solely on their rate revenue for the preceding year as a proportion of total rate revenues for all territorial and regional authorities.¹⁸ The government of the day, after a short period of time, decided not to continue the revenue sharing scheme.

a) Objectives of revenue sharing and allocation issues

A common objective of revenue sharing in overseas jurisdictions is to address differences in the level of overall service able to be funded by different councils, in order to ensure that local government bodies have a similar capacity to deliver core services to their communities (“horizontal equalisation”). An alternative objective would be simply to supplement existing local government revenues across the board.

The latter is more straightforward to implement, for example, central government revenue could be allocated on the basis of existing revenue levels. A horizontal equalisation objective is somewhat more difficult to implement. Some basis is required for determining the relative need of different councils, taking into account the functions of local government and the effective purchasing power of councils. This assessment would need to account for differences in cost drivers, such as population density and physical conditions, as well as councils’ ability to raise funds, based on community income levels, access to income from trading enterprises, and so on. This could be difficult, however it is possible. Indeed most revenue sharing schemes in overseas jurisdictions are allocated on the basis of formulae designed to support horizontal equalisation objectives.¹⁹

In a New Zealand context, the combination of diversity between councils and discretion with respect to functions makes it difficult to set a meaningful threshold for the level of revenue that should be available to each council in absolute terms. The target revenue then becomes a relative concept. This is the approach taken in Australia, where the principles underpinning the Commonwealth’s local government financial assistance scheme provide that:

¹⁷ This is equivalent to approximately \$21 million today.

¹⁸ This distribution policy was based on the Local Authority Petroleum Tax model.

¹⁹ In New Zealand, financial assistance for local roads incorporates an element of horizontal equalisation. Assistance is provided by Transfund taking into account the financial resources available to the council concerned. The level of total funding required by a council is based on an agreed roading programme.

“general purpose grants will be allocated to local governing bodies, as far as practicable, on ... a basis that ensures that each local governing body in the State/Territory is able to function ... at a standard not lower than the average standard of other local governing bodies in the State/Territory.”²⁰

b) Potential risks

The desirability of revenue sharing depends on both the level of funding under consideration and the breadth of local government activity covered. Revenue sharing for a significant proportion of local government expenditure could in principle be an effective supplementary funding source,²¹ but at the same time raises several risks for local government, in particular:

- the extent to which revenue sharing is accompanied by central government direction as to the use of the funds. There is a tension here between accountability to central government for the use of the shared revenue, and local autonomy and accountability to the local community for the delivery of local public or merit goods. Members of the local government sector consulted in the preparation of this report raised concerns about the possibility that local government autonomy might be undermined under a revenue sharing mechanism. Even if revenue sharing were initially on an “untied” basis, future governments could reduce discretion over the use of the funds. An extreme example is the United Kingdom, where the central government provides 80% of local government revenues, and in return claims considerable control over local government functions (although we note that local government in the United Kingdom is responsible for the delivery of a wide range of what in New Zealand are core central government services). Untied revenue sharing could weaken the accountability of local government, by separating funders of local government services (national taxpayers) from decision makers (councils and local communities);
- the sustainability of revenue sharing over time. It would be difficult to design a revenue sharing scheme to protect it from incursions by future governments faced by tight fiscal constraints. The risk is that funding available from such a scheme may reduce over time. Indeed, this appears to have been the case in Australia. When its revenue sharing scheme was introduced, available funding was 1% of GDP. It has now dropped to approximately 0.6% of GDP.

c) Overseas experience

Revenue sharing has been implemented in a number of overseas jurisdictions. Examples include:

- **United Kingdom:** as already noted, a significant proportion (approximately 80%) of local government revenue in the United Kingdom is provided through revenue sharing arrangements with central government. The corollary of this is a substantial loss of local government autonomy;
- **Australia:** in Australia the Commonwealth has operated an untied revenue sharing scheme since 1974/75. Grants paid under the scheme are paid through the States

²⁰ Commonwealth Grants Commission, “National Principles Relating to the Allocation of Financial Assistance Grants to Local Government”.

²¹ Setting aside for now issues of how the funds would be raised (see Section 8).

under section 96 of the Australian Constitution.²² Grants are distributed to local government bodies by the States, guided by a set of national principles. The design and operation of the scheme are largely products of Australia's federal structure. It appears unlikely that this scheme could easily be translated into a New Zealand context due to the constitutional differences;

- **United States:** some states in the United States operate what is loosely the equivalent of a local goods and services tax but on a pooling basis. Under this approach, smaller and/or less financially robust local authorities receive an extra contribution from the pool. Again, this approach appears to be largely a factor of the United States' constitutional framework. However, the concept of pooling could be considered here.

d) Fiscal impact

Any revenue sharing proposal needs to recognise the fiscal impact for central government, which will need either to reduce its own expenditure or increase taxation in order to meet the cost (which itself reduces the scope for future tax increases to meet central government's fiscal needs). Thus the feasibility of revenue sharing is limited by the extent of fiscal constraints on central government.

e) Conclusions on revenue sharing

Revenue sharing could be an effective supplementary source of local government funding. However, if revenue sharing were implemented to supplement funding of local public or merit goods, local autonomy and accountability to the local community for the provision of such goods could be reduced. As a result, local preferences regarding the mix, level and quality of local public and merit goods provided by individual councils may be compromised.

We do not recommend sharing of general central government revenues (e.g. revenues from income taxes or GST) be pursued. Instead we have identified a number of pragmatic changes which we consider would mitigate funding pressures on individual councils. As a consequence we conclude that local GST and local income tax are not feasible options as supplementary sources of local government funding.

4.3.2 Amalgamation of councils, services or funds

Options for addressing the issue of scale are either to:

- amalgamate councils;
- amalgamate selected local authority services, such as water and wastewater; or
- pool funds.

Arguments in favour of the first option are that it may facilitate economies of scale, and allow costs to be spread across a bigger population. Economies of scale may arise from shared administrative functions and/or shared service delivery. The downsides are that amalgamation of councils is likely to be politically unacceptable as it threatens local identity and autonomy. And there is no guarantee that economies of scale will in fact accrue. There may be geographical or cost reasons why, for example, there should be one water and wastewater treatment facility in one district and another in a

²² Primary responsibility for local government policy rests with the States, rather than the Commonwealth.

neighbouring district. It is also arguable as to whether it is equitable that richer districts cross-subsidise the costs of their poorer neighbours (this may be more properly a role for central government as being akin to income redistribution).

The second option has an advantage over the first in that it enables local authorities to come together to deliver a selected range of services where there are opportunities for the ratepayers of both authorities to benefit from the savings enabled through economies of scale. Practical ways of facilitating amalgamation include jointly owned LATEs, franchises, or stand alone business units (operating under the governance of a joint committee).

The third option of pooling funds facilitates cross-subsidisation. However, this option, like the first, raises questions in respect of the allocative efficiency and equity of any effective redistribution from the more well off authorities to those that are less well off and is, therefore, not recommended (although it could be an element in the distribution of funds from any new funding source).

The same questions already arise within local authorities where physical conditions require them to provide separate systems to service the needs of different communities. Some councils, following the benefit principle, take the view that individual communities should each meet the full cost of providing for their own infrastructure needs. Others, for example some rural councils, see the cost of providing infrastructure for small communities as an investment in ensuring that there are services such as labour available for the surrounding farming activities.

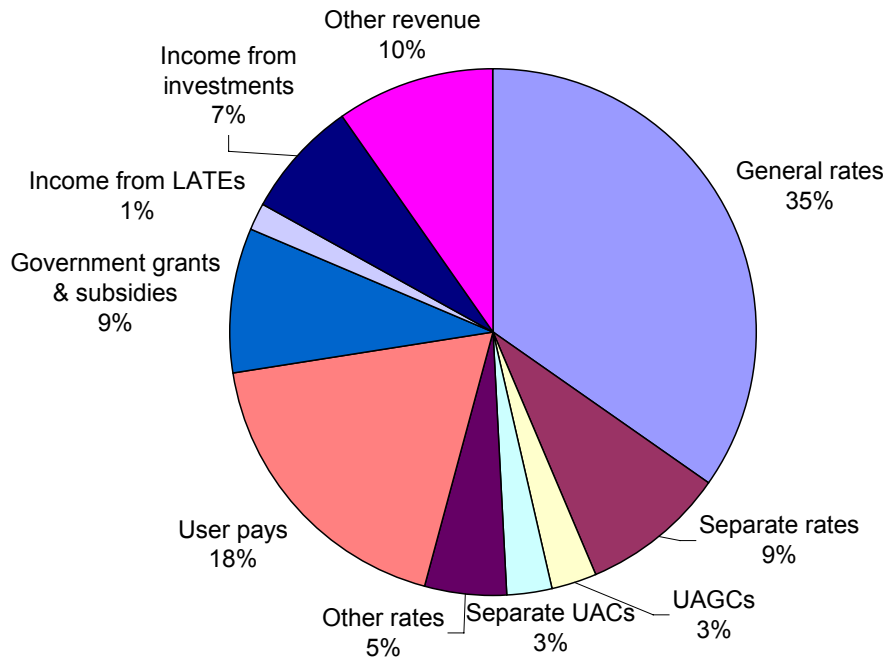
One local authority operates what it informally describes as a "club" approach. Approximately two-thirds of the council's 30,000 households are connected to one of its several wastewater systems. Its uniform annual charge is set at a level which produces a surplus. It uses this to provide a subsidy from the district as a whole for the development of new wastewater schemes. For example, one scheme for 900 households, currently under development, will be funded one-third from the district and two-thirds by specific charges on the scheme area. This approach of pooling funds within a local authority can significantly reduce problems of affordability at the community level, and can be designed in such a way that, over the long term, cross-subsidies between communities are minimised.

4.3.3 Other supplementary sources of funds

Local authorities rely heavily on rates to meet their funding needs. Rates (including UACs and UAGCs) represent 55% of the total revenue of all local authorities combined. There are limited other sources of funds available.

Figure 7 Reliance on rates

Share of total revenue in 1999



Source: Local Government New Zealand.

Local authorities who are struggling to meet the cost of providing the basics to their local communities have a limited ability to pass costs on to their already overburdened ratepayers. There is evidence of a need for other supplementary sources of funds in such cases. Given that ratepayers' ability to pay is an issue for these authorities, we need to consider supplementary sources that target people other than property owners. In the sections that follow, we identify and analyse a range of options including mechanisms that target the users of council services, developers and central government, as well as alternative taxation instruments.

4.3.4 Exemptions of certain land and facilities from rates

The Rating Powers Act provides for a number of exemptions from rates, including exemptions for certain Crown land, and certain Maori land. These exemptions are inconsistent with the principle that a tax should apply evenly across the board.

a) Crown land

A significant proportion by area of Crown land exempted from rates is made up of conservation and preservation land, which has been set aside on the basis that it is in the national interest to protect such land. The justification for the non-rateable status of such land is based on:

- the difficulty of valuing such land for rating purposes. Rating on the basis of market values could create incentives for conservation land to be developed, which would be counter to the national interest; and
- conservation and preservation land receives few direct services from local authorities.

With respect to the first issue, concerns about the difficulty of valuing certain categories of land for rating purposes relate primarily to land which cannot be used for commercial purposes and/or cannot be sold. Government conservation or preservation land falls in this category (as does Maori customary land). This issue is not insurmountable. A sensible solution would be for the government and affected councils to agree on set of principles for establishing rating valuations or agreed levels of compensation for these categories of land.

With respect to the second issue, the level of local government service received by conservation or preservation land is relevant under the benefit principle to the level of rates levied, however this does not necessarily justify an exemption from rates. In any case, conservation and preservation land does receive some services, including some roading services which can be a major source of cost for many councils.

The greater area of Crown land exempt from rates is not conservation or preservation land but land (and buildings) used for delivery of Crown services such as education and health. These services are delivered across the country, so these categories of exempt land are also widely distributed. Accordingly, the impact of the exemption is less concentrated than that of conservation and preservation land but it is still significant, especially in its impact on local authorities where ability to pay is becoming a significant consideration. These exemptions essentially reflect national priorities in relation to particular services, and the cost of exemptions should accordingly be borne by the Crown.

b) Maori land

Maori burial ground, reservation, marae or meeting ground and customary land is non-rateable under the Rating Powers Act. We discussed issues relating to the Treaty of Waitangi and rating of Maori land in Section 3.3, and concluded that the issue here is not whether these specified types of Maori land should be liable for rates, but rather who should meet the cost. Fundamentally this issue comes under the Treaty of Waitangi, and as such is a national obligation. Under current arrangements the cost is borne by those councils in whose districts such land is located. This is inequitable in that the cost falls only on those ratepayers located in affected districts, and not on others. The costs of meeting the Crown's obligations under the Treaty of Waitangi should be met at a national level, and borne by all taxpayers.

This principle also applies to Maori freehold land which is rateable but whose owners often do not pay rates (sometimes because they have difficulty affording them, especially on non-productive land, and sometimes out of principle). Local authorities do not have a power of sale for non-payment over Maori land and nor is it appropriate that they should be drawn in to what is essentially an issue between Crown and Maori. The Crown should therefore bear the cost of any shortfall from non-payment of rates on Maori freehold land. As a result, the cost of rates on Maori freehold land would be shared by Maori landowners and national taxpayers, rather than Maori and local ratepayers as is currently the case. While this approach would raise moral hazard problems – incentives on Maori landowners to pay rates and on local authorities to encourage payment would be reduced – it would be more consistent with the national scope of the Treaty of Waitangi.

c) Exemptions for essentially commercial activities

Rating exemptions also apply to some essentially commercial activities, such as land used for certain operational elements of airports and railways. Given that such activities operate on a commercial basis, there is no apparent justification for the continuation of these exemptions. Accordingly we recommend that exemptions for essentially commercial activities should be removed.

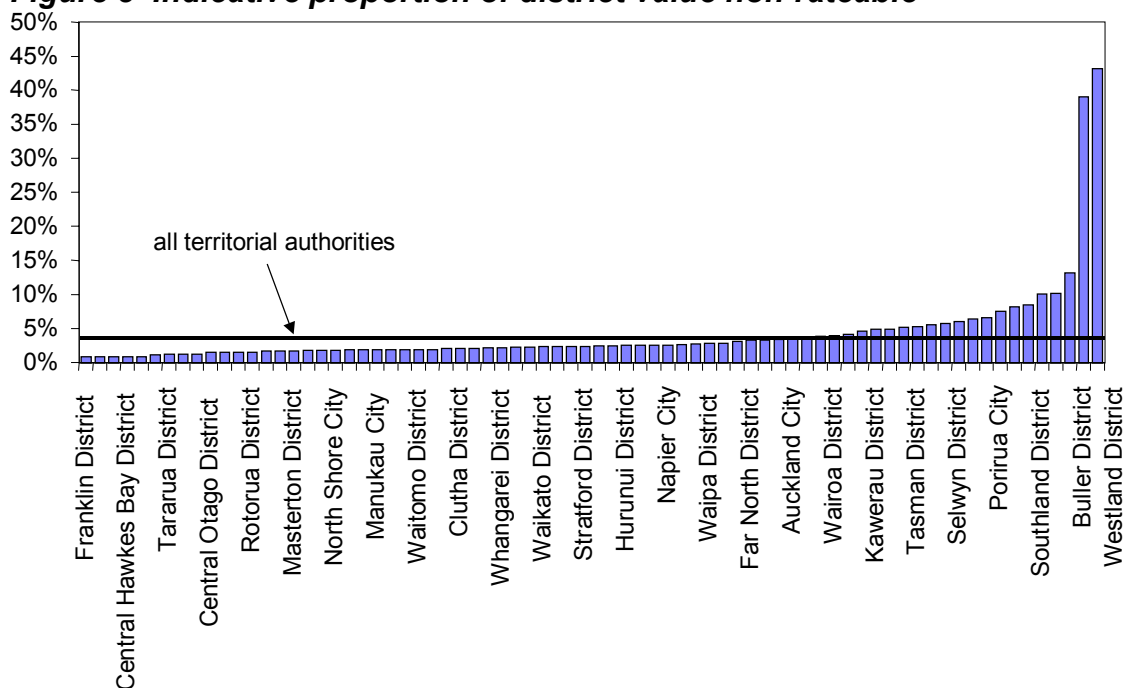
d) Exemptions for religious or charitable purposes

The above arguments may not apply in relation to exemptions for religious and charitable purposes. These activities are provided privately on a non-commercial basis, and seem likely to have local public or merit good characteristics. Exemptions from rates for these activities may therefore be appropriate.

e) Differential impact of exemptions²³

The impact of exemptions from rates is weighted to a small number of councils, as can be seen from Figure 8. This indicates that the cost burden from rates exemptions, including exemptions to protect conservation land and Maori land, falls disproportionately on a very small sub-set of ratepayers.

Figure 8 Indicative proportion of district value non-rateable



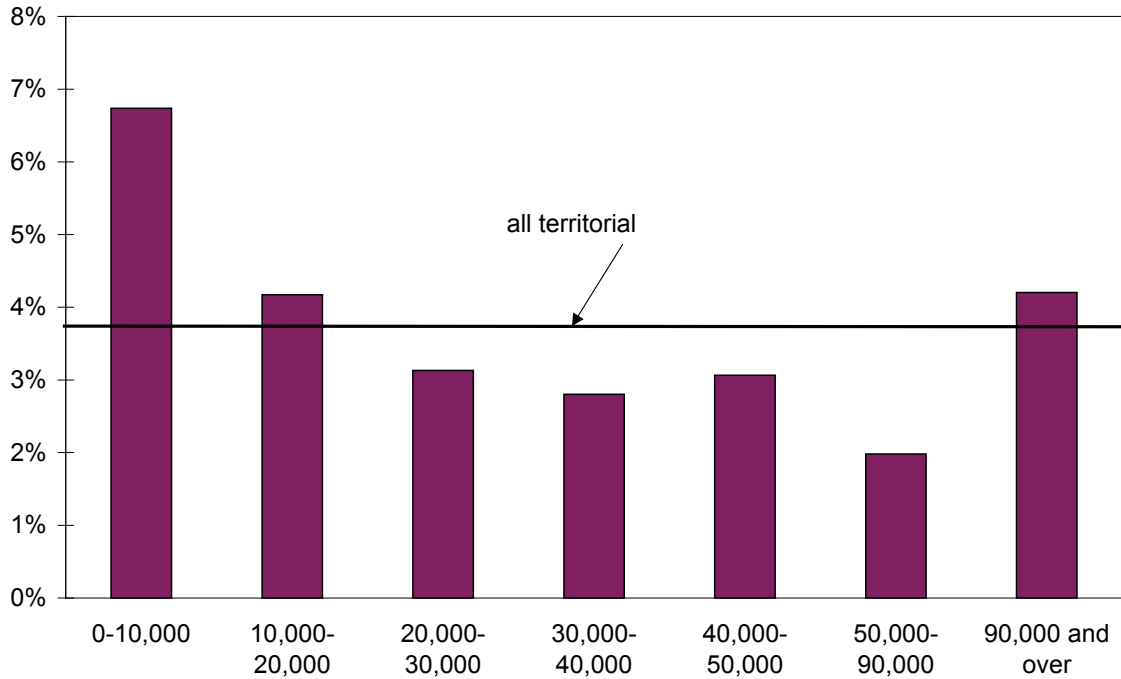
Source: Department of Internal Affairs

In Figure 9 we consider the average impact on districts of different sizes (grouped here by population). On average, those councils most affected by exemptions from rates are those with the smallest populations, and therefore the smallest residual rate bases. Small councils tend to face high costs per person in any case, due to poor economies of

²³ The data used for this analysis is indicative only, due to the problems noted earlier in valuing non-rateable Crown land.

scale. (This diagram reflects trends only, given the substantial variation in impact evident in Figure 8, it is likely that some small councils are not significantly affected, while for others a substantial part of their district is non-rateable.)

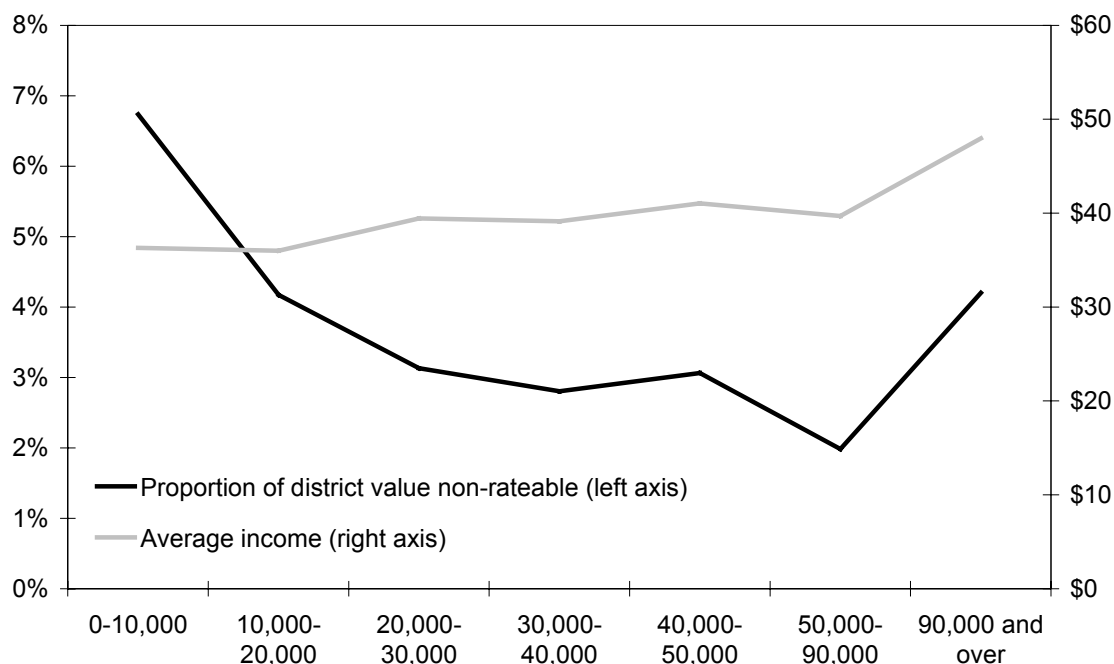
Figure 9 Average indicative proportion of district value non-rateable by TLA size



Source: Department of Internal Affairs

Finally, we consider the proportion of land that is non-rateable against average income levels for different sized councils. Small councils which are more likely to be affected by rating exemptions, also have lower average incomes than larger councils. (We note, however, that there does not appear to be any correlation between the proportion of non-rateable land and the deprivation index used earlier in this report.)

Figure 10: Indicative proportion of non-rateable value and average incomes



Average income (right axis) in thousands of dollars

Source: Department of Internal Affairs

f) Conclusions on exemptions of certain land and facilities from rates

The existing rating exemptions, particularly those for Crown land and Maori customary land, target national objectives and benefits. Under the current situation, the cost of achieving these national objectives falls disproportionately on a relatively small number of councils. In particular, smaller councils appear to be significantly affected. This anomaly should be eliminated by either removing the exemptions, or by way of Crown compensation to the councils affected. The latter approach is likely to be more appropriate in cases where valuation is problematic, such as conservation and preservation land, and Maori customary land. We understand the compensation option is being further considered by the government, in light of Labour’s manifesto undertaking that it “accepts the principle of paying compensation to local authorities with substantial holdings of DOC or other government agency land, for the loss of rates on that land”.

The government should also accept responsibility for the cost of unrecoverable rates from Maori freehold land.

4.3.5 Borrowing

The ability to meet the considerable upfront costs of long-term assets, such as infrastructural assets can, in theory, be eased through borrowing. This allows loans to be repaid as the benefits accrue to future ratepayers over the lifetime of the assets. This is an efficient outcome that promotes intergenerational equity.

It was with these desirable outcomes in mind that the borrowing provisions in the Local Government Act were amended in 1996. Under the Local Government

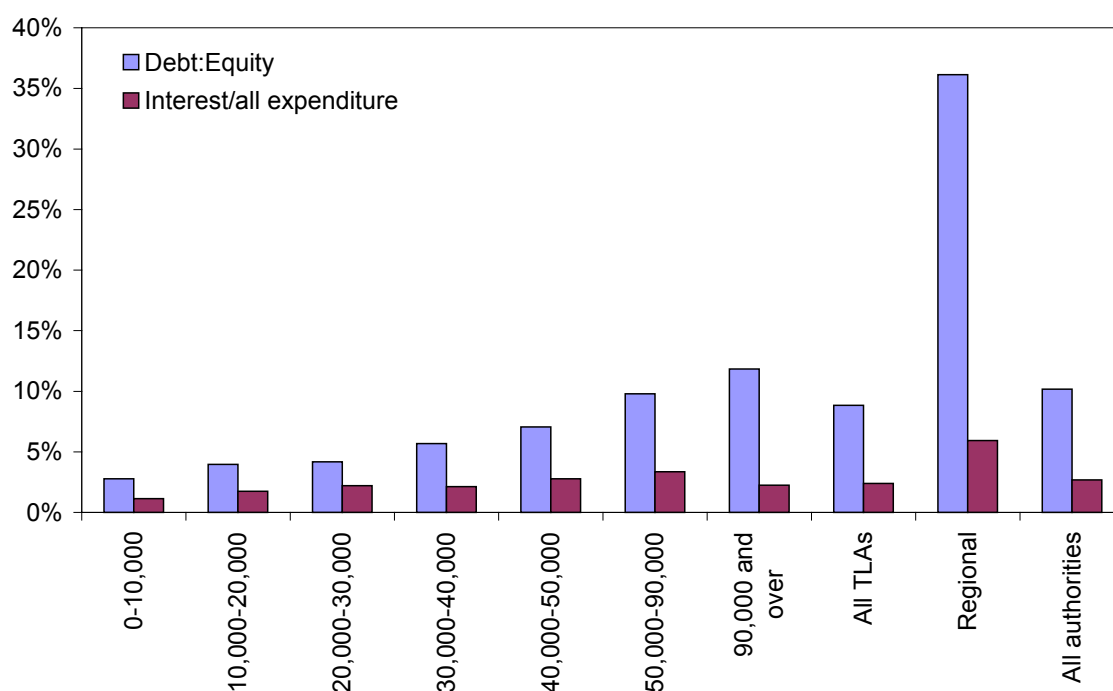
Amendment Act (No 3) 1996 prescriptive constraints on borrowing were replaced by reliance on locally developed Borrowing Management Policies. Local authorities were empowered to determine appropriate levels of debt for each of their activities. Under this framework, local government has theoretically the same access to financial products and arrangements as the commercial sector.

One could argue that they have even better access. Local authorities generally enjoy a better credit rating than private businesses as their debt enjoys a more favourable risk rating under the regime for determining banks' capital adequacy and, whether or not they formally grant security over it, their borrowing is backed by their rating power.

Another factor that contributes to the creditworthiness of local authorities is their generally favourable debt:equity ratios and the fact that servicing interest payments represents a relatively small proportion of total expenditure. The data in Figure 11 represents the averages for local authorities who service areas of increasingly larger population bases. The figure illustrates that the debt:equity ratios of local authorities are very low by commercial standards. The average for all territorial local authorities is less than 10%, while the average for regional councils is 36%. Interest payments represent only 4% and 7% of the total expenditure of territorial authorities and regional councils respectively.

Figure 11 Debt:equity ratios and interest costs²⁴

X-axis: population ranges. Y-axis: ratios and proportions. Figures for 1999.



Source: Local Government New Zealand.

The temptation is to conclude that there is little to constrain local authorities from borrowing to ease their current funding requirements.

²⁴ Regional councils stand out in this graph as having significantly higher debt:equity ratios than territorial local authorities. The main reason for this is that, for most regional councils, their principal assets are catchment schemes, drainage schemes, etc. It has been a long standing practice that these should be substantially debt funded.

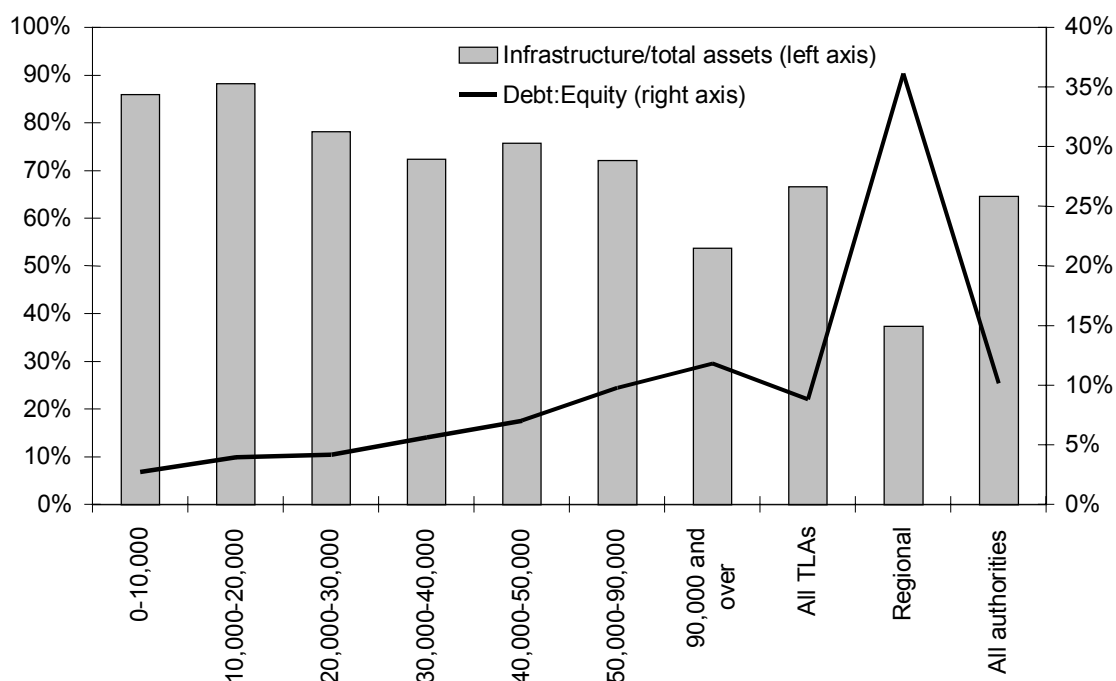
The reality is that while local authorities appear to be extremely credit worthy based on conventional commercial benchmarks and the fact that their borrowing is underwritten by their power to tax, they face quite real constraints including:

- a public perception that local authorities should not incur substantial debt;
- a recognition that although they own very substantial assets, political considerations mean that most of these are effectively non-tradable, and so could not be realised in order to repay debt. Indeed, Figure 12 shows that there is an inverse correlation between the proportion of infrastructure assets on local authority balance sheets and their debt: equity ratios;
- an awareness that, in contrast with conventional commercial organisations, their principal source of funds for debt servicing is not income earned in the market, but taxes extracted from a population whose ability to pay is not proportionately increased by additional local authority investment in infrastructure.

Figure 12 shows a positive correlation between debt:equity ratios and local authority size. This may well relate to the broader range of services which larger local authorities operate including, in some cases, significant commercial involvements, and possibly a somewhat less conservative attitude towards debt amongst larger local authorities. In addition, larger local authorities may be better able to service debt, as they are able to draw on a wider base of ratepayers.

Figure 12 Extent of infrastructural assets and debt levels

X-axis: population ranges. Left Y-axis: infrastructure as a proportion of total assets. Right Y-axis: debt:equity ratios. Figures for 1999.



Source: Local Government New Zealand.

This leads us to conclude that while local authorities are creditworthy, they face practical constraints regarding how much they can borrow.

4.4 Summary

In this section we found there is evidence that at least some councils are constrained in their ability to meet incremental funding requirements through rates. In the sections that follow we consider a range of specific issues and possible solutions that, taken together, may go some way to addressing this issue, focussing on:

- factors that impact on councils' ability to raise rates from individual ratepayers, namely individual ratepayers' ability and willingness to pay; and
- who should pay for local government services.

In the final section we identify and analyse alternative taxation mechanisms that might supplement existing local government funding.

Recommendations regarding local authorities' ability to pay:

We conclude that revenue sharing would involve a number of risks for local government and, in particular, could lead to a loss of local autonomy and accountability. We do not recommend revenue sharing in general.

We recommend that existing exemptions from rates, particularly in relation to Crown land and certain Maori land, and land used for essentially commercial activities, be removed, or local authorities be compensated by the Crown:

- the Crown should directly meet the cost of rates for currently exempt Maori land, as well as accepting an obligation to make up the shortfall from non-payment of rates on Maori freehold land; and
- rating exemptions for land used for religious and charitable purposes could be retained, to reflect the associated local benefits.

5. INDIVIDUALS' ABILITY TO PAY

5.1 Problem definition and issues

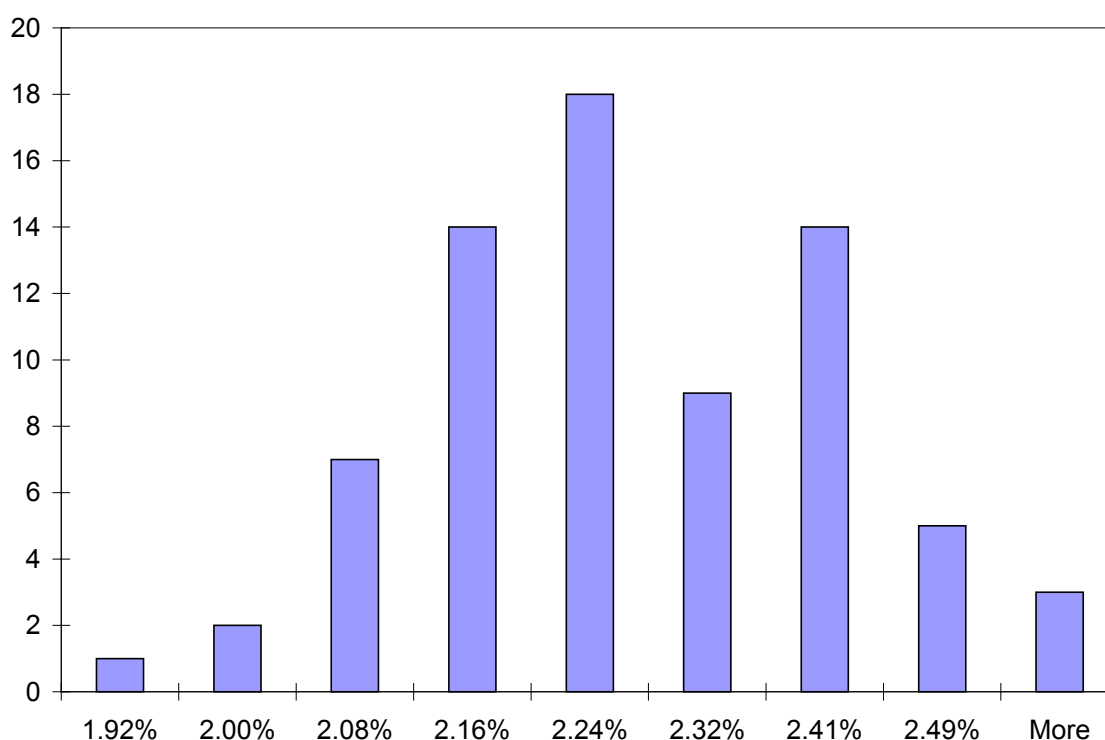
There are cases where individual ratepayers have very real difficulty affording the level of rates required to meet the costs of providing a full range of local authority services to currently expected standards. This may arise because either they:

- are poor;
- may be asset rich but have little income; or
- may struggle to meet large annual rate demands.

5.1.1 Poor individuals

Most individuals will not experience too great a difficulty in meeting demands on them to pay rates. The histogram below suggests that the rate demand for the average household in most (85% of) territorial authorities is within the narrow range of 2.0% and 2.4% of total expenditure.

Figure 13 Rates share of total household expenditure



X-axis: bin ranges. Y-axis: number of local authorities within each bin range.

Source: Statistics New Zealand.

However, some local authorities have significant pockets or numbers of low income residents but have overall income levels close enough to national norms, so that the view is taken that the authority as a whole does not have a low income issue.

In the chapter on local authorities' ability to pay we introduced the reader to an Index of Deprivation. In the grey boxed discussion below we examine the relative levels of

deprivation of people living in meshblocks within the Tauranga district. The purpose of this discussion is to illustrate that even in some of the relatively well off districts in New Zealand, there are still significant pockets of deprivation.

Tauranga – where the rich and poor live side-by-side

Tauranga has an overall Index of Deprivation of six. It is one of the relatively less deprived districts in the Bay of Plenty Region, which is the third most deprived region in New Zealand.

However, the district has proportionally fewer people than the New Zealand average who would score an Index of Deprivation level of between one and three. Thirty percent of its population lives in areas with an Index of Deprivation level of between eight and ten. Concentrations of more deprived meshblocks are found in Yatton Park, Greerton and Matapihi.

These pockets of high levels of deprivation within a district can cause heightened ability to pay problems in relation to services for communities facing high deprivation levels, relative to the district as a whole. This is particularly the case in relation to significant new developments for discrete communities within the District. The combination of relatively low income and services whose cost does not vary with income (e.g. water or sewerage) could cause substantial hardship where the cost of such services is borne by solely by those communities.

5.1.2 Asset rich vs income poor

Rates are levied on the value of property. Central government imposed taxes, by way of contrast, apply to the incomes earned by individuals and organizations. There are instances where individuals may be asset rich, but income poor. This problem is most apparent in respect of retired people living in what may be quite a valuable family home and dependent on a low fixed income. It has also at times of rural downturn affected farmers who may be struggling to make an earning from the land.

5.1.3 Timing of payments

Rates have historically existed as an obligation to pay an annual sum. Large annual demands may create payment difficulties for some individuals.

5.2 Options

Options to address this problem and its associated issues include:

- income support;
- rates waivers; and
- time shifting.

5.3 Analysis of options

5.3.1 Income support

Two types of accommodation related support are currently available, namely the:

- accommodation supplement; and
- rates rebate scheme.

Eligibility for an accommodation supplement is dependent upon an applicant's income, assets, and housing costs. For home owners, housing costs need to represent at least 30% of income. Rates can be included as a type of housing cost. The scheme is currently administered by the Department of Work and Income. There are 300,000 current beneficiaries of the supplement. Most of these are in rental properties. Relatively few, if any, will be "asset rich, income poor" retired people as they will typically be free of mortgage debt.

The purpose of the rates rebate scheme, when introduced in 1973, was to provide some measure of relief from rating costs for low income earners and/or older ratepayers who want to stay in their own homes. Rates rebates are administered by local authorities according to national criteria. Local authorities are reimbursed through the Department of Internal Affairs for rebates granted.

Under the scheme residential ratepayers can get a reduction in their rates of up to \$200. Eligibility for this scheme depends on an applicant's income and their level of rates. Other costs are not taken into account. The scheme has an income limit of \$7,400 gross plus \$156 for each dependant. However, as the level of rates is factored into the calculation of eligibility and rebate, some ratepayers with relatively high rates can receive a rebate even though their income is above this limit. Recipients must pay the first \$160 of rates.

In the scheme's first year of operation some 58,400 rebates totaling \$1.97 million were granted. In 1979/80 the total amount of money paid out peaked at \$8.72 million. This was spread across 96,000 applicants. In 1999/2000 there were 4,117 rebates granted totaling \$675,000. In 2000/01 central government provided \$700,000 in Vote Internal Affairs for the scheme.

In the current environment the scheme is deficient as an income support measure in the following respects:

- the effectiveness of the scheme is severely diminished. The maximum rebate of \$200 was set in 1979/80. The income limit for eligibility was set in 1990/91. Incomes and rates have increased significantly over the last two decades;
- the effect of the scheme is to provide for the special treatment of rates. Other costs of home ownership are not factored into the current rebate calculations;
- beneficiaries are not well targeted. For example, the scheme does not assist those low income earners who rent and effectively pay rates through their rents (although they will receive support through the accommodation benefit).

The scheme in its current form is not effective. It needs to be reviewed if it is accepted that low income home owners should be entitled to assistance. At a minimum the scheme needs to be redesigned, at a maximum it needs to be replaced, perhaps by an altered version of the accommodation supplement.

5.3.2 Rates waivers

The Rating Powers Act currently contains a collection of provisions that allow the waiving of rates that have grown in an ad hoc fashion over time, including the remission and postponement of rates on the grounds of extreme hardship (section 177).

If the rates rebates scheme was reviewed and the scheme was either redesigned or replaced then the continuing necessity of a provision to waive rates on the grounds of hardship may become more difficult to justify.

However, there may be reasons other than hardship as to why local authorities may wish to waive rates. For example, some councils provide rates relief to owners of certain categories of land, as a reward for voluntarily protecting their land. The ability of local authorities to waive rates should, therefore, be retained. Retention has been recommended in the context of the Local Government (Rating) Bill.

The proposal is that local authorities may waive rates for any purpose so long as the purpose is identified in the context of their policy objectives. Any waiver should be recorded and reported as an expenditure for the purpose of which the relief is granted. This is a departure from current practice where rate waivers are recorded as a reduction in rate revenues.

5.3.3 Time shifting

Ratepayers' income patterns suggest that it is desirable to be able to shift the obligation to pay rates over time either within a year or to future years. Options to facilitate time shifting include:

- flexible payment schemes; and
- private or central government financing solutions.

There is currently provision within the Rating Powers Act that allows ratepayers to apply to their council to defer rates payments in the case of financial hardship (section 178). This is a very specific power that sub-optimally addresses the issue of timing. A more general power that enables local authorities to implement flexible funding schemes would better address the issue of timing. The schemes could allow for any number of payment timing options, such as:

- upfront lump payments of rates;
- postponements;
- weekly, monthly, quarterly or annual bills; and
- elderly who are asset rich and income poor could choose to meet their rates commitments out of their estates.

Local authorities will need, however, to have regard to the financial implications of any flexible funding decisions. For instance, local authorities should charge interest on any rates postponed for considerable periods. They will also need to keep a watchful eye on their cashflow positions.

More flexible rate payment provisions are being considered in the context of the Local Government (Rating) Bill.

An argument could be made that flexible payment schemes are not necessary and that any attempt by local government to address the timing issue through a flexible funding scheme may crowd out and prevent private financial sector solutions from emerging. The counter to this is that such solutions are likely to have emerged by now if they were truly feasible. Experience over the past decade with attempts to encourage financial institutions to offer what are known as home equity or reverse mortgage products suggests that this is not seen as an attractive area of business.

Recommendation on individuals' ability to pay:

We recommend that:

- the rates rebates scheme be reviewed;
- on the assumption that the change proposed in the Local Government (Rating) Bill passes into legislation, local authorities consider adopting open ended postponement policies, subject to the ratepayers concerned meeting the full costs (including interest, administration and a provision for risk) and the local authority being satisfied, in any particular case, that there is adequate security to ensure ultimate payment.

6. RATEPAYERS' WILLINGNESS TO PAY

6.1 Problem definition and issues

While individuals may have the ability to pay, they may still be unwilling to pay.

Reasons include:

- ratepayers do not often see or understand the value of funding infrastructure;
- rates are visible payments. The benefits, on the other hand, are less visible;
- rates are non-voluntary payments. They may fund services that, if given the choice, individual ratepayers would not demand; and
- rates cover a very wide variety of services. Ratepayers may often not understand the value they receive for the payments they make – which may be primarily a communication issue.

6.1.1 Politically unattractive expenditure

As discussed in the chapter on local authorities' ability to pay, local authorities spend large sums of money on infrastructure. Infrastructure is a long term asset. Its benefits accrue over the lifetime of the assets and are, therefore, often taken for granted by more short term focused individuals, particularly if those individuals are mobile and may not be around to enjoy the future benefits of infrastructure they fund today.

The short election cycle of local government and the political incentive to be re-elected may cause local politicians to adopt the short term perspective of their local communities.

The risk is that infrastructure and other politically unattractive areas of expenditure will be underfunded.

6.1.2 Visibility

Rates are very visible taxes on property. Bills may arrive in the post once a year with seemingly large payments being demanded. Income tax paid to central government, by way of contrast, is relatively invisible because of the nature of the PAYE system.

The benefits that rates may fund may be less visible or assumed. When you turn on a tap to pour yourself a drink of water, for example, you are unlikely to contemplate or value the infrastructure and quality control and other processes in place to ensure that the water gets to you and is safe and healthy.

Rates to fund a range of activities are summed together in one bill. The practice of ratepayers is to focus on and react to the bottom line. They will not often study the components that contribute to the bottom line and, therefore, may not fully understand and value the range of services they receive.

A number of local authorities are particularly concerned that this mode of presentation effectively conceals the impact on the total rates demand of the costs associated with water and sewerage services, especially when these are driven by demands for new or upgraded systems. One local authority, which operates with a community board structure, provided us with a breakdown of average residential rates for two of its

community board areas. This breakdown is considered in the grey boxed discussion below.

Rates in two community board areas

Rate demands for community boards A and B were analysed on the basis of:

- district costs including a uniform annual general charge, a district general rate, roading costs and environmental protection;
- community costs (including operation of the community board) covering services specific to the area of the board;
- water and wastewater.

The percentage share of these costs in the total rate demand was as follows:

| | Community Board A (%) | Community Board B (%) |
|----------------------|------------------------------|------------------------------|
| District costs | 29.7 | 30.5 |
| Community costs | 10.0 | 14.5 |
| Water and wastewater | 60.3 | 55.0 |

As a further demonstration of the impact of infrastructure costs, roading charges made up 41.5% of the district costs for board A and 51.7% in board B.

6.1.3 Voluntary vs non-voluntary payments

Rates are non-voluntary payments. Some of the products and services in the bundle they cover will not be demanded by all ratepayers. Joe Bloggs farmer, for example, may make little use of the library in an urban center that is a considerable distance from his farm. Yet his rates cover this and it is others in the local community who benefit from his contributions. The bookworm who makes regular use of the library but does not share Joe's enthusiasm for rugby may feel similarly about paying rates to provide rugby fields.

6.1.4 Communicating value

How to communicate to ratepayers the value they receive was a strong theme in the workshops we held. One suggestion made was that local government should find an easily understandable benchmark against which to compare rates and the services they fund. The one suggested was the cost of electricity.

It was argued that the typical residential electricity bill on an annual basis would normally be of about the same magnitude as the average residential rate (the average residential rates figures used in the example in 6.1.2 are actually very close to average annual residential power costs for a typical household in that local authority district). Perhaps benchmarking the range and variety of services which local authorities provide in return for rates, against the single service provided for the broadly equivalent payment to electricity supply companies, would be one means of making the point that ratepayers do actually get value for money.

6.2 Options

Options to address any lack of willingness to pay and its causes include:

- depoliticising activities;
- separate bills;
- a portfolio approach to some rates expenditure; and
- greater use of user charges.

6.3 Analysis of options

Greater use of user charges is attractive when the charges are for voluntary services as it enables service users to communicate their willingness to pay through their demand. We briefly discuss this option in the chapter on funding mechanisms.

Below we analyse the options that remain.

6.3.1 Depoliticise activities

The purpose of depoliticising activities is to avoid the risk that politically unattractive but otherwise important expenditures, such as infrastructure upgrades, may not be undertaken. Options suggested to do this include:

- altering the local government election cycle and/or process;
- managing the services at arms length, such as through LATES, franchises, or stand alone business units; and
- central government defining what core services should be delivered and/or to what standard.

One possibility in the context of the first option is that the election cycle is extended. Another is to adopt a system along the lines of the American system whereby there are no major elections, but local authority politicians are retired after a period and mini elections are held to fill the vacated slot. Local communities also have the power to demand that a mini election be held if they are dissatisfied with the performance of any specific politician. The advantage of both options is that they address the short term outlook of politicians by providing for greater continuity. The disadvantage is that they constrain the local community from radically changing the face of their local governments if they are dissatisfied with overall performance. These pros and cons are significant and deserve a greater depth of analysis than space allows for here. Finally we regard this option as theoretical rather than practical in the New Zealand context.

The option of managing services at arms length currently exists. Auckland City, for example, manages its water activities through a LATE, Metro Water. It is questionable, however, whether, such so-called arms length relationships do, in fact, reduce political sensitivity. Local communities may not concern themselves with structures when they make their demands known to their territorial authorities or regional councils. Indeed the experience of Metro Water suggests that the arms-length structure heightened rather than reduced political pressure from users.

The third option of central government defining what core services should be delivered and/or to what standard enables local authorities to get on with the job, without risking their re-election chances. It has the added advantage of reducing compliance costs as it avoids the need to consult with the local community on these

services and service standards. The downside is that it risks taking the “local” out of local government. That is, it reduces the flexibility of local authorities to deliver those services that it assesses are in the best interests of its local community and to a locally determined standard.

6.3.2 Separate bills

The option of separate bills arises in the situation where ratepayers focus on the bottom line of their rates bill and not the detail. Just as residents receive a separate bill for their energy usage, the suggestion here is that local authorities have the ability to send separate bills to recover the costs of the utilities they provide, such as water and wastewater (or other services which could logically be separated out as having different characteristics from the rest of an authority’s activities but similarities with one another). Two benefits of this approach are that it focuses payers on the significant services their local authority provides, and it “brands” demands to meet water and wastewater costs, for example, as a “bill” for specific services rather than a rates demand for a range of services which may be of varying relevance to individual ratepayers.

This can currently be achieved by managing selected services in separate structures, such as LATEs or trusts. However, when local communities prefer that the local authority maintain ownership and management responsibility for such functions, the option of separate bills is not available to them. The Rating Powers Act provides that all rates must be provided for on the one bill. The logic of restructuring activities for the purpose of being able to send separate bills is questionable. It would be preferable for a power to send separate bills for significant activities to be provided. The Local Government (Rating) Bill, as introduced, does not contain powers for councils to issue separate bills for different services. In the view of the authors, the Bill should be amended to include such a power. This power, however, should not be an unconstrained power. Local authorities should be required to assess the compliance cost implications of separate billing before deciding to do so.

6.3.3 Portfolio approach

Most local authorities provide an extensive range of recreational and cultural opportunities for their residents. Typically, funding for these, and ratepayer reactions to funding proposals, take place on a case by case basis. Whether or not to fund a stadium, increase services at the library, develop a recreation ground, or otherwise fund any one of an almost infinite range of activities is debated in isolation with supporters (commonly a highly motivated group with a keen interest in the facility or activity concerned) and opponents (often arguing that they should not pay for things which they do not use) both lobbying their council.

Some councils have shown an interest in taking a different approach to debating these issues, preferring to see the provision of recreational and cultural services as offering their residents as a whole a portfolio of opportunities from which to choose. The purpose of this approach is to highlight the fact that different elements in the community will have different preferences and that the role of the council, as the community’s representative, is to attempt as far as possible within financial constraints and the community’s willingness to fund, to provide something for everyone.

On this approach, it makes sense to present this diverse group of activities as a single portfolio and for the council and its ratepayers to focus not so much on the cost of individual components as on the cost of the portfolio as a whole – what percentage of rates – or what uniform annual charge – should go towards funding recreational and cultural activity. Within that decision, the community and the council can then debate the priorities which should be assigned to different activities, recognising both the inevitability of trade-offs and the need to ensure, as far as possible, that all significant preferences are recognised.

This change is more presentational than legislative – there appear to be no obstacles under current or proposed legislation to local authorities presenting their recreational and cultural expenditures in this way.

Recommendations on perceptions of value for money

We recommend that:

- the Local Government (Rating) Bill, should be amended to allow local authorities to send separate rates bills for significant activities that are branded as bills rather than rate demands, subject to them first assessing the compliance cost implications of more than one bill; and
- local authorities consider presenting their recreational and cultural expenditures as a portfolio of opportunities, with the funding focus on the cost of the portfolio as a whole and the activity focus on establishing a range of opportunities to meet all significant preferences within the community.

7. WHO SHOULD PAY FOR LOCAL GOVERNMENT SERVICES?

In Section 3.2 we reached the following conclusions with respect to who should pay for local government services:

- where the service in question has either merit or public good characteristics, and benefits accrue nationally, central government should fund the national benefit component;
- where the service has either merit or public good characteristics, and benefits accrue to the local community, local government should fund the local benefit component using local taxes;
- where there are identifiable sub-groups or individuals within the community who benefit from the service, and it is possible to exclude people from using the service in question, user charges are appropriate.

In practice, the distinction between national and local benefits is not clear cut. Often a particular service will have elements of each, in which case funding should be shared between central and local government.

In this section we consider specific issues where current funding mechanisms may not allow services to be funded from the most appropriate source. Key issues of concern identified by the project team are:

- national public goods provided by local government, specifically:
 - nationally driven standards for service provision (e.g. for sewage treatment and disposal or drinking water);
 - services devolved from national government, or from which national government has withdrawn;
- services provided by local government which benefit parties other than ratepayers:
 - access to land for utilities providers;
- costs imposed by third parties:
 - new property developments;
 - areas with high visiting populations (e.g. holiday destinations).

7.1 National standards

In some areas of local government activity, central government is increasing standards of provision nationally. This is imposing substantial costs on local government. The burden is greatest for small councils with higher per capita costs. Particular cases are environmental and health standards for water reticulation and sewage treatment and disposal.

A range of standards for drinking water are provided for under health legislation. Councils can currently choose which grade of water they will provide their community. The Ministry of Health is moving to make standards for drinking water mandatory. The cost of upgrading existing infrastructure across the country to meet this has been estimated as in the order of \$200 million. Standards for sewage and refuse disposal are not mandated by central government, but are established by

regional councils under the framework of the Resource Management Act. This legislatively imposed framework creates high performance expectations with respect to environmental impacts, which may create a national bias toward standards for sewage treatment and disposal, and refuse disposal, higher than local preferences.

In a perfect world, most consumers would prefer higher standards over lower ones for services such as drinking water, sewage and refuse disposal. In theory, standards decided upon by central government should reflect the sum of preferences of local communities in New Zealand. However, communities have varying abilities to pay for this. In practice, trade-offs need to be made in funding increased levels of service. Incremental increases in standards require either a corresponding reduction in another area of local government service or an increase in funding.

There are a number of reasons why a single national standard might not be efficient in practice:

- the marginal costs of providing a given standard will vary across regions as will the marginal benefits to the local community – even assuming that the external benefits are well understood. As a result a single standard is unlikely to be efficient in all regions. At best, a single national standard will reflect average marginal costs and benefits, and so will be “too high” for some areas and “too low” for others;
- where central government does not face the costs of the standards it is imposing, it may fail to adequately take those costs into account and so may set standards too high from society’s point of view;²⁵ and
- national standards may be drafted in a way that reduces flexibility to meet community preferences in terms of how the service is delivered, for example standards may favour reticulated solutions over decentralised solutions.

In principle this is no different from the situation faced by any other segment of the economy which is subject to regulatory standards. The key difference between local government service provision and other providers is that local government is often the sole provider of the service in question, and able to impose the costs from national standards on ratepayers. If ratepayers do not wish to pay for the level of service mandated, they have no option to “opt out”.²⁶

One option to address these concerns would be to empower local government to set its own standards for water, wastewater, refuse and sewage disposal, etc. However, there are reasons why it may be appropriate for standards to be set on a national basis. For example, the quality of drinking water, particularly in tourist destinations, may impact on New Zealand’s image as a tourist destination, which could have benefits at the national level. More generally issues such as these have important public health implications, for example the prevention of epidemics. The issue is not necessarily who should set the standards, but rather if central government sets standards, who should bear the cost of meeting them.²⁷

²⁵ This partial view should not arise in policy analysis – where all costs should be included irrespective of where they are funded – but is possible in the decision making process.

²⁶ This could be seen as assuming that the cost of national standards is met through rates, rather than user charges. In practice ratepayers have little option under either approach as infrastructure such as water or wastewater services is typically a natural monopoly.

²⁷ Similar issues arise in relation to international standards that impact at a local level. By signing up to international standards, central government is in effect adopting them at a national level. The reason is

The above considerations imply that at least some of the benefit from national standards accrue at a national level. Therefore, in principle, central government should fund the incremental cost arising from the difference between national standards and the standards desired by the local community (this increment is a proxy for the national benefit accruing from the standards). This would ensure a clear weighing up of costs and benefits was made in setting standards. In practice this approach raises incentive problems. Local authorities, on behalf of their communities, would face strong incentives to argue that their desired standards are lower than is actually the case, in order to maximise the contribution from central government.

An alternative approach would be a lump sum transfer from the government as a contribution to the costs of meeting national standards. The lump sum would need to be calculated on the basis of some formula to account for the differential impacts of standards on districts. For example, such a formula could be based on cost drivers of water and sewerage infrastructure, such as population, population density and topography.

We understand the Ministry of Health is currently considering the introduction of a subsidy for local authorities to assist in meeting the costs of national standards for sewerage systems. A similar approach could be warranted for other national health and environmental standards imposed on local government services, such as standards for drinking water.

7.2 Services national government has devolved or ceased

Over the past decade, central government has withdrawn from a number of activities, particularly in the social services area. In many instances where central government has withdrawn from the provision of a particular good or service, the community demand generated by the service has continued. This has led local government to fill the gap. For example, the withdrawal of the Ministry of Consumer Affairs' telephone complaints service lead to a significantly increased workload for Citizens Advisory Bureaux. A number found that they were unable to cope with the increased workload with existing resource levels, and sought and received additional assistance from their local authorities.²⁸

The local government belief is that this type of unintended or indirect transfer of functions from central to local government is widespread. It arises from a number of different sources. Initial provision of a particular service by central government generates demand for that service. If the government subsequently withdraws, local authorities are a visible and accessible "backstop". The resulting unfunded expansion of local government activities puts pressure on local government finances. The funding must either come from increased revenue (generally rates increases) or some other local government service(s) must be cut back.

often to realise some national benefit. For example, adherence to international agricultural standards increases the marketability of New Zealand agricultural products in international markets. This benefits all New Zealand producers.

²⁸ Peter McKinlay, *Devolution: Partnership or Ad Hocism? The Relationship between Central and Local Government*, November 1998, page 20.

The Southland District Strategic Plan 2000-2015 summed up the impact on this council:

“Considerable change in the District, has occurred due to external economic and legislative factors. Some of these changes include:

- *The retrenchment and centralisation of Central Government and commercial services;*
- *The devolution of additional responsibilities and functions from Central Government to Local Government and the community;*
- *The implications of increasing emphasis on environmental issues.*

The effects of these changes have significant implications for, and are placing demands on the District’s communities and their resources.”

Similar issues are raised where central government consciously devolves functions to local authorities without associated funding. For example, central government may introduce new regulatory provisions which it requires local government to administer (the Resource Management Act is often cited as an example, the requirement for local pest management strategies under the Biosecurity Act 1993 is another). The major restructuring of government services such as health and social welfare has put new strains on local government as communities look to their councils to act as their advocates for service provision or to top up funding for voluntary and community services as government contracting practices reduce the funding available from central government.

The government’s proposed new purpose for local government creates increased potential for local government to be under pressure to pick up this type of activity, particularly given the emphasis on economic, social, environmental and cultural outcomes. While the increased discretion has clear benefits for local government, the proposed changes would make it easier for local government to be forced to fill a vacuum left by the withdrawal of central government services. As a result, some local authorities are concerned that the proposed new regime could force councils to expand their role in providing social services.

7.3 Utility rentals

Utility companies, such as telecommunications companies and electricity and gas lines companies, currently have statutory rights of access to land owned by local authorities for the purpose of establishing and maintaining their networks. While such networks are legally rateable, councils are not currently able to charge utility companies rental for use of their land.²⁹ Local authorities also report considerable difficulty in getting utilities to minimise the impact of their activities. It seems that their statutory powers

²⁹ Under the Telecommunications Act, network operators may establish or maintain networks on or above local authority owned land but may be required to pay reasonable compensation. Under the Electricity Industry Act and Gas Act, network operators have similar powers to establish and maintain networks but a local authority may impose a condition that its reasonable costs and expenses be met. None of these Acts give local authorities power to charge rental or otherwise exercise the normal rights of a landlord.

are insufficient for them to require that utilities (for example) co-ordinate their activities with those of local authorities in order to minimise the damage done to assets such as roading, partly because the principal remedy available is through legal action that will often cost more than the value of the remedy.³⁰

As a result utilities face very little incentive to minimise the costs on local authorities. The key areas of concern from a local government perspective are making good the cost of damage to local roads as a result of utilities laying or repairing cables or pipes underground and the inability to charge a fair rental for the use of their land.

This contrasts with the situation in other jurisdictions such as Japan or the United States where utilities rentals make up a significant part of the income of many local authorities. Introducing a utilities rental in New Zealand would have redistributive impacts requiring careful consideration (it is likely, for example, that lines companies would seek to pass the full cost on to users). Changing the relationship between local authorities and utilities so that it was more in the nature of a lease (even if a local authority could not refuse to grant a lease) should have efficiency improving impacts. It would remove what is in practice a cross-subsidy, thus facing utilities with the full costs of their operations and thus, presumably, encouraging them to be more efficient both in terms of costs and co-ordination. It would also give local authorities power to minimise unnecessary damage to their assets or, alternatively, be fully compensated for it.³¹

The concept is one which appears to have merit and warrants further investigation – even if the outcome is simply to improve the ability of local authorities to minimise the damage (or resulting cost to the ratepayer) from the activity of utilities.

7.4 New developments

Property developers trigger additional infrastructural costs for local government by causing increased demand for services in particular areas. If developers do not face the costs of this incremental demand:

- the location of property developments may be sub-optimal in terms of the age and capacity of existing assets, and the costs required to extend or upgrade water, stormwater and sewerage assets;
- current ratepayers will be required to cross-subsidise future purchasers of properties in the new development (or contribute to excess profits by developers).

The difficulty faced by councils in charging developers a full contribution toward infrastructural costs appears to have contributed to urban sprawl in parts of the country (e.g. Auckland), while at the same time existing infrastructure is not fully utilised.

If developers meet the cost of infrastructure investment necessitated by their activity, this cost will be factored into the price of the properties that will use the additional

³⁰ One major local authority reported that utilities would often open up newly sealed road surfaces, weakening the integrity of the surface and significantly reducing its expected life. They were often also poor at restoring surfaces so that the local authority itself was forced to do so (with the alternatives of either leaving the surface in that state or taking legal action both being less attractive).

³¹ This proposal is distinct from the issue of charging utilities rates on their networks, which has been implemented by at least one local authority and is being considered by others.

capacity. As a result, the costs will fall on the ultimate beneficiaries of the service (rather than existing ratepayers) which is consistent with both efficiency and equity objectives.

The government has signalled in its discussion document on the Local Government Act Review an intention to clarify that councils can levy financial contributions from developers to fund the costs of increased infrastructure capacity, through one of two options:

- use of the financial contribution provisions under the Resource Management Act, subject to the scrutiny of the Environment Court, and supplemented by the ability to use fees and charges under the new LGA; or
- a specific provision in the new LGA to provide for developer contributions.

The first option, contribution under the provisions of the Resource Management Act, is problematic. In particular, for a financial contribution to be levied under the RMA, provision for this must be included in the district plan, and the district plan as a whole must be operative. This creates incentives for developers to object to some totally different provision of a district plan, and appeal the issue through to the Environment Court, in order to delay or avoid financial contributions. Further, the objective of financial contributions is an economic rather than an environmental one. Accordingly, we recommend that the second option, a specific provision in the new LGA, be pursued.

7.5 Visitors

Some districts, primarily holiday destinations, have relatively high transient populations compared to their permanent residents. This is often seasonal, for example, a small Coromandel community may have a substantial number of visitors in summer, but none in winter. In other cases, communities may have high visitor volumes who do not stay in the area - visitors on day trips or who are “passing through” – such as Picton or Kaikoura. Such communities often need to fund additional capacity for core infrastructural services and other amenities from a relatively small ratepayer base. The concern has been raised that this is inequitable as visitors from outside the district benefit from the additional capacity, but local ratepayers bear the cost.

The extent to which this concern is valid depends on the extent to which general rates are passed on to visitors through prices for services. In general we would expect local businesses to pass rates through in prices. As a result, higher business rates are likely to ultimately fall on both local ratepayers and visitors. Residential ratepayers in general do not have the ability to pass rates on in the way that businesses do,³² so the higher rates will be borne by residents. In summary, some of the additional cost attributable to visitor numbers is likely to be borne by visitors, while some will be borne by the local community (primarily residential ratepayers). This is not necessarily inappropriate, as local communities may reap considerable economic benefits due to high visitor numbers.³³ However in some cases the increased costs of providing for

³² The exception to this is where residential ratepayers rent out their property, in which case they can pass rates through in the rental price.

³³ Arguably even residential ratepayers who do not benefit directly from business generated by visitors will enjoy some benefit, for example, through expanded employment opportunities, or capital gain.

high transient populations, particularly in relation to infrastructure services such as water and wastewater, place considerable burdens on small communities.

Recovering the additional costs of local authority services to meet the incremental needs of visitors directly is problematic as it is difficult, if not impossible, to capture visitors directly. It may, however, be possible to recover some revenue from visitors indirectly by charging businesses who cater to visitors, such as licensed accommodation or tourism operators, with the expectation that these businesses will seek to pass the costs on to their customers. This option is imperfect, as it is unlikely to capture all visitors, however, is more feasible than attempting to target visitors directly.

One option that has been put forward in the past to meet local government costs associated with high visitor numbers is an accommodation tax. We consider that option in section 8.3.7 below, with the conclusion that the differential rating powers currently available to local government, and the targeted rating powers proposed by the government, are likely to be more cost effective tools for addressing this issue. Accordingly, we conclude that, where substantial costs are imposed on the local community by large visitor populations, councils should be encouraged to use flexible rating policies to recover at least part of those costs from businesses that serve visitors.

7.6 Protocol for central and local government activities

Both the issues around national standards, and the pressure to provide national public good services as the result of central government action, highlight the need for a coherent agreement on the respective roles and functions of central and local government. We recommend that LGNZ investigate the establishment of a protocol between central government and local government. Such a protocol would cover:

- respective responsibilities in economic, social, cultural and economic areas;
- where the interests of each level of government lie; and
- agreement (or a process for reaching agreement in individual cases) as to which level of government should ultimately fund different services.

Such a protocol would promote a principle based approach to the provision of public goods and merit goods at both the national and local level, building on the principle that central and local government services should be funded to enable full cost-recovery, based on their economic characteristics and not on who delivers the service.

Recommendations on who should pay:

We recommend that:

... for national public goods provided by local government:

- Local Government New Zealand investigate the possibility of establishing a protocol between central government and local government covering:
 - respective responsibilities in economic, social, cultural and economic areas;
 - where the interests of each level of government lie; and
 - agreement (or a process for reaching agreement in individual cases) as to which level of government should ultimately fund different services;
- building on the Ministry of Health's current work on a sewerage subsidy, consideration be given to the introduction of central government grants toward the cost of meeting the national public or merit good component of health and environmental standards for services such as sewerage and drinking water, and allowing for regional differences in costs;

... for utilities:

- further consideration be given to the option of a local government power to charge utility rentals, and that local authorities have the equivalent of the normal powers of landlords to enforce compliance with the terms on which access was permitted. However, further work is required on the likely economic incidence of utility rentals in the New Zealand context;

... for costs imposed by third parties:

- a specific provision be included in the new LGA to provide for developer contributions;
- councils whose districts have high visitor numbers be encouraged to consider the use of differential rates, and targeted rates once they become available, to recover some of the costs of local government services attributable to visitors.

8. RANGE OF FUNDING TOOLS

In the preceding sections of this report, we found evidence to suggest that councils in some regions are approaching the limits of rates as the best source of funding for additional expenditure. In particular, in areas with high levels of deprivation, further increases in rates could reduce discretionary spending by low income households on essential areas such as health related items.

The options we discussed in sections 4 to 6 of this report, taken as a package, should go some way to relieving the pressure on local government. However, the impact of these options will vary across councils, and will not necessarily fully address the problem. In this section we therefore consider whether alternative local tax mechanisms are available to provide supplementary funding for local government.

This section is structured as follows:

- we identify the main sources of funding available to local government, and consider the concerns that have been raised, particularly with reliance on property taxes as local government's primary source of income;
- we assess the alternative options for funding local government's general revenue requirements;
- we consider the possible supplementary source of funding which appears to be the most feasible – extension of the national fuel excise – in further detail;
- finally we briefly discuss two specific issues related to the current rating powers:
 - the 30% cap on UAGCs and UACs; and
 - the requirement to fully fund depreciation.

8.1 Problem definition and issues

The major sources of funding currently available to local government are:

- property taxes (rates);
- user charges; and
- government grants and subsidies – principally in relation to roading activities.

Local authority general revenues are also supplemented by the Local Authority Petroleum Tax (LAPT). Appendix B illustrates the current overall mix of funding tools for a selection of local government activities: water, sewerage and stormwater; roading; regulatory activities; economic development and libraries.

The brief for this report is to consider the need for, and options for, *supplementary* sources of funding for local government. We therefore assume for the purposes of this report that rating will continue as a significant source of funding for local authorities. However, we assess the merits of rating as a revenue raising mechanism below in order to evaluate its merits for incremental funding needs, compared to the available alternatives.

8.1.1 Rates

Property taxes, in the form of rates and uniform annual charges, are the principal source of revenue for local government in New Zealand.³⁴ In the past, when the primary focus of local government was on the provision of services to property (for example water reticulation, sewerage, stormwater), rates were highly appropriate as a form of tax, as property owners are the direct beneficiaries of those services. However, increasingly councils are providing a variety of “people services”, including a range of cultural, social and economic development activities. Clearly the extent to which councils are providing non-property related services varies depending on the priorities of the local community; for most councils property related infrastructure remains the major source of expenditure.

This extension of focus does raise the question of whether property rates continue to be the most appropriate primary source of additional funding for local government going forward, or whether alternative options exist that would be preferable. This question is particularly relevant if the government confers on local government a power of general competence, which would enable councils to further alter their focus if they so chose.

Rates have the advantage of being clearly locally derived, and so are aligned (albeit imperfectly) with the local community, and are entirely independent of central government. Rates are also highly transparent. This is good for accountability, as rates and particularly rate increases are highly visible to ratepayers. At the same time this high level of visibility may contribute to the “willingness to pay” issues discussed in section 6 of this report, particularly where the level of benefit received by ratepayers is often much less visible. A further contributor here may be a perception on the part of some ratepayers that rates are a charge for services rather than a tax.

Another factor, not always acknowledged, is that rates are used not just to fund operating expenditure but also as the mechanism by which local authorities raise new capital from their “owners”. For this reason comparisons between rates increases and inflation usually overstate the degree of increase as they do not net out the capital component of rates.

The concept of contemporary equity we have adopted in this report (see Table 1) embodies the principles that the level of tax levied should take into account the benefit received and the taxpayer’s ability to pay.

As we have already discussed, there is a wide belief that some local government services (e.g. cultural and social services) benefit a wider group than just ratepayers, and should be paid for over a wider tax base. This includes residents who are not property owners, as well as visitors to the district. This view implies non-property related services should be funded through a mechanism that draws on all potential users as the tax base. This view appears to be based on the legal incidence of rates, which falls solely on property owners. In practice, the economic incidence of rates is likely to be wider. Rates will be passed on in property rentals and in prices for goods and services to some extent, depending on the particular conditions of the market. (We are not aware of any studies into the economic incidence of rates in New Zealand.)

³⁴ As noted in Section 4.3.3 rates, including UAGCs and UACs, make up around 55% of all local authority revenues.

Property values are not always a good proxy for ability to pay. Property values in general do not increase in direct proportion to increases in income. In some cases an individual may own a high value property, but may have a low cash income (pensioners and occasionally farmers may fall in this category). Rates therefore tend to have a regressive impact overall.³⁵ This issue can be addressed if sufficiently flexible powers for waiver and postponement are available, as discussed elsewhere in this report.

The accountability of councils for the way in which they spend rates is undermined by a lack of alignment between ratepayers and voters. Many voting individuals are not direct ratepayers, while at the same time the business sector (which pays substantial rates) has very limited voting rights.

In summary, rates have a number of desirable characteristics, particularly a high level of transparency with positive implications for local government accountability. The major potential drawbacks of rates as a sources of additional local government funding are the equity concerns that:

- the benefits derived from rates increasingly accrue to a wider group than solely property owners; and
- communities in some regions are increasingly constrained in their ability to pay for future rates increases to meet increasing demands on local government.

a) Specific issues with existing rating powers

In the course of this project, several issues were raised which relate to current restrictions on councils' rating powers:

- the ceiling on UACs and UAGCs (uniform annual charges and uniform annual general charges);
- the requirement to fully fund depreciation from operating revenues; and
- powers to charge for infrastructure services on a user pays basis.

We discuss these issues at the end of this section.

8.1.2 User charges

In Section 3 we found that, where there are identifiable sub-groups or individuals within the community who benefit from the service, and it is possible to exclude people from using the service in question, user charges are appropriate.³⁶ This principle is embodied in current local government financial management provisions in Part VIIA of the Local Government Act, although councils do not appear to have implemented user charges to the extent possible under the current law.³⁷

This report focuses primarily on funding mechanisms for public and merit goods provided by local government. We do not consider user charges in any detail, except to note that local authorities should face no specific restriction on the application of user pays mechanisms, provided such mechanisms are genuine user charges, i.e. where a user chooses not to take the service in question they are not liable for the charge.

³⁵ UAGCs and UACs are particularly regressive, as they are a flat rate charge.

³⁶ This finding applies to both "private" goods and "club" goods.

³⁷ User pays made up 18% of total local government revenue in 1999.

8.1.3 Government grants and subsidies

The major area of local activity funded by government grants and subsidies is local roading. The government, through Transfund, provides financial assistance for the provision of local roads equivalent to 50% of the cost of local roads nationally, based on approved District Roading Plans. The proportion of cost met by government varies between councils, taking into account differences in the financial resources available.³⁸

Financial assistance for local roads is sourced from the National Roads Fund. The fund is a dedicated fund, utilising revenue from the fuel excise tax³⁹, road user charges (which apply to diesel vehicles) and motor vehicle registration fees. Road safety activities of both the Police and the Land Transport Safety Authority are drawn as a first charge on this fund. The balance of the fund is transferred to the National Roads Account, which is under the direct control of Transfund. The costs of the National Roading Programme, including contributions to local road construction and maintenance, and Transfund's administration costs are met from the National Roads Account. Transfund's budgeted expenditure for the 2000/01 year was \$940 million. Of this, 25% (\$235 million) is allocated to local road maintenance and 7% (\$65.8 million) to local road construction.

8.1.4 Local Authority Petroleum Tax

The Local Authority Petroleum Tax (LAPT) was introduced in the 1970s to supplement existing sources of local government funding. The LAPT is levied at a rate of 0.66 cents/litre for petrol and 0.33 cents/litre for diesel, and distributed to local government. Revenue generated by the LAPT is used for general local government expenditure.

Since its establishment there have been several calls for revenue from the LAPT to be tied to roading activities (including public transport and road safety measures). For example, in 1988 the Officials Co-Ordinating Committee on Local Government found that the petroleum tax failed virtually every test of a good tax and should either be abolished or the revenue tied to roading activities.⁴⁰

When the LAPT was implemented it was anticipated that it would increase over time, reflecting economic growth. However, this anticipated revenue growth has not eventuated. The LAPT accounts for only around 1% of total local authority revenue.

8.2 Options for general revenue

The brief for this project requires our assessment to include the following forms of local tax as possible sources of additional funds:

- local income tax;
- local goods and services tax;
- local payroll tax;

³⁸ Available financial resources are assessed on the basis of net equalised land value (i.e. the available rating base) and does not take into account other factors such as income levels in the district. We understand Transfund is considering a review of its allocation formula.

³⁹ This is a central government excise on petrol, distinct from the LAPT.

⁴⁰ The Officials Co-Ordinating Committee on Local Government, *Reform of Local and Regional Government: Funding Issues*, December 1988.

- local sales taxes, e.g. local petroleum tax;
- local commodity levies, e.g. a levy on sawn logs leaving a particular district.

In addition to the above options, a number of other forms of tax have been considered previously, which we briefly revisit here:

- poll (citizens) tax;
- corporate profits tax;
- accommodation tax;
- totalisator tax;
- tax on electricity consumption;
- other excise levies, e.g. a beer tax.

8.3 Analysis of options

In this section we consider the feasibility of alternative local tax mechanisms to supplement rates. Our primary focus in assessing the options is on:

- economic efficiency (particularly allocative efficiency) impacts;
- administrative and compliance costs; and
- contemporary equity, taking into account where the benefits fall and ability to pay issues.

Additional taxes at the local level would not make significant inroads in addressing the issues faced by those councils facing overall affordability problems, for example due to local levels of deprivation, as the ultimate pool of local resources would be the same.

The effectiveness of rates compared to a range of alternative local government taxes has been considered several times in the past. The most comprehensive consideration of options was by the Officials Co-Ordinating Committee on Local Government in 1988 and before that by the Local Government Finance Committee in 1973. Previous considerations have generally concluded that no alternative tax is available that:

- would be as good as rates in terms of efficiency, equity and yield; and
- would be feasible at a local level.

In general, alternative forms of tax would be prohibitively costly to administer and enforce at a local level. Compliance costs associated with a locally administered income tax or GST would be high. From a practical point of view this implies that alternative local taxes are in general only practicable if centrally administered and enforced on a national basis, with the revenue distributed between councils on some agreed basis (in effect this would be a form of revenue sharing, which we discussed in section 4.3.1).

We briefly discuss the relative merits of the various options for local government taxes below, drawing on previous reviews. Additional detail on previous reviews is provided in Appendix C.

8.3.1 Local income tax

Income tax correlates well with ability to pay. Depending on the structure of the tax rate, income taxes can have proportional or progressive impacts. This means the tax burden as a proportion of income either remains constant or increases as incomes

increase. This contrasts with rates, which probably have a greater impact on low income households, as a proportion of income. The major drawback of income taxes in terms of economic efficiency is that they can act as a disincentive to work. Higher tax rates are also thought to be a disincentive to attracting foreign direct investment.

Previous reviews have generally found that a local income tax levied and collected by local authorities would be administratively impractical and prohibitively costly. We see no reason to disagree with this conclusion. A locally administered and enforced tax would have the following drawbacks:

- duplication of systems across councils. This would be a significant burden, particularly for smaller councils;
- mobility of taxpayers between different local authorities could create collection and control issues (e.g. taxpayers who live in one district, but work in another). The tax could be payable in the district where the income is earned (which would be complex where individuals or companies earn income in more than one area) or in the district where the taxpayer resides (this could distort locational decisions if tax rates varied between districts);
- it has income redistribution effects, which is a primary function of central, not local government. As such, the implementation of a local income tax by councils could conflict with central government policy;
- it would have a differential impact between local authorities, as income levels vary geographically (those with the greatest need for a supplementary source of revenue may gain the least from a local income tax);

A local income tax would only be feasible if established as a uniform local government tax across the whole country. The least administratively complex approach would be collection of the tax by central government (e.g. as a surcharge on PAYE) and distribution to councils (this amounts to a form of revenue sharing). However such centralisation would undermine transparency and councils' accountability to local taxpayers.

8.3.2 Local GST

In principle a local GST appears desirable. It would capture the full range of beneficiaries from local government services (including visitors from outside the district). Avoidance problems would be limited, and the revenue would automatically adjust with inflation and economic growth. GST can have less of an impact on allocative efficiency than other tax mechanisms, provided it is levied over the widest possible tax base (as is currently the case with New Zealand's national GST).⁴¹

However, a local GST would have drawbacks similar to those discussed above in relation to a local income tax:

- many local authorities lack the scale to cost-effectively administer such a tax;
- administration and compliance could be costly (probably prohibitively so), particularly if the tax rates between districts were not uniform.

In addition, sales taxes tend to be regressive, which raises equity concerns. The tax would need to be levied on a comprehensive basis in order to minimise allocative

⁴¹ The Issues Paper of the Tax Review 2001 has found that GST is preferable to income tax for any additional central government revenue requirements in the future.

efficiency impacts. Yield would depend on volumes of sales, and so could vary between regions. If the tax were imposed on a comprehensive basis, only a very small rate would be required to meet the funding needs of local government.

Previous reviews have consistently found that, due to the high administrative costs of a local GST, this option as a regionally autonomous tax is not feasible. We concur with this conclusion. If a local GST were pursued the most feasible approach would be a single national tax rate, collected by central government and redistributed to local authorities. This would be a form of revenue sharing.

8.3.3 Payroll tax

To be worthwhile, a payroll tax would need to be levied over a sufficiently large area to include a worthwhile amount of employment, and to ensure the tax cannot easily be avoided by shifting activities across local authority boundaries. Even so, a payroll tax would have a differential yield for local authorities depending on the level of commercial activity in a district. The need to achieve an appropriate balance between population and employment implies a payroll tax would need to be implemented on a regional basis.

Although administratively possible this would nevertheless be an undesirable source of local government finance. In particular it:

- would act as a disincentive to employment, which is inconsistent with both central and local government social objectives; and
- would not achieve the objective of spreading local government costs over a wider tax base – indeed there is no reason to believe employees better represent the beneficiaries of local government services than property owners.

8.3.4 Excise taxes

Excise taxes can be appropriate where the primary objective is to discourage consumption of a particular good or service (e.g. taxes on tobacco products and alcoholic beverages) or where demand elasticities are low. In addition, excise taxes can also incur high collection costs in relation to the yield.

Two specific forms of excise tax are discussed below: petroleum taxes and commodities taxes.

a) Petroleum tax

As we discussed above, there are currently two excise taxes on fuel operating in New Zealand. The LAPT is a petroleum tax (i.e. is levied on diesel as well as petrol), which is dedicated to local authority general expenditure. The central government fuel excise applies solely to petrol. Both these taxes have been implemented as revenue raising mechanisms: the LAPT for local government general expenditure and the national fuel excise for national general expenditure as well as roading related activities.

We understand revenue from the LAPT is distributed to local authorities based on their rate revenue for the preceding year as a proportion of total rate revenues for all territorial and regional authorities. Thus those councils who are constrained in their ability to raise rates are disadvantaged under this mechanism. However, as the fuel excise is collected centrally, there is scope for the resulting revenue to be distributed

between councils according to need. Indeed, Transfund's funding formula for local government roads incorporates an element of councils' ability to pay.

The key drawback of an excise tax as a revenue raising mechanism is its potential to distort consumption and production decisions. The magnitude of distortion, and associated welfare losses, depend on price elasticity of demand (i.e. the sensitivity of purchasers to changes in price). However, the efficiency distortions associated with petrol taxes are likely to be relatively low, as the price elasticity of demand for petrol in New Zealand is estimated to be low. The most recent estimates of which we are aware place the elasticity of petrol consumption between 0.1 and 0.2 in the short run and 0.3 to 0.6 in the long run.⁴² This means that a 10% increase in the price of petrol would lead to a reduction in consumption of between 1% and 2% in the short run, and up to 6% in the long run.

The fuel excise tax has the added advantage that mechanisms for collecting the tax already exist – we would expect the extra administrative and compliance costs from raising additional revenue in this way to be relatively low. Accordingly, we consider the national fuel excise warrants further consideration as a possible mechanism for meeting future local government funding requirements.

b) Commodities taxes

A commodities tax would impose a levy on specific products leaving the district. This would have similar effects to an excise tax, but targeted solely at the proportion of the taxed good that is sold or consumed outside the district. This would include exports, and sales or consumption in other parts of the country. As a result, a commodities tax would share the disadvantages of an excise tax, particularly the allocative distortions. If the tax were applied differentially across districts, locational decisions of industry may also be distorted.

In practical terms a commodities tax would be extremely difficult to administer and enforce without the co-operation of the producers in question, and compliance costs could be significant. It would be impractical to monitor quantities of the taxed goods at district boundaries. Rather a paper based system would be required, with affected producers being required to document production quantities and local/out-of-district sales.

One objective of a commodities levy might be to target industries that impose additional costs on local government, to seek to recoup some of those costs. For example industries such as forestry and dairying, which rely on heavy trucks to transport their products, can impose significant costs on local roads that often were not designed for such use. While this concept is consistent with the exacerbator pays principle, we consider that there are likely to be more cost-effective ways to address this issue, including:

- the use of differential rating, and proposed targeted rating powers; and
- powers to charge for infrastructure services on a user pays basis.

⁴² Travers Morgan (NZ) Ltd, *Travel Demand Elasticities Interim Report (Revised)*, Report to Transit New Zealand October 1995.

8.3.5 Poll tax

A local poll tax would have a good potential yield, and would cover a broad base of taxpayers. Poll taxes do not in general impact on allocative efficiency, as they are unrelated to the supply or consumption of any product or service. In addition, accountability would be stronger than is the case for rates, as a poll tax would provide clear alignment between taxpayers and voters.

In practice, however, a poll tax is unlikely to be feasible. In particular, effective enforcement would be problematic and potentially very costly. Some form of registration of adult residents would be required, which could discourage people from enrolling to vote. Distinctions between residents and transients would need to be made. As a result, poll taxes are administratively complex and costly and are open to avoidance and evasion.

A poll tax may not be well received due to its potentially regressive impacts (poll taxes are flat charges set with no reference to ability to pay), and a poor general public perception of this form of tax based on overseas experience, particularly in the United Kingdom. While the regressive effects of a poll tax could be mitigated to some extent through targeted waivers or remissions, such policies would reduce the efficiency advantages of this option.

8.3.6 Corporate profits tax

A corporate profits tax is clearly inferior to rates as a source of funding for local government. As an addition to national corporate income taxes, a corporate profit tax would penalise entrepreneurial and productive behaviour, with negative results for the economy at both a local and national level. This option may also distort decisions on the legal form for business enterprises, by introducing a bias away from corporate structures. The potential yield would vary, depending on the level of commercial activity in a district. There would also be very considerable difficulty in many cases in determining where the income arose and thus which local authority was entitled to tax it. Finally, accountability would be weak compared to rates.

8.3.7 Accommodation tax

This would be a tax on paid accommodation with the aim of targeting visitors to the area. Revenue from a targeted tax of this nature could be appropriate to fund incremental costs incurred to meet the demands of visitors (see Section 7.5 for further discussion of this issue), particularly in areas with a high visiting population, such as holiday or tourist destinations. However, an accommodation tax would be administratively costly given the high and variable number of collection points, and the scope for avoidance and evasion may be quite substantial. Such a tax would also discriminate between holiday makers who use paid accommodation and those who have the use of private facilities.

This same aim could be achieved, more simply and as effectively, through differential rating. The government is proposing to introduce greater flexibility for targeted rating in the Local Government (Rating) Bill, which could be used in lieu of an accommodation tax. The use of flexible rating mechanisms to target services used by visitors to the district would have the advantage of leveraging from existing council systems and processes.

8.3.8 Totalisator tax

This option was considered in 1973 by the Local Authority Finance Committee. The only feasible method for implementing a totalisator tax would be as a uniform national levy. This would suffer from difficulties in distributing the revenue, and so was not considered a suitable source for local government funding.

8.3.9 Tax on electricity consumption

This option was considered in 1973, but was not favoured as it would be administratively very costly and would distort choices between fuels. Administrative costs would increase where the boundaries of electricity suppliers did not coincide with local government boundaries.

8.3.10 Conclusions

Of the available options for an alternative local government tax, none appear to have significant net benefits if implemented at a local level, among other things due to the administrative and compliance cost implications. A local government GST or income tax could be feasible if it were administered by central government and distributed to local government (a form of revenue sharing). Of these, GST is preferable from an efficiency perspective. An increase in the total level of GST, provided it is levied over a wide base as is currently the case, is likely to be less distortionary than an increase in income taxes. A further potential option would be an increase in the central government fuel excise.

Of these two options, the fuel excise appears to be the more feasible. Given the very broad tax base across which GST applies, it is not possible to fine tune the level of revenue raised in this manner. It would be problematic in practice to set an increment for GST that would raise just the amount of revenue required to supplement existing sources of local government funding. A further significant drawback of this option is that the compliance costs of changing the level of GST would be very high. For example such a change would require changes to billing and accounting systems and prices, impacting on a large number of firms.

In comparison, the fuel excise option is considerably more amenable to raising relatively small increments of funding, and we would expect the additional administrative and compliance costs to be kept down by utilising the systems already in place. While in principle excise taxes are not consistent with allocative efficiency, this concern is mitigated by the relatively low elasticity of demand for petrol.

Finally, as we discussed in section 4.3.1, the allocation of funding by central government to local councils (revenue sharing) carries the risk of reduced local government autonomy and accountability. This is particularly the case where such revenue is not tied to a specific activity. We consider this risk can be mitigated in respect of the fuel excise option to the extent that it is based on existing processes for funding local roads (see below).

Accordingly we conclude that, out of the available options for meeting future local government funding requirements, an increase in the national fuel excise is likely to be the most feasible. We discuss this option in more detail below.

8.4 The fuel excise tax

In this section we consider how an increase in the fuel excise tax as a source of local government funding might be designed and allocated, and identify some issues that would require further work if this option were pursued.

8.4.1 Should the increase be tied to roading activities?

Funding from the fuel excise is allocated to local authorities by Transfund, for approved roading activities. We therefore need to consider whether an increase in the fuel excise, to provide for future funding requirements, should be tied in the same way. In principle, restricting the additional funding to roading activities would make very little difference to local authorities. By freeing up funds from other sources for expenditure on non-roading activities, this option would increase the total level of available funds in the same way that an un-tied subsidy would.⁴³

There are no strong economic efficiency arguments in relation to this question, however there are several pragmatic arguments in favour of tying additional funding from the fuel excise to roading expenditure, at least partially.

a) Minimising risks to local authority autonomy and accountability

Earlier in this report we noted that revenue sharing as a supplementary source of funding for general local authority expenditure carries some risks, in particular the potential for a loss of autonomy and accountability to the local community. The extent of these risks is dependent on the breadth of local government activity funded in this way, and whether it is ring-fenced in some way.

We consider such risks to be much lower with respect to an increase in the fuel excise to contribute to local authority roading expenditure. The revenue from this proposal would be fixed and distributed through Transfund, making it less likely to be used by central government as a means of influencing local government expenditure and activity. In addition, the revenue sharing mechanism in the fuel excise, via the National Roads Account, is already well established and understood by central and local government.

b) Equity concerns: the beneficiary pays principle

Roading is widely viewed as a “special case” for local government. The benefits of access to the roading network accrue at a national, regional and local level. For these benefits to occur, co-ordination between the provision of state highways nationally and local roading networks is necessary. As a result of this, and the wide incidence of benefits, a shared approach to the provision of roads has developed between central and local government.

Under current arrangements, the government collects a fuel excise tax and charges Road User Charges (RUCs) for diesel vehicles. Some of this revenue goes to the consolidated fund, while the remainder is set aside for roading expenditure. Central government uses this revenue to fully fund construction and maintenance of state

⁴³ One noteworthy exception to this is the situation of a local authority with low or no expenditure requirements in relation to local roads.

highways, and meet some of the costs of constructing and maintaining local roads (50% on average). The remainder of the costs for local roads are generally met by ratepayers.

The issue of who should pay for local roads is a contentious one. Ratepayers receive some benefit from local roads, due to improved access to their property. Substantial benefits also accrue to road users, who fund the balance of local roading costs through Road User Charges and the fuel excise. In the past, technology to charge individual vehicle owners based on their use of roads has been prohibitively expensive. It is now becoming more cost-effective to charge heavy road users such as trucks based on the costs of their road use, although it is not useful to do the same for light vehicles since they give rise to negligible marginal costs.

We are aware of the following equity concerns in relation to current funding arrangements for local roads:

- the current extent of reliance on ratepayers to fund the cost of local roads is viewed as inequitable by many. Previous policy consideration of road user charging in New Zealand reached a similar conclusion that the cost to ratepayers for local roading was greater than the benefit they receive while at the same time road users may be paying too little;
- in some specific areas, the development of industries such as forestry and dairy is resulting in increased damage to local roads that were not designed to carry heavy logging trucks or milk tankers, with the costs falling on ratepayers and general road users. This issue affects a subset of local authorities. For example, the forestry industry is likely to have a substantial impact on councils on the east coast and in the far north. The growth of the dairy industry in the South Island is leading councils to budget substantial increases in maintenance funding going forward to account for increased wear and tear on rural roads.⁴⁴

c) Leveraging from existing systems

As we have already discussed, the administrative and compliance costs of this option can be minimised by relying as much as possible on existing collection and allocation systems. (However, see our discussion of allocation issues below.) These existing systems are designed to allocate funding to roading activities.

d) Roading is a major source expenditure for local authorities

Roading is a major source of expenditure for local government in New Zealand, and was identified as a particular area of concern in our discussions with local government in preparing this report.

⁴⁴ The Southland District Strategic Plan 2000 – 2015 budgets targeted road maintenance in response to the growth of the dairy industry in the district of \$500,000 in 2000/01, increasing to \$1,150,000 by 2012/13. Specific roading expenditure driven by the forestry industry is also planned.

Roading expenditure made up approximately half of total local government infrastructure expenditure in 1999, and is a source of significant funding pressure for some councils, as illustrated by this excerpt from the Rangitikei District Council Annual Plan 2000 – 2001:

“Roading maintenance is the most significant activity the Council has consuming approximately half of our overall budget. Even allowing for the subsidy received from Transfund, the overall rates requirement for roading is almost \$3.5 million. This is proving difficult to sustain.”

The National Roads Account is already stretched – we understand the Auckland region alone has outstanding capital projects of approximately \$1 billion which satisfy Transfund’s current benefit cost ratio threshold - and central government is constrained by its other spending priorities.

While this does not necessarily mean that additional funding *should* be tied to roading activities, the significance of roading costs to most local authorities indicates that the objective of increasing overall funding could be achieved through a tied approach.

8.4.2 Level of the increase

The next question then is: how much of local government roading expenditure should be funded from this new source? In Section 4 we found that some local authorities appear to be under funding pressure, and for many of these authorities road maintenance is a substantial and ongoing cost. In light of this, we take road maintenance costs as a proxy for the level of funding difficulty facing local authorities. Raising this revenue from the fuel excise tax would lead to a corresponding reduction in funding required from rates. In terms of public support, a study undertaken for Auckland City Council last year showed significantly greater support for user charges to pay for road maintenance than for construction.⁴⁵

We understand annual local government expenditure on roading maintenance is in the order of \$250 million across the country. Funding this would require an increase in the fuel excise of approximately 8 cents/litre. Based on the estimates of elasticities in section 8.3.4, we estimate the dead weight loss from an increase in the fuel excise of this magnitude as around \$3.6 million in the long run.⁴⁶ This is around 0.1% of estimated annual petrol sales. The increase in the consumer price index arising from a petrol price increase of 8 cents/litre would be 0.2%. The increase in CPI after allowing for any offsetting reductions in rates would be even lower.

8.4.3 Allocation issues

In order to implement this proposal, a formula on which to distribute funds would need to be developed. Financial assistance for local roads is currently allocated by

⁴⁵ Around half of the respondents to this survey supported user charges to fund road maintenance, while over 50% of respondents considered construction should be funded from general taxation. (This is based on a personal comment by an Auckland City Council employee.)

⁴⁶ This estimate uses the mid-point of the long-term elasticity range cited above, and is based on petrol consumption and pricing information for the year ended September 2000. Sources: Ministry of Economic Development; Shell New Zealand Limited.

Transfund on the basis of costs (derived from councils' agreed district roading programmes) and the financial resources available to the council. The proposed expansion in the fuel excise could build on these existing policies.

Some change to the way in which funds are allocated might be appropriate if this proposal were pursued.⁴⁷ If the additional revenue were allocated solely on Transfund's existing funding criteria the greatest benefit would accrue to those territorial local authorities that currently have the greatest access to financial resources.⁴⁸ This outcome would serve to further exaggerate differences in councils' ability to fund local government services identified in Section 4 of this report. We have identified two options for addressing this issue, both of which would be explicitly redistributive in their purpose:⁴⁹

- set the total increase in the fuel excise at the proxy level (i.e. current local government spending on roading maintenance), but allocate this revenue such that some councils receive more than their local roading maintenance costs, and some receive less; or
- include an additional surcharge on the increased fuel excise tax to be paid into a local government assistance fund, and distributed to those councils in need of financial assistance.

As we note below, further work on allocation issues would be required if this option is pursued. However we recognise that Transfund, while more than capable of allocating funding for roading activities, is not well equipped to make decisions on the allocation of financial assistance to councils for general expenditure purposes. This issue might more effectively be addressed within the context of a protocol between central and local government (see Section 7.6 above).

8.4.4 Areas for further consideration

We note three features of our proposed approach that would benefit from further consideration. First, further work to assess the economic implications would be desirable. Second, under this approach, care would be required to minimise the scope for councils to modify their spending patterns to attract a higher share of the additional funds. Third, further consideration of the appropriate allocation formula for revenue raised under this proposal would be required if it were to have a redistributive component.

Finally, if this option were adopted it should be on the basis that local authority rates were initially reduced correspondingly, with any increase above the reduced base the subject of explicit public consultation, through local government planning processes. Thus, as a result of this proposal councils would be able to either free up funding for other expenditure requirements, or reduce rates, depending on the preferences of their local communities.

⁴⁷ We understand Transfund is considering revising its allocation policy.

⁴⁸ Those local authorities with the greatest revenue raising capability receive the lowest financial assistance for local road maintenance under Transfund's current policy (43%).

⁴⁹ The practice of pooling part of a tax set aside for local government for redistribution to offset differences in local funding capability is quite common internationally, for example in the United States.

8.5 Specific rating issues

8.5.1 Ceiling on uniform annual charges and uniform annual general charges

Uniform annual general charges (UAGCs) and separate uniform annual charges (UACs) are currently subject to a combined cap of 30% of total rate revenues.⁵⁰ This cap was imposed to allay concerns about the regressive impact of UAGCs and UACs. These charges are levied as a flat rate per property, and so have a much greater impact on low-income households, as a proportion of income, than on high-income households. As such it is not inappropriate to constrain their use, to support equity objectives. In any case the overall impact of the cap may not be significant; UAGCs and UACs account for a little over 10% of total local government revenue.

8.5.2 Requirement to fully fund depreciation

Local authorities are currently required to set annual operating revenues to recover annual operating expenses, including depreciation. This requirement was introduced to ensure the long-term sustainability of infrastructure assets by requiring councils to build up sufficient funds to replace infrastructure assets as required. It has two major drawbacks. The first is that it forces councils to depreciate assets they do not intend to replace, which increases costs to ratepayers for no benefit. Accordingly we recommend that local authorities be permitted to waive the requirement where they do not plan to replace the asset concerned, but subject to this being spelt out in the Long Term Financial Strategy.

This is consistent with Labour Party's stated position. Its manifesto states that:

"There is a need for a more flexible depreciation regime. Labour recognises the importance of sensible planning for depreciation, but the regime should be relevant to local government's needs and circumstances. The current model is too inflexible and needs to be overhauled in consultation with the local government sector."

The second drawback is a consequence of the application to some local government assets of conventional means of calculating depreciation developed in a different context. An example from one local authority makes the point. This council's water and wastewater systems are relatively new as the result of major investment over the past few years. Its engineering advice is that no significant expenditure on maintenance will be required for the next 15 or 20 years. Despite this, if the council applies conventional straight line depreciation, which now seems necessary in order to comply with the relevant Financial Reporting Standard, it would be required to include depreciation in the order of \$3 million per annum in its operating expenses and fund that through rates.

This requirement does not seem consistent with the statutory obligation to "make provision for funding the decline in the service potential of any asset" – in essence the council and its ratepayers have already done this for the next 15-20 years by investing in quality infrastructure.

The present treatment of depreciation will also compound the difficulty for a number of local authorities facing the need for significant investment in water and wastewater

⁵⁰ Charges for water supply or sewerage disposal are not included in the cap.

systems. Not only do they face a capital cost a number will find it difficult to finance; the burden will be exacerbated by the need to comply with a technical accounting requirement that may have no real world justification in their particular circumstances. We recommend that Local Government New Zealand give priority to seeking a more appropriate definition of depreciation for infrastructure assets.

Considering how best to deal with depreciation has also gained added impetus as a result of the report of the Controller and Auditor-General on results of the 1999 -- 2000 audits of local government. His report makes two important points in respect of depreciation. The first is that depreciation may not of itself be the most appropriate tool for determining the level of funding required to maintain a local authority's assets over the long-term. Implicit in this comment is that, when considering their long-term funding requirements, local authorities will need to go beyond applying a depreciation charge to assessing whether the depreciation provision will be sufficient to provide for future replacement having regard to factors such as changing technology and environmental requirements.

The second is a critical comment on the policy adopted by some local authorities of phasing in depreciation increases over time rather than moving to provide, in each year's funding requirements, the full amount of depreciation for that year. The report expresses the Controller and Auditor-general's concern that "a local authority ought not to raise less revenue than is necessary to maintain its core assets and services..." and goes on to state that audits for 2000 -- 2001 will monitor this practice.

8.5.3 Powers to charge for infrastructure services

Under current arrangements, local authorities can only charge for trade wastes, storm water and sewage disposal on a user pays basis if they actually corporatise the activity. This is seen as a major obstacle to councils putting more effective charging mechanisms in place, especially in areas where there are significant commercial activities. The apparently rational solution of corporatising often runs into strong public opposition arising from the belief that corporatising is the first step on the way towards privatisation. It is not clear that the government's proposed power of general competence would extend to allowing councils to charge for these activities. A clear legal provision for councils to levy charges for water, sewerage and trade wastes on a full cost recovery basis is desirable to encourage more efficient charging practices.

Recommendations on funding tools

Options for general revenue:

We recommend against the introduction of a new local government taxation mechanism. A new local tax is likely to have significant administrative and compliance costs. Local income taxes and GST are likely to only be feasible if implemented as a form of revenue sharing with central government.

Supplementary sources of funding:

We recommend that:

- consideration be given to extending the current national fuel excise, with the additional revenue applied to local government funding of roading costs (the effect of this would be to free up an equivalent amount of local government revenue either for other expenditure or for rates reductions). A useful contribution might require an increase of approximately 8 cents/litre;
- funding of individual projects continue to be through Transfund in order to ensure consistency;
- consideration be given to the appropriate allocation formula for revenue raised under this proposal, if it is to redress, and not exaggerate, differences in councils' ability to fund local government services;

Specific rating issues:

We recommend that:

- the requirement to fully fund depreciation from annual operating revenues be retained, but:
 - local authorities be given the ability to waive this requirement where they do not intend to replace the asset concerned, subject to this being spelt out in the Long Term Financial Strategy;
 - Local Government New Zealand give priority to seeking a more appropriate definition of depreciation for infrastructure assets;
- a clear legal provision for councils to levy charges for water, sewerage and trade wastes on a full cost recovery basis should be introduced.

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APPENDIX A: ABILITY TO PAY: ANECDOTAL EVIDENCE FROM COUNCILS

A.1 Gisborne District Council Annual Plan 2000 – 2001

Mayoral Forward: “The net effect of all these influences is a much reduced work program, the reduction or elimination of some Council grants, and a greatly reduced capital works program for the next decade...”

CEO Comment: “...draft Annual Plan has been an extremely demanding exercise, not the selection of what services and improvements to provide, but more particularly a definite desire to minimize any real rate increase and thereby delete or defer projects.”

Significant Issues: “The district once again has experienced financial demands which conspire to push rates up to horrific levels.”

A.2 Horowhenua District Council Annual Plan 2000 – 2001

Mayoral forward: “After much deliberation we presented the draft which proposed a 7.8% increase in general rates rather than the 6.1% plus inflation increases....Council had arrived at this increase only after cutting out many desirable works initially proposed....The major changes made to the draft Annual Plan were: the increase in general rates was reduced from 7.8% to 5.8% as a result of not needing the 2% allowance for cost increase associated with the major contract retenderings...”

A.3 Rangitikei District Council Annual Plan 2000 – 2001

CEO comment: “Roading maintenance is the most significant activity the Council has consuming approximately half of our overall budget. Even allowing for the subsidy received from Transfund, the overall rates requirement for roading is almost \$3.5 million. This is proving difficult to sustain.”

A.4 Papakura District Council Draft 2001/2002 Annual Plan, Long Term Financial Strategy and Funding Policy

CEO Forward: “This draft Annual Plan has resulted from many sessions held involving a great deal of work by elected members, Council staff and consultants. Principally, the following areas have been considered in assessing possible options to funding operational costs:

- Reducing operating expenditure
- Reducing level of services
- Increasing user charges for services
- Using cash reserves
- Selling Council assets
- Increasing rates

The latter only resulted after a considerable review of all the other five. The result is that the Council will need to raise the level of rating income by 14.7%....The Council is concerned about the impact of such a cost increase on ratepayers, but will as always

endeavor to ensure that costs will be kept to a minimum without affecting the quality of the services being provided.”

A.5 Wanganui District Council Annual Plan 2000/2001

Overview of the long-term financial strategy: “The revised wastewater project will require the total debt target to be breached for a period of six years. The Council is working to reduce projected debt levels by seeking Government funds, exploring private funding options for the wastewater treatment plant and reduced costs through technological improvements. Until new resource consent is granted, the Council’s best estimate of the project cost indicates that total debt will peak at \$43 million, of which \$24 million will be incurred by the wastewater project.”

A.6 Mackenzie District Council Annual Plan 2000 – 2001

Statement from Mayor and CEO: “While Council’s rates requirements are forecast to decrease overall by \$10,000 this year, our financial strategy predicts significant increases into the future. By and large these increases are influenced by the drive to handle our waste in a much better way and the legal requirement for the Council to set aside funds on an annual basis (depreciation) to ensure funds are available for replacement of our essential services networks.

A.7 North Shore City Council Draft Annual Plan, Long Term Financial Strategy and Funding Policy 2001 - 2002

Mayor’s Introduction: “ We know that there are many issues within North Shore City Council that must be addressed....But we do have to be mindful of costs, which may leapfrog over the ratepayers’ ability and willingness to pay.”

A.8 Far North District Council Annual Plan 2000 – 2001

Message from the Mayor: “Council has approached this year’s plan positively but also realistically given the tight financial position Council faces.... Roading continues to be a substantial consumer of the rate dollar. Approximately 33% of the total operational costs is spent on roads. This year Council is working within extremely tight constraints and has consequently concentrated its limited resources in maintaining roads.... Council recognises that a number of desirable works have been deferred. These decisions were made so as to minimize the potential impact on services and to avoid imposing a further burden on rate payers.”

A.9 Taupo District Council Annual Plan 2000 – 2001

Mayor’s Report: “Councilors and staff have spent many hours painstakingly deliberating over what is essential work, what is needed and what is desirable and wanted. At each meeting the emphasis is on containing rate increases to a minimum, yet still progressing developments sought by the community.”

Chief Executive’s Report: “This year will be a difficult one for those in the Turangi-Tongariro rating area again, with last year’s 21 percent average rate increase followed with a further 10.5 percent rise overall. The Community Board’s recommendations for this increase have been accepted by the Council.”

A.10 Southland District Strategic Plan 2000-2015

Situation Assessment: “Considerable change in the District, has occurred due to external economic and legislative factors. Some of these changes include:

- The retrenchment and centralisation of Central Government and commercial services
- The devolution of additional responsibilities and functions from Central Government to Local Government and the community
- The implications of increasing emphasis on environmental issues

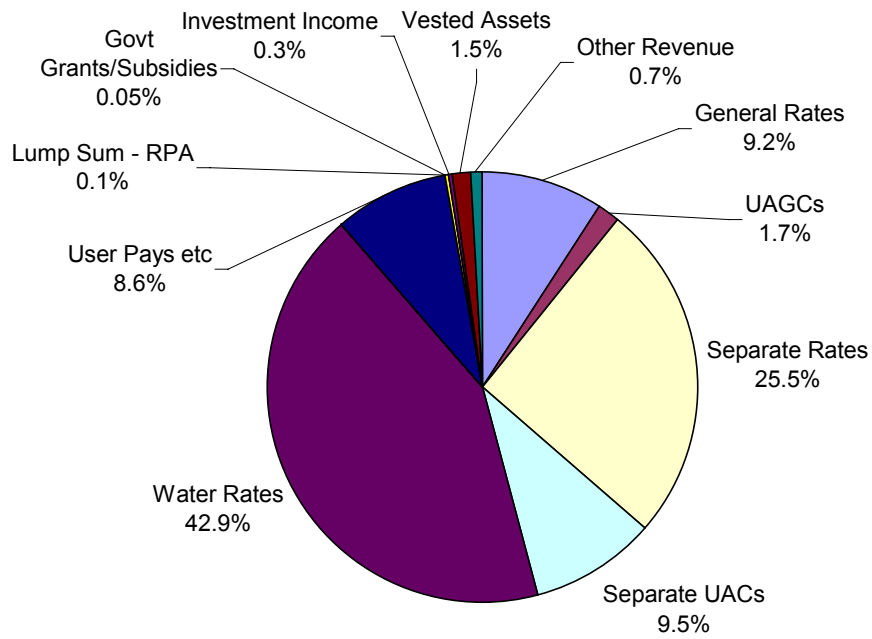
The effects of these changes have significant implications for, and are placing demands on the District’s communities and their resources.”

A.11 Dunedin City Draft Annual Plan 2001/2002

Mayor’s Foreword: “Councilors started the Annual Plan process with a desire to achieve a budget with a nil increase. We have concluded that this is an unrealistic goal and the draft Annual Plan currently includes a rates increase of 4.6%. ... Some of the additional costs are driven by factors largely outside the Council’s control ... [including] legal requirements affecting how councils manage assets (accounting and depreciation demands).”

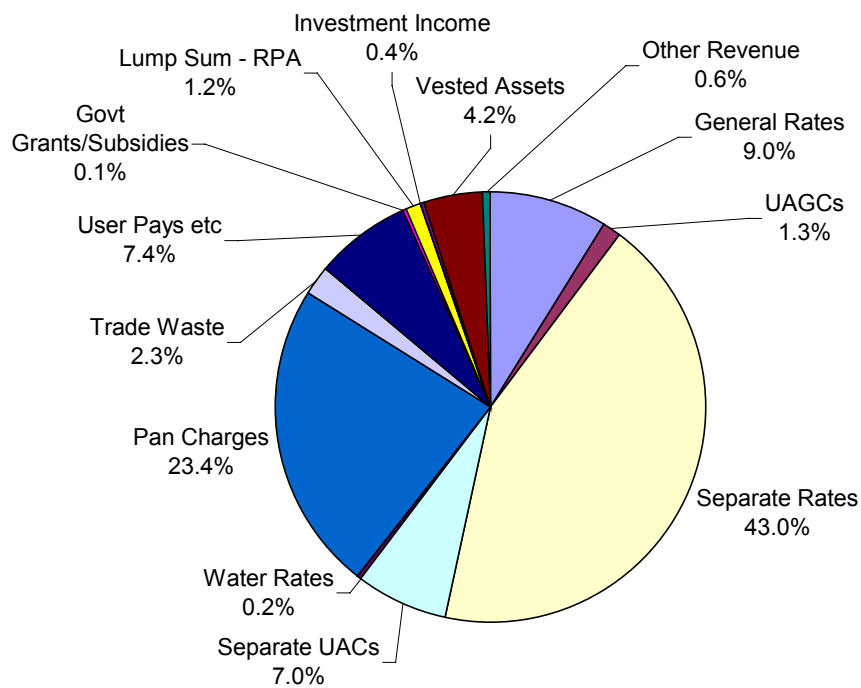
APPENDIX B: CURRENT FUNDING MIX FOR SELECTED SERVICES⁵¹

B.1 Water reticulation

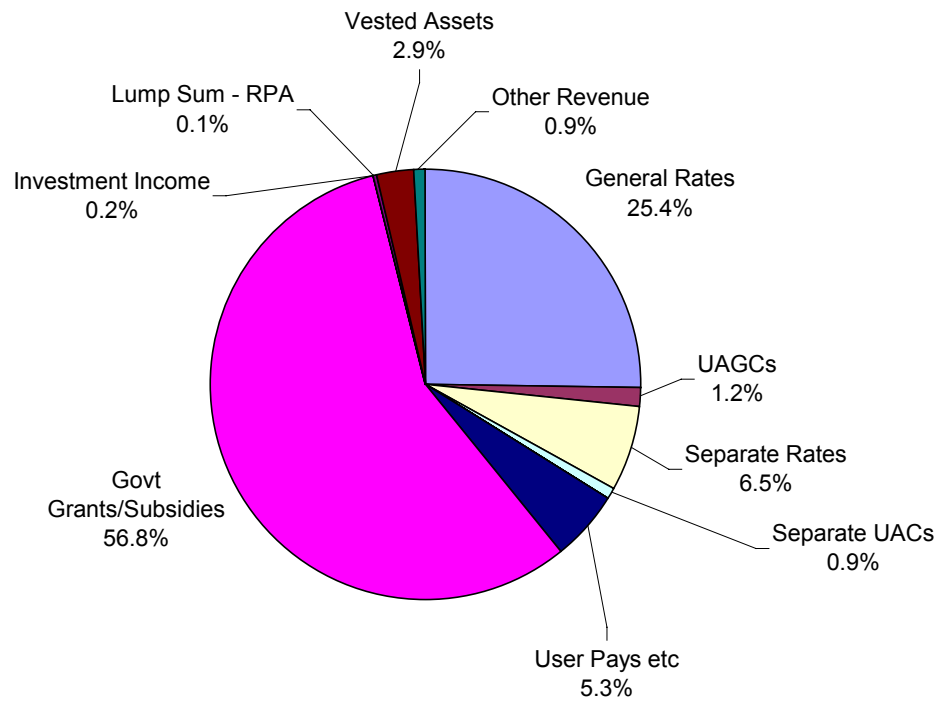


⁵¹ Source: Local Government New Zealand.

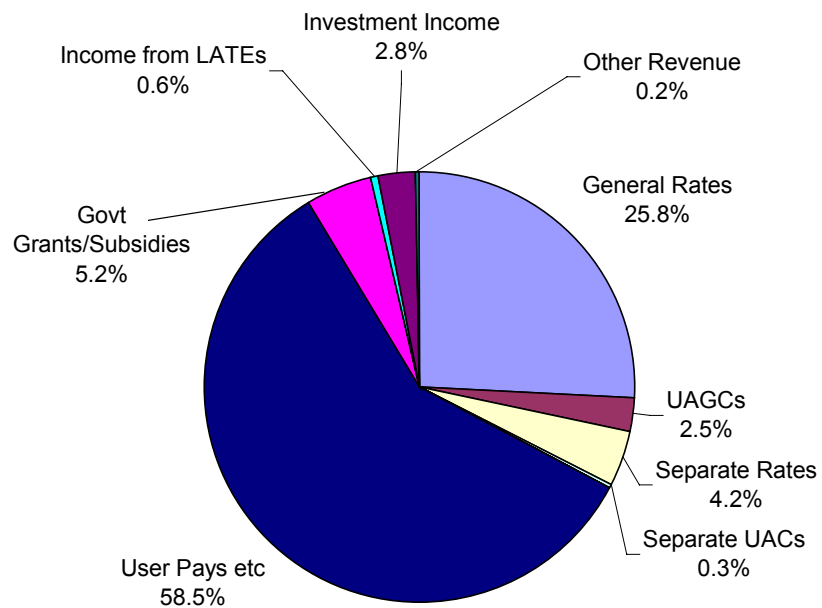
B.2 Sewerage and stormwater



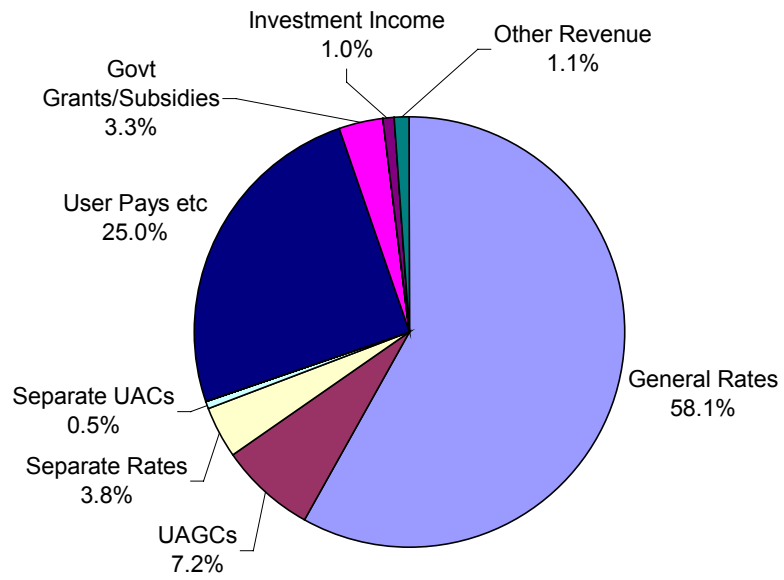
B.3 Roothing



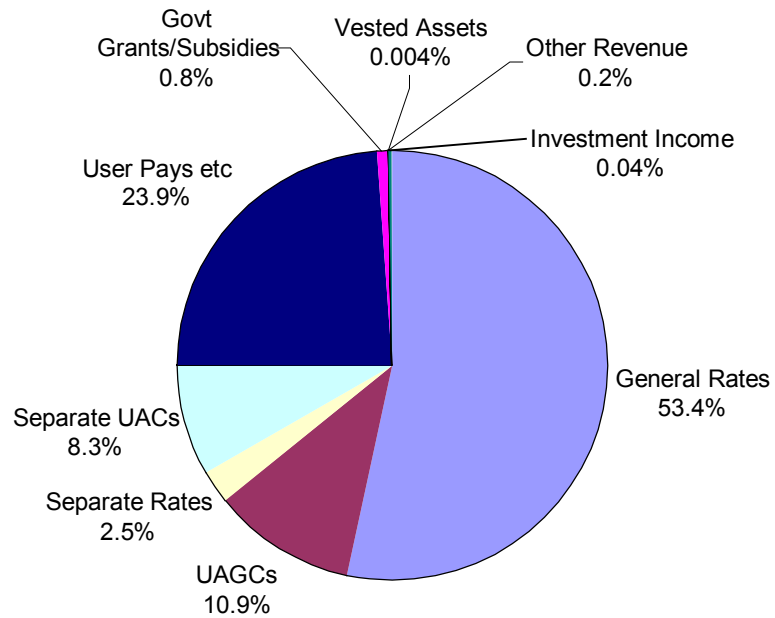
B.4 Regulatory activities



B.5 Economic development



B.6 Libraries



APPENDIX C: PREVIOUS POLICY CONSIDERATION OF FUNDING OPTIONS

The issue of local government funding mechanisms has been considered a number of times over the years. In the course of previous analysis a number of mechanisms for local and regional government funding have been considered. These previous reviews have generally concluded that property rating is the preferred primary source of revenue for local government. This appendix identifies funding options that have previously been considered in the New Zealand context and summarises the conclusions from those previous reviews.

The following funding options have been considered previously for local government funding at the regional and/or local level:

- rating (property taxation);
- income taxation;
- goods and services taxation;
- tax on electricity consumption;
- totalisator tax;
- payroll tax;
- corporate profits tax;
- accommodation tax;
- poll tax;
- excise levies;
- petrol tax;
- beer tax;
- government grants/subsidies;
- profit from trading activities;
- fees and charges;
- borrowing.

C.1 1958 Report of the Royal Commission on Local Authority Finance

Recommendations for additional revenue sources:

- subsidies for roading and library services;
- removal of Crown rating exemptions;
- introduction of a local body levy on earnings and profits, to be collected by the Government and distributed to local government on the basis of population, rateable capital value and rates revenue (equally weighted), and left to each local body to decide how to use the funds. Arguments for this recommendation included:
 - many services paid for by rates benefit a wider group than just ratepayers;
 - rate increases have a regressive impact, as rates are not wholly based on ability to pay.

C.2 1963 Report of the Committee on Local Authority Finance

This report looked at alternative/additional revenue sources with a view to spreading local government costs more evenly through the community, with a focus on local collection:

- a local income tax levied and collected by local authorities, as most other local taxes, were rejected on practicality grounds;
- a local authority tax on retail sale of goods, operated on a regional basis was recommended for further consideration, due to practicality and consistency with ability to pay. The general tax rate would be set by central government and funds be distributed on a population basis.

C.3 1970 Report of the Local Authority Finance Committee on Proposal for a Local Authority Tax on Petroleum Products

The Committee made the following comments on rates:

- rates would be likely to become burdensome if they increased much over the 1970 levels;
- the rating system is not sufficiently flexible to accommodate increasing responsibilities and demands on local authorities, including services which cannot be seen as services to property;
- there was “a growing feeling” that the local authority tax base should be widened to ensure non-ratepayers who benefit from local government facilities make some direct contribution.

After considering and rejecting poll tax, citizen’s tax, turnover tax, sales tax and Government grants, the Committee recommended a commodity tax on petroleum products. Flexibility should not be hampered by restrictions on the application of tax proceeds.

C.4 Local Authority Finance in New Zealand, Report of the Local Authority Finance Committee, June 1973

C.4.1 Conclusions on rates

Two advantages of rating are that it is:

- clearly locally derived; and
- entirely independent of central government.

However a major drawback is that some services (e.g. cultural and social services) benefit a wider group than just ratepayers, and should be paid for over a wider tax base. A further drawback is the need to increase the rate of property taxation each time additional revenue is required, except in the case of revaluations. The lack of an automatic growth factor in rating, to take advantage of increases in incomes without increasing the taxation rates was seen as having a detrimental effect on the development of local government.

The Committee did not agree with the contention that rates were or ever had been a burden for very many ratepayers. It did however note that rates could be a burden for low income households, and that large *increases* in rates can cause hardship.

Rates are regressive, and are especially a burden on pensioners and lower income groups. Ratepayers have no control over the level of their rates bill (i.e. it does not change with consumption of relevant goods and services).

Despite their regressive impact, rates should remain the basic source of revenue for local government.

C.4.2 Overall conclusion on taxes other than rates

There is no additional tax which could be levied by local government (on a district or regional basis) which could provide adequate revenue. The Committee's findings on alternative taxes are summarised in the table below.

Table 3 Local Authority Finance Committee: Summary of findings

| | |
|--|---|
| Local income tax | If regionally levied difficult to administer If centrally levied, in effect, grants in aid |
| Local sales tax | Administratively practicable (levied on a regional or national basis) but an unsuitable source of local government finance, due to allocative impacts |
| Local beer tax | See comments on local sales tax |
| Local electricity consumption tax | Inequitable and unsuitable |
| Totalisator tax | Unsuitable |
| Payroll tax | Unsuitable, particularly because it is sectional |
| Accommodation tax | May have some value in some areas, to meet costs of services/amenities for travellers. Unsuitable for general revenue |

C.4.3 Detailed conclusions on alternative local government taxes:

C.4.3.1 Local income tax

A local income tax would have high local administrative costs and may not be economic. Mobility of taxpayers between different local authorities could create collection and control issues. Similarly, taxation of individuals and companies who earn income in more than one area would raise administrative complexities.

For these reasons, the Committee concluded that a local income tax would in general not be feasible. The only feasible option would be a uniform local government tax across the whole country. The administratively least complex approach would be collection of the tax by central government.

Two forms of income tax were considered: proportional (flat rate) and progressive (by way of a surcharge on income tax paid to central government). The progressive option, combined with administration and collection by central government, was preferred.

C.4.3.2 Local sales tax

The issues raised here are similar to those above in relation to a local income tax. Many local authorities lacked the scale to cost-effectively administer such a tax.

Administration and compliance could be difficult if the tax rates between districts are not uniform (e.g. for companies that operate in a number of locations). A wholesale tax would be impracticable due to the extent of trading that takes place across local authority boundaries.

Two possible options were:

- a regional retail sales tax would probably be feasible if regional boundaries were drawn so as to minimise cross boundary trading;
- a local government sales tax levied at a nationally uniform rate, and allocated between local authorities.

However, a local sales tax would also have some drawbacks:

- in general sales taxes tend to be regressive (i.e. impact proportionately more on those with lower incomes);
- the administrative costs would be potentially high;
- a sales tax could distort resource allocation (savings are not included, and any exemptions further distort decision making).

Overall, a local sales tax was considered to be unsuitable.

C.4.3.3 Tax on electricity consumption

This option was not favoured as it would be administratively very costly and would distort choices between fuels. The Committee noted that a tax on electricity prices while having similar drawbacks to a tax on consumption, would impact differently on various user groups due to variations in per unit prices (e.g. between business and residential customers).

C.4.3.4 Totalisator tax

The only feasible method for implementing a totalisator tax would be as a uniform national levy. Distributing the revenue could prove complex, and so was not considered a suitable source for local government funding.

C.4.3.5 Payroll tax

To be worthwhile, a payroll tax would need to be levied over a sufficiently large area to include a worthwhile amount of employment, and to ensure the tax could not easily be avoided by shifting activities across the local authority boundary. The need to achieve an appropriate balance between population and employment implies a payroll tax would need to be implemented on a regional basis.

It may be argued that there should be no mandatory limit on the rate of tax imposed, however a suitable limit (e.g. 2%, based on the then national payroll tax) “would not unduly restrict the autonomy of the taxing authority”. However, on balance, if it were to be considered at all the Committee favoured the idea of a payroll tax levied at a uniform rate over the whole country. Although administratively possible this would nevertheless be an undesirable source of local government finance. In particular, being a sectional tax, it would not help to spread local government costs more widely.

C.4.3.6 Accommodation tax

This would be a tax on paid accommodation with the aim of targeting visitors to the area. Revenue would (probably) be used for local tourist amenities, parks etc.

One drawback is that an accommodation tax would discriminate between holiday makers who use paid accommodation and those who have the use of private facilities.

Administrative costs could be high, given the high and variable number of collection points, and the scope for avoidance and evasion may be quite substantial.

The Committee concluded this option may have some value in some areas to finance services and amenities for travellers. However, this same aim could be achieved, more simply and as effectively, through differential rating.

C.4.3.7 Poll tax

A poll tax has no regard for ability to pay, could be administratively costly and open to avoidance and evasion. It was not favoured by the Committee due to its equity and administrative drawbacks.

C.4.3.8 Other forms of tax

Betterment levies, lotteries and a beer tax were also considered as possible options.

C.4.4 Revenue sharing / Distribution of central funds

C.4.4.1 Allocation on the basis of population

This approach fails to account for changing populations, differences in wealth, or differences in regional characteristics (e.g. topography). All these factors may increase funding needs. Population is therefore an inadequate index of need by itself.

C.4.4.2 Allocation by a central body

Allocation by a central body, responsible for assessing needs, scrutinising projects and supervising grants expenditure, was considered but not favoured by the Committee. Such a body would have significant influence in a range of spheres, beyond the scope of local government, and so co-ordination with other agencies would be essential. "The price would inevitably be an undue extent of control of local authorities."

C.4.4.3 Subsidies

Subsidies result in greater control for central government and a loss of local autonomy. Subsidies based on revenue, and incentive subsidies (tied to particular activities) were recommended.

Such subsidies could be drawn from a fixed percentage of income tax, to be set aside for the purpose. Two possible disadvantages were identified: central government's control over the economy would be weakened; and earmarking a percentage of taxation receipts is inconsistent with government practice.

C.5 1975 Report of the Interdepartmental Committee

(Inter alia) recommended the establishment of a local authorities special assistance fund to provide financial assistance to local authorities which could establish special

needs. This was implemented in 1975/76, but declined over time and was abolished in 1983/84.

C.6 1977 Report of the Local Authority Finance Committee

The Committee found that there was a case for extending the local government taxation base. The emphasis on property as a basis for local authority taxation was not considered appropriate given the growing range of local government services with no bearing on property ownership or occupation.

If devolution of responsibility from central government to local government were to proceed the rating system must be supplemented by a system which provides additional revenue on a wider and more equitable basis (with an emphasis on progressive incidence).

There was a case for appropriating to local authorities a specified percentage of Government's income tax receipts. This could best be achieved through a surcharge on national income tax receipts, e.g. through PAYE.

All grants and subsidies to territorial authorities (excluding National Roads Board subsidies) should be funded from the proceeds, including general grants in aid to be distributed on a formula based on deficiencies in rateable capacity, rating effort and population.

C.7 The Officials Co-ordinating Committee on Local Government, *Reform of Local and Regional Government: Discussion Document*, February 1988

C.7.1 Profit from trading activities

Trading activities should be operated on a commercial basis. Where trading activities are used to provide a public good or service this should be financed through explicit subsidies.

C.7.2 Local taxes

Redistribution was seen as a central government function. The Committee was concerned that differences in local taxes could lead to migration between districts

C.7.2.1 Local payroll / corporate profits tax

This option would have national efficiency implications, and would have differential benefits for local authorities depending on the level of commercial activity in a district. It was not favoured.

C.7.2.2 Excise tax

Excise taxes distort consumption, and were not favoured..

C.7.2.3 Local income tax

A local income tax would correlate well with ability to pay, and *may* have low administrative costs. However, this option:

- would have redistributive effects, which is not a function of local government;

- may conflict with central government policy;
- would have a differential impact between local authorities, as income levels vary geographically;
- could be administratively difficult where taxpayers live in one district, but work in another.

C.7.2.4 Local sales tax

Yield would depend on volumes of sales, and so could vary between regions. Sales taxes can be regressive, i.e. would be likely to impact disproportionately on low income households. In order to minimise distortions, a sales tax would need to be levied on a comprehensive basis (i.e. across a wide range of goods).

C.7.2.5 Rates

Rates were viewed as transparent and largely predictable. However, they are not related closely to income. Accountability of local authorities for expenditure was viewed as weak, in particular because businesses did not vote and yet bore a substantial proportion of the rates bill.

Uniform charges for particular services were viewed with concern due to their potentially regressive impact, because they do not account for ability to pay, and because they are not necessarily related to the benefit received by an individual ratepayer.

C.7.2.6 Poll taxes

Poll taxes were viewed as good in terms of accountability, but potentially regressive and administratively complex.

C.7.2.7 Should there be central government assistance to pay local taxes?

This was (and still is) undertaken through the Rates Rebate Scheme. The document noted that the Scheme had been criticised for poor targeting, as:

- only home owners are eligible for assistance, not tenants or others who ultimately pay the cost of rates; and
- it is based solely on income, not other measures of wealth.

C.7.3 Fees and charges

Fees and user charges were viewed as a useful means of raising local government revenue. They are generally appropriate where the benefits of a good or service accrue to an identifiable beneficiary, even where there may be some public good elements. It was noted that where there are no public good elements, the good or service should be provided through a commercial structure.

C.7.4 Borrowing

Borrowing is in effect deferred tax, and so similar regulatory treatment compared to local government taxation powers was considered justifiable. Borrowing raises intergenerational equity issues, as it can result in future ratepayers bearing the cost of services to current ratepayers. This raises the question of whether tight controls are

needed to protect future ratepayers. (The document didn't put forward a position on this.)

C.7.5 Central government funding

The provision of central government funds for local government activities, e.g. by way of subsidies, can undermine local autonomy. In particular the extent to which funds are "tied" is an issue. Central government subsidies for particular local goods or services can distort local service provision, by encouraging provision and consumption of the subsidised activity at the expense of unsubsidised activities. Finally, central government funding can weaken local accountability by reducing ratepayers' incentives to monitor expenditure by their local authority.

C.7.6 Revenue sharing

At the time this document was written, an interim revenue sharing arrangement had been instituted. The Working Party's main recommendation in relation to allocation of revenue under this arrangement was that revenue sharing should reflect revenue needs and functional variations of individual authorities. It also noted that under a revenue sharing regime, central government acts in effect as the agent of local government. While revenue sharing increases the finances available to local authorities, local accountability can be weakened as electors are divorced from the financing implications of local spending decisions.

C.8 NZ Local Government Association, *Reform of Local Government: Statement of Principles*, 8 April 1989

The following drawbacks of funding arrangements in 1989 were identified:

- statutory constraints on local government financial discretion;
- tied grants and subsidies impinge on autonomy, often distort expenditure priorities, do not provide for direct local accountability and are subject to central government expenditure requirements;
- valuation-based property rating has limitations such that it cannot be relied on to fund all local government revenue requirements. It bears little relationship to service consumption, does not reflect ability to pay, may be inappropriate to fund non-property services, limits accountability to consumers of local government services;
- A local GST was viewed favourably. Advantages of local GST were seen as:
 - locally determination and derivation;
 - consistency with central government tax policy;
 - visibility to purchasers;
 - limited potential for avoidance;
 - potentially low administration cost;
 - comprehensiveness – the full range of local government service consumers would be captured;
 - revenue neutrality to inflation/would increase with economic growth;

The document proposed:

- removal/reduction of statutory restrictions on local government financial discretion;

- replacement of central government grants/subsidies with a system of specific negotiated service contracts;
- improved local government user pays charging policies;
- introduction of a local GST, along the following lines:
 - rate set collectively by local government;
 - collected by IRD – payers would have a regional identifier;
 - revenue from each region paid to local government in the region, with an agreed share held back into an Equity Fund for distribution among regions based on ability to pay/need.

C.9 The Officials Co-Ordinating Committee on Local Government, *Reform of Local and Regional Government: Funding Issues*, December 1988

C.9.1 Local GST

KPMG and officials considered it would not be possible to establish local GST as a regionally autonomous tax. Rather it would need to be a nationally imposed tax with revenue sharing. KPMG found costs of collecting a local GST would be prohibitive.

It would be problematic to set the level so as not to over-collect, given that small increments in national GST lead to substantial revenue increases.

Collective rate setting between authorities would reduce the accountability of individual authorities to their communities. As a result the rate could be pushed up to any statutory cap.

Transparency was considered to be poor, as it would be seen as part of national GST, and the amount attributable to local GST would be small.

Distribution between regions may raise fairness issues.

C.9.2 Local income tax

The definition of where (in which region) the tax is payable raises the following issues:

- if the tax were payable in the region where income is earned this could be difficult in some cases, e.g. where activities span a number of regions;
- if the tax were payable in the region of residence/location of the taxpayer, regional variations in rates could distort locational behaviour, and would pose enforcement difficulties similar to a poll tax.

For these reasons the Committee concluded a local income tax could only be effectively applied on a national basis as a uniform surcharge on national income tax.

As for local GST, yield would be good, but accountability and transparency would be weak. The same issues regarding distribution of the revenue to regions would arise.

IRD raised a number of concerns regarding the costs of allowing local variation in any centrally collected tax, and accordingly did not support local income tax or GST.

C.9.3 Poll tax

A poll tax has positive features, but also some major drawbacks. Yield would be potentially good, and accountability would be strengthened (the correlation between local voters and taxpayers would be increased).

However, effective enforcement would be problematic and potentially very costly. Some form of registration of adult residents would be required, which could discourage people from enrolling to vote. Distinctions between residents and transients would need to be made.

A tax would be regressive (i.e. would have a greater impact on low income earners as a proportion of income than on higher income earners). This effect could be softened to some extent by rebates.

C.9.4 Petrol tax

In its 1988 form the local authority petroleum tax failed virtually every test of a good tax. The Committee recommended it should either be abolished or the revenue tied to roading activities.

C.9.5 Payroll tax

A payroll tax was rejected as it would act as a disincentive to employment, and would be inconsistent with central government policy.

C.9.6 Excise taxes

Excise taxes undermine neutrality between goods and services, and some incur high collection costs.

C.9.7 Rates

Accountability with respect to rating revenue is generally good, but can be undermined by the fact that:

- many individuals are not direct ratepayers;
- business pay substantial rates but have limited voting rights.

Property value is not a good indicator of the ability to pay. Central government should take any regressive impacts of rates into account in its redistribution policies.

C.9.7.1 Flexible rating mechanisms

The Committee raised the following concerns about the use of differential rating and uniform annual charges by local authorities:

- differential rating can affect location decisions;
- rates were being used for objectives additional to revenue raising (e.g. redistribution from commercial to residential). More appropriate alternatives were proposed:
 - widest possible conversion of rates to true user charges and where appropriate general to separate rates;
 - more frequent valuations to avoid big rate increases;
 - reliance on the central government tax/welfare system for redistribution;

- where local authorities have other objectives, such as encouraging/discouraging particular types of land use, policies and powers tailored for the specific objective should be used, rather than differential rating powers.

Differential rating could allow for excessive taxation of Crown land if the Crown rating exemption were to be lifted.

UACs should not be used as a proxy for user charges or tied rates. UACs have a regressive impact and were seen as inequitable, UAGCs even more so. Both should be abolished. Rates should be used to fund general purposes of the local authority, not just property related services.

Special rateable values should also be abolished – the problems they seek to fix can be addressed through user charges and separate rates. It was suggested that rates postponement values be retained and broadened, as a substitute for differential rates and special rateable values. Rates postponement values were seen as having the advantage that less revenue is lost to the local authority than under other mechanisms, as the previous five years' postponed rates are payable when the property is sold or ceases to be a residence.

C.9.7.2 Recommended approach

Simplify rating with the sole objective of revenue raising. Local discretion in taxation powers should be reduced to the setting of taxation levels. Any problems resulting from the system, which the system is not designed to solve should be addressed by means “specifically appropriate” to the problems. There should be a nationally uniform rating base – either capital value or land value (or both could be retained).

Differential rating powers should be abolished, or the criteria and processes strengthened.

C.9.7.3 Other issues related to rates

There are serious shortcomings with the Rates Rebate Scheme and it should be abolished in favour of reliance on the general welfare system.

If the Crown mandates remissions it should face the cost.

C.9.8 Regional Councils

Regional councils should have a separate tax identity from local authorities, but not necessarily a separate tax base. The Committee considered no new regional tax was necessary.

If a supplementary revenue source was required for regional councils, this would not have to be a regional tax – resources rentals, fees and charges, and regional trading organisations are all possible funding options.

Additional regional tax options were considered:

- a poll tax would be less impractical on a regional level (although there would still be collection/enforcement problems). It was not supported unless priority is given to full separation of local and regional tax bases;
- regional GST/income tax surcharge would have drawbacks similar to a local GST/income tax surcharge. Officials developed a possible regional income tax option, based on differential treatment of individuals and businesses:

- individuals: regionally varied regional income tax, collected by IRD on the basis of the address used for other taxes;
- businesses: nationally uniform regional income tax set by central government, and distributed based on some formula.

C.9.9 Government Grants/Subsidies

Government has three options for providing national public goods which are local in application: direct provision; legislate for provision; contract for provision. The legislation option is inflexible and reduces autonomy. Without accompanying funding it would reduce provision of other local public goods.

Voluntary arrangements were viewed as generally preferable to regulation in the local provision of national public goods. Where regulation is the preferred option, local government should not bear the cost. Instead costs should be met by individuals/businesses or by central government. Local authorities should have the power to pass on reasonable costs of services to users.

Grants may cause a reduction in local taxes or efficiency, and so fail to achieve their objective. In particular, subsidies tend to distort behaviour toward the subsidised activity. These options, particularly tied grants, undermine local autonomy.

Explicit contracting was put forward as an alternative to grants and subsidies. The voluntary/contestable nature of negotiated contracts would create incentives for performance and encourage autonomy. Accountability would be better than for straight grants/subsidies. However, contracting could be administratively costly.

Four justifications for central government grants were considered:

- revenue insufficiency: the appropriate approach was through tied grants to meet specific needs where local authorities face high expenditure due to their particular circumstances;
- national standards greater than local standards: local government should not have to pay. It should be for central government to determine the level of any minimum standards grant as part of defining national public goods. Any such grant would need to be sufficient to induce local authorities to enforce the relevant standard;
- spill over effects between local authorities: central government funds could possibly be used to address this, but may not be cost effective;
- special cases of local need: other policy options should be considered. Any grants should be in conjunction with programmes to encourage self-reliance.

The key criterion for assessing grants is: “is it a national public good?”

C.9.10 Borrowing

The Committee supported a regulatory regime based on general principles and some specific restraints, and increased reliance on capital markets and public accountability. Local authorities should face:

- essentially the same requirements as private sector borrowers;
- a statutory “duty of care”, i.e. requirement to act prudently.

Public information on debt levels and their effects should be made available to promote accountability.

The Committee recommended considerable loosening of the (prescriptive) constraints on local authority borrowing at the time.

C.10 NZ Local Government Association, *Statement on Reform of Local Government Funding*, 3 March 1989

C.10.1 Local government charges

Local government should be responsible for decisions on charging policies, including full discretion on appropriate charging systems. Local government should determine the level of private benefit (funded through charges) and public benefit (funded through taxes) subject to a set of guidelines.

The ability of individuals to pay should not be a factor in determining levels of cost recovery. If central government wishes to address the income redistribution effects of local government rating policies it should do so in a way that doesn't interfere with rating discretions. If central government imposes restrictions on charging levels it should meet the resulting costs.

Differential annual charges should be available to local government as an alternative funding mechanism.

C.10.2 Commercial activities

Local government powers to enter commercial activities should be broadened, subject to a NZLGA code of practice. For-profit activities should be corporatised unless it is demonstrably in the best interest of ratepayers not to do so. Dividends from commercial activities should be available for general expenditure

C.10.3 Central government transfers

Appropriate funding arrangements should accompany government devolution of responsibilities. Tied grants were considered to have a number of drawbacks, including reduced autonomy, distortion of local expenditure priorities, and inconsistency with direct local accountability.

The concept of voluntary specific service contracts was supported, and tied grants delivered on that basis.

Delegated services should be fully funded by central government, and mandatory services by government or users.

C.10.4 Local government tax

A local government tax system based solely on property rating does not meet the principles of good local government taxation. A permissive power for regional councils to levy a regional petroleum tax was proposed, to fund incremental roading and urban transport. RUC and national fuel excise revenues should all go to roading, urban transport and road safety activities.

Central government should meet the cost of any mandatory rates remissions. Clear guidelines for local authorities in the use of differential rating supported, to help ensure the costs and benefits of services to properties are properly taken into account.

All land should be initially rateable. This was viewed as encouraging “competitive neutrality”.