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Local Government: The Forward Agenda

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LOCAL GOVERNMENT: THE FORWARD AGENDA

Why is local government important?

Local government has been of increasing interest to the New Zealand Business Roundtable for two main reasons. First, local government is an important sector of the economy. It accounts for over 3 percent of GDP and employs about 36,800 people. In terms of income, expenditure and assets, many councils rank with New Zealand's largest enterprises. The Wellington City Council, for instance, plans to spend \$160 million in 1995/96. It has assets of \$2 billion, which is equal to almost 4 percent of the aggregate assets of the top 40 non-financial corporations listed on the stock exchange.

In addition to the delivery of services, local governments frame or administer many bylaws or regulations that affect community welfare. Regional councils are primarily regulatory agencies.

Local authorities are subject to relatively weak monitoring arrangements, which can lead to a divergence between the interests of the principals (ratepayers) and their agents (councils). Pressures for excessive spending can arise where the benefits of services are highly concentrated amongst a few ratepayers but the costs are spread thinly over a diffuse majority.

Unless local government spends and regulates wisely, national output, income and employment will be lower than otherwise. An important reason for examining local government is, therefore, to assess whether it is making the best possible contribution to the economy.

The business sector has a specific interest in local government because its activities affect every business in the country. Local government currently provides many services such as local roading, water reticulation, storm water and sewage disposal that are essential to businesses as well as residents. Its regulatory activities affect many decisions including the establishment of projects that require resource consents, the location of businesses, the design of buildings, and work practices such as the handling of food.

For many businesses, local authority rates are a significant cost. The mayoral taskforce on commercial rates found that Wellington City imposes the highest annual rate per capita (\$728) of the ten major cities surveyed. In addition, an

excessive proportion of its rates is borne by businesses. A separate study showed that rates payable by four middle to top class Wellington hotels amounted to between \$1,820 and \$3,430 a room. The most heavily taxed hotel would need to let each room at its standard rate for 18 nights just to meet its annual rates bill. Such taxes discourage tourism, investment and employment. They swamp the positive effects (if any) of programmes aimed at attracting major events to the city.

Les Mills, the mayor of Auckland City, recently reflected the public's scepticism that local authorities provide good value for ratepayers' dollars. He said:

The thing that everyone is sick of is having money taken out of their pockets by politicians who think they can spend it better.

It is interesting to note that the real income before tax of a worker with a dependent wife and two children earning the average wage increased by about 20 percent in the thirty years to the mid-1990s. However, after tax and net of cash benefits, the result for the average worker was a slight reduction in real income. What happened was that all the growth in real per capita incomes went to increased services supplied by the public sector.

A start has been made in cutting back public spending from the peak reached in the early 1990s. However, public expenditure broadly defined (that is, including that funded by compulsory levies and fees such as ACC and the fire service) still amounts to at least 40 percent of GDP. This is more than double the equivalent percentage for successful Asian countries.

The proper role of local government

In January this year, the Business Roundtable published a report entitled *Local Government in New Zealand*. It noted that considerable changes have been implemented since 1987 when the latest phase of local government reform began. The functions of regional and territorial authorities have been clarified and the sector has been substantially reorganised. Most special purpose authorities have been absorbed by territorial and regional councils, while territorial authorities have been expanded by amalgamation. A few local government trading activities have been sold and some have been

corporatised. In addition, port, airport, transport and energy companies have been established under specific legislation.

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

There is, however, substantial room for further improvement in the efficiency of local government. As New Zealand moved away from being an outward-looking market economy during the century up to 1984, local government became increasingly involved in activities of a private rather than a public nature. The process of reversing that wealth-destroying trend has only begun. Most councils, particularly larger city councils, have not undertaken a sufficiently rigorous examination of their proper role. They appear to lack a clear view of the appropriate demarcation between the public and private sectors. Wellington City, for example, stated that it would undertake a thorough review of its role in 1993/94 but it has not yet done so. This is now one option that has been put forward in the draft 1995/96 plan.

Many activities that local governments perform cannot be justified in terms of standard criteria for government intervention in the economy. Where government action is desirable, its current form is often inappropriate. Local authorities continue to hold interests in a large number of commercial enterprises such as off-street parking, airports, energy supply, rental housing, refuse collection and disposal, commercial property development, ports and transport operations.

Auckland City, for instance, is currently planning a property development of 'Think Big' proportions. Wellington City intends to increase its investment in off-street parking. Christchurch City seems the most confused of all about the proper roles of the public and private sectors. It is heavily involved in business activities in the mistaken belief that revenues from them are necessary to fund other services. Through its shareholding in Southpower which has bought into

Enerco, Christchurch City is on a path to nationalisation not privatisation - an extraordinary move given worldwide trends since the 1980s.

There are no compelling grounds for local government to engage in business activities. There is substantial evidence that public ownership of commercial businesses is less efficient than private ownership. That is the reason why governments of all political persuasions are engaged in privatisation. Politicians should not be playing with ratepayers' money and taking risks on their behalf. Subject to the resolution of any outstanding regulatory issues, local government interests in commercial businesses and activities should be sold. A vigorous programme of privatisation and asset sales should now be an urgent priority for local government.

Infrastructure

Now that the economy is performing so strongly, thanks to the reforms of the last ten years, attention has turned to the task of sustaining growth and avoiding bottlenecks. In this context it has become fashionable to raise concerns about infrastructure. However, from an economic perspective there are no compelling grounds for regarding investment in infrastructure as being different from any other investment. There is no likelihood of significant shortages where infrastructure is supplied through private markets, for instance construction, telecommunications, transport and some forms of energy. The construction of the Auckland casino has taken place without the strains and disruption that were common in old New Zealand.

On the other hand, difficulties are being encountered where infrastructure is supplied by the public sector and where resource management regulation is creating investment uncertainty. Examples include roading, overcrowding at preferred schools, water shortages in Auckland, and the time taken by successive councils in Wellington to resolve the issue of sewage disposal. If we are not careful electricity supply will be added to this list in the next couple of years. These failures arise because public supply relies on political and administrative decision making which is costly, unresponsive and subject to interminable wrangling between political factions and interest groups. Market mechanisms for decision making, competitive pricing and commercial disciplines should be introduced into the provision of infrastructure wherever possible to avoid bottlenecks to growth.

The role of competition

Local government services are commonly subject to inadequate competition. Local authorities are often the sole suppliers of services or their output is highly subsidised, thereby discouraging private providers from competing. Competition, including a genuine threat of competition, is essential to focus suppliers on satisfying the needs of consumers, containing costs and innovating. How many private libraries do we now have lending popular books to the public? *City Voice* reported last year that a private tip in Happy Valley Road was likely to close because it could not compete with the subsidised council tip. How many potential businesses simply don't get off the ground because they can't compete with subsidised council services?

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

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

Over recent years, public policy in a number of countries has promoted competitive private participation in the provision of local government services. The community has benefited from improved services and lower costs. Corporatisation and privatisation of water supplies, for example, have been common developments in many countries.

Some local authority leaders like Stuart Macaskill, chairman of the Wellington Regional Council, adopted a head-in-the-sand attitude when we raised such possibilities for water supply earlier this year, dismissing them as "nonsense." He seemed unaware that communities like Oamaru and Waiheke Island obtain all their water from private sources, that Adelaide is planning to contract out

its water supply and that the state of Victoria is engaged in a bold programme of water reforms. Any local authority not looking at metering, restructuring, corporatisation, franchise bidding and other options for improving water industry performance is neglecting its responsibilities.

User charges

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

Most services provided by local government should be subject to direct user charges. The main exceptions are parks and reserves, certain recreation facilities where the costs of collecting user charges would be excessive, civil defence and democratic processes. These may be viewed as public goods in the economic sense of the term.

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

A 1994 study by the Wellington City Council showed that each visit to the city art gallery and the maritime museum was subsidised at a rate of \$20 and \$8 respectively while each book borrowed from a local library was subsidised by \$4. The Council's priorities survey showed that facilities such as the art gallery, council housing, parking enforcement and the zoo were of least importance to residents.

Another council reported that its community surveys showed that there was 80 percent support for part charges for services like the art gallery, the library and aquatic centres. It is clear from these surveys that the public does not believe

that such services should be free or largely free to users, as some interest groups would have us believe.

Rating policy

Rates provide a financial base for local government that is independent of central government, relatively cheap to administer and capable of being adapted to suit local circumstances. If expenditure is kept to an appropriate level, rates are a satisfactory tax base for local government.

The distribution of total rates between business and residential ratepayers is inequitable in many cases, nowhere more so than in Wellington City. The present rate differential cannot be justified by any principle relating to the benefits of services supplied to businesses.

One rationale that has been advanced for differential rating is that rates are a tax deductible expense to businesses but not to households. This argument is simply wrong, as the mayoral taskforce pointed out. It reflects a misunderstanding of the way in which the tax system is designed.

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

A related claim is that businesses are favoured because they can claim an input tax credit for GST paid in respect of rates. However, GST was designed to impose tax on final consumption spending. For this reason, firms (but not final consumers) generally receive a deduction for GST paid on inputs. This deduction is intended to avoid a cascade effect where the amount of tax is affected by the number of traders involved in the production and distribution of goods and services. Business firms, other than those supplying exempt

services, pay GST on the net value that they add. The sum of net value added by each firm, together with the cost of imports (which are subject to GST at the border), equals the final selling price of goods and services. There is no concession for firms.

This myth about the preferred tax status of business should therefore be disposed of once and for all.

In Wellington City businesses bear 67 percent of the rate burden. The rate per dollar of rateable property levied on businesses, which is the best measure of the relative rate burden, is six times higher than that payable by residential ratepayers. Consider for a moment a simplified example involving a residential house on Tinakori Road. If the house is converted into a small shop with no change in its value, rates payable by the owner would rise six fold. Could this change in the property's use possibly suggest a six fold increase in the level of services demanded from the Council? Consider the same issue from the other side of the coin. If a shop is converted to a private residence, would the level of services required fall substantially? If there were a large reduction in the number of businesses, would the Council plan for a six fold reduction in its expenditure?

The mayoral taskforce examined the issue of the rates differential and and come up with a sensible strategy involving:

- a reduction in total spending to reduce Wellington City's revenue requirements;
- a review of user charges with the objective of recovering the private costs of services provided which cannot be justified in terms of broader public benefits; and
- a progressive phase-down in the commercial/residential share of rates from 67:33 to 50:50 over five years. A further review would take place in four years' time.

The Council has included the phase-down suggestion as an option in its draft plan for 1995/96. However, its attractiveness to residents is reduced because

an increase in residential rates is suggested rather than a reduction in Council expenditure as recommended by the taskforce.

Unjustified rate differentials reflect the voting strength of householders relative to businesses. It is up to the business sector to challenge unfair rating policies, if necessary through the courts.

Borrowing and financial management

The borrowing powers of local authorities have been under review since 1987. They are restrictive and most local authorities have avoided excessive debt. The Local Government Law Reform Bill provides for central government oversight of local authority borrowing to be replaced by a more modern borrowing regime. The Bill would also apply the principles of the Fiscal Responsibility Act to local authorities. The Business Roundtable has supported the thrust of the proposals in a submission on the Bill. We have also suggested that there is scope to upgrade the Bill by improving its monitoring provisions, requiring local authorities to set out clearer targets for net worth and debt levels and to establish a risk management strategy, introducing a credit rating requirement in the case of larger local authorities, and requiring a statement of the principles behind the activities engaged in by individual councils.

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

Recent reports by the Controller and Auditor-General suggest that there is considerable room for better financial management practices, particularly in respect of core services such as drainage, sewage and water supply, and in the management of trading activities. The development of performance indicators that meet the intent of the legislation has not yet been generally achieved. Some councils, such as Christchurch City, have made more progress than

others, like Auckland City. The quality of annual plans has improved but still varies markedly.

Conclusion

Our report *Local Government in New Zealand* was generally well received. A number of council chief executives wrote to indicate that they agreed with most of it. One response suggested that local government was moving in the right direction and, measured against our conclusions, deserved a mark of about 7 out of 10.

An exception was the response of the Labour Opposition spokesperson on local government, Richard Northey, who "rejected the thrust" of the report. He opposed the arguments for privatisation, contracting out and user charging, despite the evidence of the benefits of such policies both in New Zealand and around the world. Expressing the view that local government is the best deliverer of most community services, Mr Northey added:

Dunedin and many other councils have demonstrated that local government is usually the most effective organisation for co-ordinating and ensuring growth in their districts.

No evidence was advanced to support this assertion. If it were true, the community would be petitioning councils to supply basic necessities like food and clothing. This is not the case, as Les Mills correctly noted. It is nonsense to suggest that the Dunedin City Council or any other council is the most effective organisation for ensuring regional growth. The prerequisites for growth are a sound national economic framework and a healthy, competitive business sector. The best contribution local government can make is to stick to a limited range of core activities and perform them well.

Let me end with the conclusion of our report:

The local government sector has a large effect on the welfare of the community. It is important that it fulfils its proper role in the economy, that it uses resources wisely and that its regulatory activities are soundly based. The quality of the services provided by local government and their costs have an important effect on the international competitiveness of the economy. Local government performance is now a priority issue for many business organisations. There is some evidence of a slackening in performance, such as the

tendency for rates to move up again, following the gains that occurred in the late 1980s and early 1990s. This must not be allowed to happen; productivity improvements in the local government sector must be part of overall efforts to maintain the present momentum of economic growth. The main conclusion of this study is that, while commendable progress has been made, there is still substantial scope to improve the contribution of local government to community welfare.

I hope your association will play its part in promoting that goal.