

Queenstown Lakes District Chamber of Commerce and Industry

Seven Deadly Sins in Local Government

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SEVEN DEADLY SINS IN LOCAL GOVERNMENT

This is the time of the year when most local authorities are engaged in public consultations on their draft annual plans. These are key documents in local government decision making, and the quality of the information contained in them has markedly improved in recent years.

Nevertheless, we should not pretend that the analysis underlying many councils' policies and the level of scrutiny provided by the consultation process are anything like rigorous. Few councils, for example, have presented any objective analysis of the pros and cons of retaining ownership of their commercial undertakings, or a cost-benefit analysis of their regulatory activities. According to a Department of Internal Affairs study, only a minute proportion of citizens (an average of 160 per local body) make submissions on draft plans, and only 20 percent of local bodies consider that the public has much, or even some, influence on the final shape of the plan.

Criticisms of specific local authority policies are sometimes met with the response that they are supported by the majority of ratepayers. This misses the point. No one argues that local government decisions should be made other than through a proper democratic process, or that election commitments should be put to one side. The issue is rather the quality of public decision making. Sir Robert Muldoon's policies were backed in three elections - his routine claim was that "the people" were on his side - and he was a stickler for manifestos, but he ran the country into the ground. Populist claims are no substitute for informed debate about the merits of policies. Public choices change in response to logic and evidence. Sound local democracy requires decisions to be made on the basis of good information, careful analysis and open debate. Politicians should lead and encourage that debate, not try to stifle it.

Another common response to criticism of local government performance is to say the critics are only concerned about money, not people. Again, this has a Muldoonist flavour: he claimed his aim was to help people, but his policies were destroying the economic base on which New Zealanders' livelihoods depended. The most important social role of councils is to run their own affairs efficiently - to undertake the right activities, and to manage them at least cost. Anything else wastes resources, reduces the capacity of the local economy to create wealth, and hurts the community at large.

Making sound public choices is not a random process. It should be done on a principled basis which justifies government action as a first step, and then achieves legitimate goals in a cost effective way. It is pleasing that there is increasing acceptance of some key principles in local government administration.

One such principle is that local governments should be concerned with the provision of public, not private goods. In the words of the recent Wellington City Council Funding Review Taskforce, public goods are those which are non-excludable (i.e. where it is not possible to exclude a person from using the service), and non-rival (i.e. where the use of the service by one person does not reduce its value for another person). Such goods will not be supplied, or will be undersupplied, by the private sector. Services with high public goods characteristics are properly the core business of local government. Stormwater and parking enforcement were given as examples. Many local authorities are reviewing their activities in terms of a public goods criterion. The Wellington Taskforce found that a large number of the services provided by Wellington City were in fact private goods.

Another principle that is becoming widely accepted is that the funding of a service should be related to the benefits derived - the so-called 'benefit principle'. The Wellington Taskforce defined public benefits as those which accrue to third parties when another user has access to the service. Private benefits are those which accrue to users. City safety and litter control are examples of services with a high public benefit content, and parking and marinas are services with a high private benefit content. Where the benefits are largely private, it is appropriate that beneficiaries pay for them through user charges or the like, whereas rates should be the main source of funding where benefits are primarily public.

There is scope for both genuine confusion about the benefit principle and unproductive soul-searching about the ultimate beneficiaries of services. In the private sector, the rule is that the customer pays regardless of who is the ultimate beneficiary or end-user. Not all who benefit necessarily pay. The bookshop owner charges those who buy books or magazines and does not claim that the local council should rate all who derive some 'third-party' benefit from their purchases. Leaving aside any equity considerations, a library which issues books 'free' to borrowers is effectively operating on the principle that all the benefits are derived by third parties. Third-party effects do not, by themselves, justify departures from the 'customer-pays' approach taken in the private sector.

The thinking of some local authorities has become clearer on these issues of public goods and the allocation of charges according to benefits. On some other issues, however, thinking remains confused. I have identified seven such issues - or deadly sins - in this paper. Probably deadly is too strong a word, but the practices are certainly harmful for local communities.

#1 'The tax treatment of business justifies rate differentials'

It is often argued that the commercial sector should pay higher rates because:

- it can pass on higher costs to consumers in prices;
- it can deduct rates from income before calculating taxable profit; and
- it can claim refunds on the GST portion of rates.

These arguments are all invalid, as a Wellington mayoral taskforce pointed out in 1995. Regrettably, the latest Wellington Taskforce, in a brief comment, got the issue wrong again.

First, there is minimal scope for businesses today to pass on higher costs in prices. Typically they are trading in competitive markets: the cost-plus days have gone. Many do not have to locate in high-rate districts. If the proposition were true, its implication would be that councils were really rating customers, most of whom would ultimately be residential ratepayers, in which case it would be more transparent to rate residential ratepayers directly.

Second, as the mayoral taskforce pointed out, all businesses are ultimately owned by individuals, who are generally treated on a consistent basis for income tax purposes by central government. Rates are a legitimate business expense to be deducted from gross income before tax is assessed. Just as wage earners do not get a tax deduction for residential rates, owners of businesses are also unable to deduct their residential

rates from income. In respect of rates and taxation, the owners of businesses and other citizens are treated exactly the same.

Third, GST is a tax on final consumption spending. A deduction may be claimed on inputs, including rates, but businesses pay GST on all taxable output. This enables GST to be collected in stages and ensures that the correct amount of tax is applied to final consumption spending. The owners of businesses which distribute profits pay GST just like other consumers when their income is spent. Owners of businesses gain no special advantages through the operation of GST.

It follows that rating differentials should not be imposed in the belief that central government's taxation policies favour businesses. It is to be hoped that current rating cases before the courts will clarify this point once and for all. It is a simple technical matter that should be beyond dispute. Any rating differentials should be justified on other grounds.

#2 'Lower costs of borrowing justify lower returns on council investments'

In comparing their in-house operations with services available in the private sector, some councils factor in a cost of capital based on their borrowing costs (currently just over 9 percent for a 5 year loan). Not surprisingly, if councils seek only a 9 percent return on their investments, many find that their own services are cheaper than those offered by private firms in a competitive tender.

This is a totally inappropriate procedure. In the first place, it is clear from the balance sheets of many councils that the vast majority of their assets are financed by ratepayers' equity and not by debt. A good portion of the equity has been derived from rates. The deadweight cost of rates should be taken into account in computing the cost of capital to a local body. These are the additional economic costs which arise because rates affect incentives and reduce the amount of goods and services produced by the local economy. The marginal deadweight costs alone are likely to exceed the cost of borrowing.

As far as borrowing is concerned, councils should not be providing capital to trading activities at a cost which is affected by the explicit or implicit security associated with the power to impose rates. These activities involve risk which should be priced into the cost of the capital they employ. For this reason central government has always insisted that there is no implicit guarantee associated with the borrowing of its state-owned enterprises.

In respect of trading activities, councils should price capital in the same way as a private firm, otherwise they will draw resources away from more productive uses in the private sector and thereby reduce community welfare. As a starting point, they should apply a weighted average cost of capital (WACC) which takes account of the costs of equity (in their case ratepayers' funds) and debt, and reflects an optimal capital structure. The appropriate WACC would depend on the risk characteristics of the project and required returns on debt and equity at the time, but at current market rates it could be in the 10 - 13 percent range. Councils which are not following such practices in their LATEs or business units are distorting the terms of competition with private firms and misallocating scarce economic resources.

#3 'There's no reason why councils shouldn't own commercial enterprises, provided they run them efficiently'

Put this way, the statement is unexceptional but it is also, as a general proposition, an oxymoron. The evidence is overwhelming that, on average and over time, private enterprises outperform public enterprises - that is to say, they produce better quality and lower cost goods and services and therefore do more to raise living standards. This has been the motivation for the massive wave of privatisations around the world in the last 15 years.

It is important to emphasise that I am talking about the general rule - quite clearly some public enterprises have performed well for a period and some private firms fail spectacularly. All firms make wrong decisions, but private firms face disciplines which mean they make fewer and correct them faster than firms owned by governments, which tend to cover them up. The better performance of private firms is due to the fact that monitoring by owners and capital markets generally is more rigorous than political oversight, and because government owners tend, over time, to adopt other goals than the efficient operation of the businesses and interfere in decision making. Moreover, the diversion of effort and resources into running businesses means that governments do a poorer job of discharging their core responsibilities.

Local government in New Zealand has been notoriously slow to accept the evidence for privatisation. In a debate over a Business Roundtable report on water last year, Wellington Regional Council chairman Stuart Macaskill flatly ruled out any thought of privatisation. A role for the private sector in supplying water was only one among a large number of reforms canvassed - including changing water allocation methods, restructuring bulk and retail supply, metering and corporatisation - but in our view it clearly warrants consideration. A recent comparative study by the Reason Foundation of private (investor-owned) and government water systems in California found among other things that:

- investor-owned water companies provide comparable water services to consumers at the same price as government-owned water companies even though they pay taxes;
- investor-owned companies are substantially more efficient in their operation of water services than government-owned water companies;
- it is likely that government-owned water companies spend more on facilities than investor-owned water companies; and
- governments can better regulate an investor-owned water company than a government-owned water company.

In the light of such evidence, the refusal even to look at the possible benefits to local communities of private sector ownership options is irresponsible. The fact that water and some other infrastructural services raise monopoly issues is no reason to rule such options out. The same issues arise with corporatisation, and Nobel laureate Gary Becker has observed that "private ownership seems to work better than public management even without competitive pressure". It may well be true, as Mr Macaskill has argued, that some local electorates in New Zealand are currently opposed to privatisation of assets such as ports, airports, power and water supply. However, this is not true in all cases, and it is arguably the job of their representatives to study the evidence and inform the public of options which might benefit them, not to retreat into an ideological bunker.

#4 'Council ownership of businesses keeps down rates'

This claim is still occasionally heard - for example David Close, a Christchurch City councillor, recently argued that "the profit which the council receives from its trading enterprises funds council projects which directly benefit residents and ratepayers".

Can you imagine a central government politician today making the parallel argument: that Air New Zealand, New Zealand Steel, Petrocorp, the BNZ or NZ Rail helped keep down taxes? We know the opposite is true: that SOEs typically made poor returns and were a burden on the taxpayer. Privatisation has helped put the government in the present position of being able to lower tax rates.

With privatisation, a local body does not just lose revenue. The price paid for the asset reflects the expected future income stream. Asset sales will be accompanied by some combination of lower debt, lower debt servicing costs and the capacity to return the proceeds of sales to ratepayers. Any combination would lower the financial burden on ratepayers overall.

There is no need for local bodies to hold on to businesses in order to finance their core activities. These should be financed from rates and user charges. For councils to be accountable, the method of financing should be transparent; it should not be confused with revenue from business ventures. Few councils today would argue that they should raise equity and loans to engage in risky new business activities such as gas distribution or container terminals in order to finance things like libraries and parks. Where is the logic in holding on to assets such as electricity and port companies for the same purpose?

If councils cannot bring themselves to put commercial operations on the market and return the proceeds to their true owners, the ratepayers, by reducing rate burdens, a serious alternative in many cases would be to give the shares to ratepayers directly. Ratepayers, rather than politicians, would then be able to decide for themselves whether to hold the shares or quit them, which is surely a more democratic process than one which depends on majority voting on a council.

#5 'Councils should invest surplus funds on behalf of ratepayers'

Some councils such as the Waikato Regional Council have had the good sense to sell non-core assets such as their shares in port companies, but rather than return the proceeds to the ratepayers who own them they have invested the surplus funds in equities, bonds and other financial assets. The Auckland Regional Services Trust is seeking to extend its life by using income from commercial assets to finance major infrastructure projects in the Auckland region.

Essentially, such attitudes reflect an unwillingness on the part of local authorities to curtail unnecessary activities. In the private sector, shareholders are increasingly demanding that firms with surplus funds release them through share buybacks or special dividends. They want to ensure that managers remain subject to tight financial disciplines rather than invest in unrelated or non-core activities. Local authorities should face similar constraints because interest groups are likely to apply pressure to invest surplus funds in projects which would yield a low return - like uneconomic public transport facilities.

All investments are risky. Councils which have withdrawn from business activities and invested the proceeds in financial assets have merely swapped one risky asset for

another. The use of professional fund managers who pursue low risk strategies does not overcome this criticism, as experience in bond and equity markets in 1994 demonstrated. Ratepayers would be exposed to risks which they may not want to bear. Some, such as those on low incomes, would clearly place a higher priority on paying for basic necessities. Councils should not be making paternalistic decisions on behalf of ratepayers, who should be allowed to decide for themselves whether they wish to invest in commercial assets. Both investment risk and the potential for poor decision making by councils can be minimised by returning surplus funds to ratepayers.

#6 'Councils must help combat unemployment through job creation schemes'

A few councils have seen it as their role to implement job creation programmes, either by 'creating' jobs on their own payroll or by subsidising private employers in some way. The basic problem with such schemes is that they are largely ineffectual. All give rise to second-round effects which negate or reduce their impact on unemployment. Firms may take on the actual workers that they would have taken on in any event; the subsidised workers may substitute for unsubsidised workers; and subsidised firms may gain a competitive edge over other firms, resulting in the latter laying off workers. Moreover, the extra rate revenue required to provide or subsidise jobs has deadweight costs and reduces household purchasing power on other goods and services, and hence the labour requirements of other firms. Most of the expenditure is thus wasted, with little net gain in jobs.

Of course this is not an argument against strategies to combat unemployment; it is simply an argument that council employment schemes are not the way to go. By far the most important factors in New Zealand's sharp fall in unemployment have been the freeing up of the labour market and general policies to promote economic growth. Much more can still be done to make the labour market more flexible and enhance growth. The best contribution a council can make to employment growth is to create an environment which encourages investment and business expansion by keeping rates and regulatory burdens low, providing infrastructure where government action is required, and performing its own core functions efficiently.

#7 'Councils must step in to meet "needs" not being met by central government'

Usually this argument is put forward in the context of social services such as housing, welfare or health. Again the criticism is not of the goal but of the view that councils are an effective or appropriate vehicle for achieving it.

Inevitably, the delivery of social services involves issues of income redistribution. This is not a role which councils are well placed to undertake. They lack both the information available to central government agencies such as Inland Revenue and Social Welfare and the mechanisms to pursue equity objectives in any systematic way. The Local Government Association's view that income redistribution is not an appropriate local government function is sound, and should be accepted by all councils.

A second problem with local government involvement in social service delivery is that it overlaps with central government programmes in ways that can be perverse. For example, now that the government has moved to provide housing assistance through the accommodation supplement, councils providing housing assistance are in part picking up a burden which would otherwise be carried by taxpayers. Many councils

are now realising that, by and large, housing is not an appropriate local government function and are scaling down their involvement.

Clearly there are problems with social service delivery in New Zealand, but the issue is to devise the most effective solutions to them. A combination of better central government structures, more private provision, and greater family and voluntary sector responsibility seem the most promising avenues. There may be a case for some councils providing small-scale information and advisory services, but not for a more ambitious role.

By no means all local authorities are committing the sins of policy making that I have listed. Indeed, few of these issues should be controversial if properly analysed or understood. It would pay councils that are still getting them wrong to study those that are getting them right. The local government financial management legislation which is due to be enacted should help remedy some of the problems. The courts could play a helpful role by clarifying issues such as the tax treatment of rates; alternatively the Local Government Association could help resolve confusion on issues that are essentially technical. It would be helpful if central government established a unit which could monitor and comment on local government practice and performance. Central government, the courts and other parties have a legitimate interest in the decisions of individual local authorities because they affect not just their own communities but the health of the economy in general. Much can still be done to encourage best practice in local government, and to maximise its contribution to the well being of the country as a whole.