

The New Local Government Conference

**Local Government: Clarifying
Public And Private Roles**

Roger Kerr
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
16 NOVEMBER 1995

LOCAL GOVERNMENT : CLARIFYING PUBLIC AND PRIVATE ROLES

I suspect most of us at this conference would agree on one proposition: that the new local government sector in New Zealand is better than the old. Stuart Macaskill, president of the Local Government Association, is right to claim, as he did recently, that local government has achieved significant efficiencies since the 1989 reforms.

It is salutary to remember, however, that those reforms were primarily driven not from within the sector but from outside, in particular by central government and the private sector. Today a handful of local authorities, such as Rodney, are leading the way in exiting activities which should be left to the private sector, contracting out the provision of services and concentrating on their core business of providing local public goods and regulations. Nevertheless, it is regrettably the case that most of the pressures for improved efficiency are still coming from outside the sector, and that many in the sector are resisting ongoing change.

Let me start by giving you an illustration of how far we still have to go in getting a proper understanding of what constitutes efficiency in local government.

Of the major city councils, Christchurch City appears to have been the most confused in recent years about sound financial management and the proper boundaries between public and private sector activities. It is failing to capitalise on its generally sound record in the 1980s and is engaged in a raft of activities which, on any definition, would be regarded as commercial businesses.

Let me illustrate this confusion. The Council maintains that it makes sense to own a range of income-producing trading activities because the revenue derived from them helps keep rates down. One would have thought the fallacy in this argument would have been evident from central government's experience: asset sales have not led to increased taxes; indeed they have helped pave the way for tax reductions.

This year, in response to our submission on Christchurch City's draft annual plan in which we advocated divestment of its commercial shareholdings, the Council wrote to us explaining that it was opposed to such a step because it would mean rates would go up by 13 percent. We queried the basis of this figure, and the Council replied that it represented the amount of dividend income that would be forgone with divestment as a proportion of the Council's total rating base which, on further investigation, was found to be 11.5 percent not 13 percent.

We then pointed out that this calculation was not correct because asset sales would 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 direct financial burden on ratepayers overall.

The Director of Finance wrote back, saying "I accept the validity of the comments ... regarding other positive impacts from the sale of assets which must be offset against the reduction of income." However, he added that the calculation would apply if shares were simply given away to ratepayers.

However, the Council is still wrong. With a share giveaway, the liabilities of the business are in effect transferred to the new owners as well as the shares: the debt doesn't stay on the council's books. The financial implications for a council of a share giveaway are much the same as a sale. If a council sells an asset, a proper course open to it is to return the proceeds to its true owners, the ratepayers, either directly via the equivalent of a special dividend or through reduced rates. Giving shares straight to ratepayers, together with the dividend streams and debt servicing liabilities that go with them, simply crystallises their in-substance ownership status. In no way does such a move require or justify an increase in rates.

I might add that even if a local authority lost out in cash flow terms as a result of giving away shares, this would not constitute a sound argument for not doing so. Following a giveaway, ratepayers would directly own the asset needed to finance any higher rates; they would not be worse off. The true burden, that of funding all local government expenditure, would remain. The higher rating burden would merely signal more transparently to ratepayers the cost of local government spending.

You may think it extraordinary that such a basic misconception is harboured by the professional advisers of a major council, but the reality is that it is widely believed in local government. In the recent elections, many candidates were reported as saying that they would vote against the sale of income-producing assets like port companies "in order to hold rates down". A central government politician arguing against the sale of, say, the government's investments in forestry "in order to keep taxes down" would rightly be laughed out of court. Most people can now see that privatisation helps reduce tax burdens.

Indeed, from the perspective of the impact on local government finances, the position is even less favourable to the prevailing viewpoint in local government than I have described it. Under the constraints of local government ownership, a power company or a port may be worth much less than it would be if operated under market conditions in the private sector. Investors will generally pay a price for an enterprise based on its projected future stream of earnings. Thus if, as is usually the case, commercial freedom yields greater efficiency and higher earnings, investors will pay more for the business than it would be worth had it remained in local government ownership. Hence the impact on local authority finances is likely to be not just neutral; it is likely to be positive.

My horror story does not end there, however. Some councils, the Waikato Regional Council being a case in point, have had the good sense to quit some of their investments, such as port company shareholdings, on the very rational grounds that they were not core activities and the Council had no expertise in running a port company. Yet, extraordinarily, instead of using the proceeds to reduce rates (and any excess level of debt) Waikato has turned around and invested a large part of them in the sharemarket and other financial assets. The fact that the investment is being handled by a professional fund manager is irrelevant. What Waikato has done is to swap the exposure of its ratepayers from one risky business investment - ports - to another, the general investment market. One only has to look at the performance of the investment market - shares and bonds - last year to realise the foolishness of such a course. Even if the investment were totally risk-free, the question which has to be asked is why a council should withhold from ratepayers funds which it does not require for its statutory functions, and which many ratepayers are likely to wish to use

differently. Sooner or later some interest group is likely to apply pressure to use surplus funds for inappropriate purposes. No sound business operates with excessively high reserves or free cash flows.

Once again, Waikato's action was supposedly taken in the interests of holding down rates; the Council has said the investment fund has provided a general rate subsidy of 25 percent over the past few years. However, this is simply an illusion. The economic burden of local government represented by total spending is unaffected by the investment fund's existence. Councils should not try to conceal from ratepayers the true rating burden. Councillors are not generally elected for their business acumen, and even if some of them are business people they do not face the same incentives to make sound decisions as they do in a commercial environment. They should not be playing with other people's money. Ratepayers have different preferences for bearing risk, and those on low incomes in particular are not well served by having a part of their net worth involuntarily invested in risky projects. Nor are ratepayers well placed to monitor councils' decisions. The core functions that local government needs to undertake can legitimately be financed from user charges and rates. The idea that local authorities should retain surplus assets needs to be killed stone dead.

The weak capacity of ratepayers at large to monitor the behaviour of elected politicians on councils was highlighted by events surrounding the recent local government elections. A *Sunday Star-Times* poll reported that 25 percent of people were unable to name their local mayor, and nearly 20 percent did not know which local council district they belonged to - three weeks before election date.

Graham Bush of Auckland University was reported as finding this incredible. He should not have been in the least surprised. Unlike academics, most people are not political people. Even political people are little better off. A very competent mayor of a major city to whom I spoke did not know half the candidates standing for the council. Only about one in two eligible ratepayers voted in the elections; in 1992 the figure in Lower Hutt was one in four. Media coverage of local government is limited and party affiliations, which used to provide some guide to policy platforms, are weakening. How many voters in the main centres really knew in any detail who or what they were voting for?

Graham Bush commented that the *Sunday Star-Times* results were "an indictment on the community"; in other words that many voters were lazy, stupid or irresponsible. But it is not stupid or irrational of people to take so little interest in political affairs which they are powerless to influence. Paul Johnson, who is presently visiting New Zealand, has made the point well:

Political democracy does not work, certainly not in [Britain]. People know as much. That is why they now loathe professional politicians and want to get rid of the present set-up. Market democracy works much better, being a natural system of choice which allows you to vote every time you pull out your purse or wallet, instead of just once every four or five years. And manufacturers and suppliers take more note than politicians of what the public wants and usually make successful efforts to supply it. That is why, for instance, Marks & Spencer and Sainsbury's are among the most popular institutions in Britain, while Parliament and Government are held in contempt.

There is plenty of evidence in New Zealand to support Johnson's view. A 1992 Heylen survey found that customers were happy with the service they got from supermarkets, professional firms, banks, restaurants and other private businesses, but were unhappy with the service they received from local government. Supermarkets and food stores were rated very good or excellent by 63 percent of respondents, while only 16 percent put local government in this category.

It goes without saying that Johnson is not arguing that we can or should do away with democracy and government. There are some things that can only be handled through the political process and the public sector. The debate is not about whether the private sector is better than the public sector; it is about which roles each is best placed to undertake. The argument being made is that over the last fifty years governments have become over-extended - they have grown beyond their proper limits. Just like unwieldy private sector conglomerates, they ventured into areas they did not understand, spawned large centralised bureaucracies and often delivered poor quality services. The lesson is that governments must learn to assume a more modest role, to identify the genuine public goods functions they need to undertake, and to focus more on setting policy rather than operating businesses.

The downsizing of government is analogous to the painful downsizing that has occurred in the corporate world. In both cases, the result is a refocusing on core functions, with non-core functions being spun off to those better equipped to carry them out. If governments concentrate on performing a narrow range of functions well, we stand a chance of restoring respect for politicians and for politics as an institution.

There are dramatic examples of such downsizing taking place around the world. In Indianapolis, a city smaller than Auckland, virtually all municipal services have been privatised or contracted out, ranging from street-sweeping and garbage collection to managing the airport and running the world's biggest privatised wastewater treatment plant. The savings have been US\$300 million a year, the difference between what it used to cost the city to deliver these services and what it now pays private firms to deliver them on its behalf.

Recently a Christchurch City councillor reported on a visit to Phoenix City Council, which serves a population three times as large as Christchurch but has 9 councillors instead of Christchurch's 24. It provides a large range of services, including fire, ambulance, justice and police, but, by following similar strategies to Indianapolis, manages to do so at a per capita cost of around US\$150 a year - well below that of any New Zealand city.

Of course there are dozens of similar stories of gains from privatisation and contracting out in New Zealand, both at central and local government level. To cite just one local example: the privatised Wellington bus company, now owned by Stagecoach, has cut fares in real terms by 10 percent, boosted passenger numbers, improved services and reduced the subsidy required from ratepayers from \$14 million a year to \$5 million. Yet the new Auckland Regional Services Trust seems no more inclined to give up running a bus company and to deliver similar benefits to Auckland than its Alliance-dominated predecessor.

Beyond the obvious explanations of power and political self-interest, it is becoming increasingly difficult to fathom why councils continue to cling to notions of public ownership given all the evidence against it. The irony is that politicians like Stuart Macaskill and academics like Graham Bush label their critics as 'ideological' and politically 'right wing'. It seems to have escaped them that not only is privatisation taking place in every region of the world, but it is being carried out by governments of virtually every political complexion - not excluding Castro's Cuba and communist China.

It is a cop-out for politicians to say privately that they agree with arguments for private ownership but that they won't push the idea because a section of public opinion is opposed to it. If they are genuine about improving the community's well-being they should be showing political leadership, informing the public rather than treating people as incapable of understanding the issues, and undertaking research and analysis to demonstrate the achievable gains.

Fifteen years ago it may just have been credible to question whether private enterprise did a better job of providing goods and services than businesses in public ownership. But for Graham Bush to argue today that:

... what remains to be satisfactorily explained is why the model of local body shareholding in conjunction with normal commercial management suffers from an allegedly fatal flaw

is little short of breathtaking. The ivy covering the walls of Auckland University has clearly blocked out all the daylight that has been shed on this issue. A mountain of conclusive research on the subject has been summed up by the World Bank in response to the question "Is privatisation necessary?" To quote the Bank:

The answer is a decided "yes". Privatisation is necessary, and not simply to improve performance of public enterprises - though the evidence is striking that it can and does improve performance. Privatisation's essential contribution is to "lock in the gains" achieved earlier by reforming public ownership or in the process of privatisation; to distance the firm from the political process; and to inoculate the company against the recurrence of the common and deadly ailment of public enterprises: interference by owners who have more than profit on their minds.

An eight-volume World Bank study of 12 privatisations in 4 countries found that in 11 of the 12 cases the benefits to the countries concerned were positive and substantial. Former New Zealand state-owned enterprises that have been privatised have achieved large efficiency gains, over and above those realised under the corporatisation model. Since being privatised two years ago, Tranz Rail has reported additional productivity gains of 35 percent. The reasons for these results are well established: market disciplines are a far stronger spur for performance than political oversight.

Of course there is nothing written in the stars to say that a particular state-owned or local body enterprise might not match the performance of a private sector counterpart, at least for a time. There probably was a world class firm somewhere in the Soviet Union, though we have yet to hear of it. But policy should be driven by the rule not the exception, and the rule is clear - on average, and over time, privately owned

businesses out-perform publicly owned ones. In the face of both theory and worldwide evidence, Graham Bush's argument that "the only objection to the shareholders being local bodies must be ideological" should be turned on its head.

Similarly, Stuart Macaskill's statement that "competitiveness, not ownership, is the decisive factor" is wrong for the same reasons. Of course competition matters; no organisation has been a stronger advocate than the Business Roundtable of the case for opening up public and private sector markets to competition. I hope Mr Macaskill's statement means the Local Government Association is now strongly promoting the use of competitive tendering, for example for in-house professional services and minor and ancillary works, as many local authorities have been slow to take advantage of the benefits of competition. A recent official Australian report estimated that the economy-wide efficiency gains from wider use of competitive tendering and contracting in delivering government services could result in annual gains of between 0.3 and 1.7 percent of GDP, or up to \$A7 billion.

But competition isn't the only spur to better performance; ownership is also crucial, as the experience of privatised firms in New Zealand and elsewhere demonstrates. Again the World Bank has summarised the evidence:

... it is clear that ownership matters; that ownership is a significant determinant of profitability and productivity in an enterprise.

The problem with public ownership is that, ultimately, politics trumps economics.

Former British Labour politician Bryan Gould told delegates to this year's Local Government Association conference: "You must conduct your affairs in a business-like fashion, but you are not businesses." We can all agree with that statement, but it is too woolly to be of any use in defining the proper role of local government. This needs to be based on sound criteria for government intervention. There is no case for local government being involved in owning, say, farms or restaurants, even if they were run in a business-like fashion.

My argument has been that, indeed, local governments are not businesses and should not be in business activities at all. Their role is to arrange the provision of public, not private, goods and services, i.e. those goods which it will not be profitable for the private sector to supply, at least in sufficient quantities, under normal market conditions. Arranging the provision does not necessarily mean being the producer, however; it will often be better for councils to contract with the private sector to ensure such goods are supplied. Local governments should concentrate on performing a narrow range of core functions well, and leave other functions to private individual, community and commercial initiative.

What that core should be will obviously differ from place to place and from time to time. The range is likely to include ensuring the provision of local roading, water and sewerage, parks and reserves, other civic amenities where public good issues arise, and the administration of resource management, health and safety, and other local regulations. There is considerable evidence that some local authorities are over-stretched and are not performing even these core functions adequately - in the water area, for example, loss rates are high in some places, pollution of beaches and rivers is a problem, infrastructure has not been maintained, and timely capital expenditure

decisions have not been made. Councils should concentrate on improving their performance in these core areas and not be diverted into extraneous activities - such as employment, tourism or business promotion - which offer ego trips for some councillors but do little or nothing for the real needs of their communities. It is pleasing that the Local Government Association is acknowledging that local government should not have an income redistribution role, for which it has neither the information nor the mechanisms available to central government and the voluntary sector.

Where local governments are currently involved in commercial activities, they should, of course, be run as commercial businesses, in the form of LATEs wherever possible. Many infrastructural services could be provided in this way. Waitakere City Council, for example, has estimated that corporatisation of its water supply operations could save its ratepayers \$133 million over the next twenty years, a cost reduction of 25 percent per household. The only question is why it has taken so long to initiate such savings, and why more local authorities are not following suit. But for the reasons outlined in our organisation's recent study on the water industry, there are inherent weaknesses in the corporatisation model for water, and private ownership combined with light-handed regulation would provide additional gains.

Finally, there is a long list of conventional commercial enterprises which most local authorities are now running as businesses. It includes forestry, quarries, refuse collection and disposal facilities, rental housing, commercial property development, off-street parking, ports, airports, energy supply and transport operations. All of these are undertaken by the private sector in New Zealand or overseas. None of them is a genuine public good. Since any non-commercial objectives can be achieved in other ways, there is no reason for such businesses to stay under political control and every reason to realise the efficiencies of private ownership. Subject to the resolution of any outstanding regulatory issues, these businesses should be sold, or shares in them issued directly to ratepayers.

Some local authorities are moving strongly in the directions I have discussed. Others are not, using arguments for inaction which I have suggested do not stand up to scrutiny. Graham Bush has described the analysis I have just outlined as "monotonous". I dare say that adjective could be applied to Don Brash's defence of the Reserve Bank of New Zealand Act 1989 and the case for price stability. It just so happens that his case is also right. If we are concerned about performance of the economy and overall community interests, I suggest it is time the critics stopped bandying about labels like "monotonous" and "ideological" and, if they have some substantive reasoning and evidence to offer, to put it forward for examination and debate.