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**Getting Up to Speed: The Challenge for Local
Government**

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GETTING UP TO SPEED: THE CHALLENGE FOR LOCAL GOVERNMENT

It is no longer possible for objective observers to deny that New Zealand has experienced a remarkable turnaround in its economic fortunes. Prior to the recent economic reforms, New Zealand was widely seen as an economic museum. Our special brand of highly centralised and interventionist economic policies, in tandem with borrow-and-hope financial 'management', had brought the government to the verge of default. Government policies had increasingly been those of central edict. But while the minister of finance might command people not to put up prices, or not to buy foreign exchange, or not to do a thousand other things, he could not command the economy to grow, any more than King Canute could command the waves. By 1984 that was becoming overwhelmingly apparent: our foreign debt was mounting at an alarming rate, living standards had been stagnating for years, and unemployment was rising. Sir Robert Muldoon tried to persuade his followers that the economy was "just coming right", but economists, investors and ultimately voters recognised it was in dire straits.

The market-based reforms that subsequently transformed New Zealand were traumatic for many people. But they have resulted in an economy with a dynamism and potential for expansion which is unrecognisable from just a decade ago. We have discovered that it is businesses operating in competitive markets which create wealth, not governments. In those sectors in which the government has taken on a more limited role, the skills and enterprise of individual New Zealanders have been unleashed. Often the results have been spectacular. In your own industry, we are seeing world-class private sector engineering skills being applied locally and internationally in a much more client-focused way than before. Gone is the command-and-build regime of yesteryear, where valuable engineering skills were often wasted on expensive white elephants. Now your focus is far more on commercial solutions, profitability and meeting the genuine needs of clients.

Any number of statistics can attest to New Zealand's overall success. Since 1991 we have had one of the fastest economic growth rates of any country in the OECD, while our unemployment rate is now around the lowest. The government is cutting taxes while simultaneously running a budget surplus, a situation which would be the envy of most other governments.

This turnaround has not gone unnoticed abroad: there is a steady stream of foreign visitors wanting to learn at first hand about our reforms. In the last fortnight, the Business Roundtable, and no doubt many other organisations, have had visits from a former Japanese prime minister and a Federal government minister from Australia; in the last year we have had visits from senior figures in government and politics from the United States, Canada, Britain, Germany, Italy, Sweden, Argentina, South Africa, Malaysia, South Korea, the OECD, the World Bank, the World Trade Organisation (WTO) and a host of other countries and organisations. Amid such overseas interest, it may seem staggering that some domestic observers somehow manage to deny that anything worthwhile has been happening at all. A commentator like Bruce Jesson in

Metro still thinks that there has been no economic recovery. But of course there are people around to this day who think the earth is flat.

It is fair to say that changes to local government have played only a small role in New Zealand's overall economic turnaround. Local government has not been a sector where the new thinking about the limits of government, and the role of markets, has been very prominent. Progress has been generally slow and inconsistent. Moreover, those changes that have occurred in local government have been driven largely by central government initiative. While some local bodies have absorbed many lessons from the experience of the wider New Zealand reforms, others have carried on almost as if nothing has changed.

This becomes especially apparent when we compare developments in local government with the changes that have taken place in central government administration. When people talk about 'public sector' reforms, it is almost exclusively the reforms to central government which they have in mind. Those reforms have been notable for both their quality and overall consistency. They resulted from a first principles examination, first of the tasks that central government should be undertaking (as opposed to the tasks that should be left to the private sector), and then of the best institutional methods for carrying out those remaining functions. In a forthcoming comparative study for the Business Roundtable, David Henderson, formerly a top OECD official, writes of New Zealand that:

In no other OECD country has there been so systematic an attempt at the same time (1) to redefine and limit the role of government and (2) to make public agencies and their operations more effective, more transparent, and more accountable.

In this process, policymakers were not afraid to take a sound idea to its logical conclusion - even if this meant having to rebut a great deal of ill-informed criticism. One sound idea was that trading activities should be placed on a quite separate basis from the government's other activities - and opened up to competition. It was recognised that we should not be treating departments such as the railways and the post office as giant employment schemes which needed to be protected from potential competitors. There was no logic in having resources tied up in such activities unless they were being used efficiently. And the incentives under the old departmental structures to run trading activities efficiently were next to non-existent. The welter of conflicting objectives, bureaucratic incentives and centralised controls made efficient management of resources just about impossible.

The establishment of trading activities as state-owned enterprises, and the consequent freeing-up of entrepreneurial talent, are now history. The SOEs were given new boards of directors, made to pay tax and dividends, and forced to undertake their own borrowing. Despite the claims by their permanent heads, the State Services Commission and the Public Service Association that the old government departments were well-run and should not be changed, huge improvements in productivity were soon achieved in almost every case.

But the creation of SOEs was only one step. For all the improvements associated with the SOE model, the government appreciated that there was commonly no rationale for the state to own businesses at all. There were better incentives and better monitoring

mechanisms in the private sector. Government-owned businesses were not subject to the disciplines of the equity market, or to the threat of takeover. They were also still potentially subject to political interference and control, if a government were minded to turn the clock back. The logic of privatisation was strong, and the subsequent privatisation programme has been an undoubted success. For example the privatisation of Telecom, along with the introduction of competition in that industry, has increased consumer welfare by over half a billion dollars and led to New Zealand having one of the most efficient telecommunications sectors in the world.

The reforms in the rest of the central government sector were almost as thoroughgoing. The focus is now on accounting for outputs rather than inputs. Chief executives have been given the power to manage, and are responsible for delivering their department's outputs. There is much greater use of contracting out than formerly. More sophisticated information and reporting are required of departments. At the aggregate level, we now have a Crown balance sheet and accrual-based accounts for the whole of central government. The government is also legally bound to publish regular forward projections of the major fiscal aggregates, such as expenses, income, the operating balance, and central government debt.

The public sector reforms have gone a step further: they have recognised that there are strong political forces that can compromise sound fiscal policy. The short-term horizons of many politicians can lead to a bias towards debt-financed government spending, which damages economic growth. The lobbying power of special interest groups often leads to spending in areas that are of low value to the community as a whole. Because of this very real potential for policy failure, the Fiscal Responsibility Act 1994 provides a valuable framework of constraints for fiscal policy. Central government must now conduct policy in accordance with certain principles of responsible fiscal management. It must run broadly balanced budgets, keep debt at prudent levels, manage its risks, and provide taxpayers with a reasonable degree of predictability regarding future tax rates. Any government departing from these principles without good reason will be in breach of the law.

The benefits of our public sector reforms have been huge. There is in general a much improved culture of service and efficiency in government departments, while formerly loss-making enterprises are flourishing in the private sector rather than remaining a bottomless pit for taxpayers' money. The government's overall fiscal position is healthily in the black. By divesting itself of many tasks that it was doing unnecessarily and badly, central government has been able to concentrate on activities it believes it should be involved in. As a result, it has measurably improved its performance in its core functions. Running businesses, or undertaking work in-house that could have been contracted out, had been a drag on the economy and a drain on the taxpayer.

The job is not finished yet, and indeed it never will be. There are still too many agencies, too much interest group capture, and too many low quality policy proposals emanating from government ministries. The State Services Commission has performed relatively poorly in recent years in attracting talented outsiders into top positions and insisting on performance and accountability. Another review of public sector management would be timely to address these weaknesses; the goal has to be continuous improvement.

While New Zealand has been a world leader in some aspects of our public sector reforms, in most cases there are overseas parallels to developments here. In particular, privatisation and the contracting-out of services are trends which have swept the globe in recent years. Governments of all political persuasions have been deciding that they do not need to own businesses: there are privatisation programmes underway today in over 100 countries. When even Fidel Castro signs up to privatisation, however tentatively, we are surely talking about a worldwide trend. It is a trend which is reflected at all levels of government. In many countries it has moved well beyond returning previously nationalised industries to the private sector, and includes the privatisation of infrastructure and utilities. Contracting out of services is also extensive and growing. With so much privatisation activity, there is now a substantial body of evidence as to its benefits. The World Bank, which only 15 years ago was still finding good things to say about centrally planned economies, is now strongly advocating privatisation of large-scale infrastructure and private sector investment in such industries, and the extension of similar moves into social spending as well.

When we turn to consider local government in New Zealand, we see a sector which has tended to lag behind the play, and where progress has not been comparable to the developments in central government. And while attitudes in local government are gradually changing, too often one hears views expressed that would be regarded as positively antediluvian in a central government context. Many of these arguments are no different from those we heard from opponents of the central government reforms - such as the PSA - back in the 1980s. Indeed the PSA still hires advocates such as the Centre for Labour and Trade Union Studies at Waikato University to trot them out. Unlike wine, these arguments have not improved with age.

If there are forces that can cause 'political failure' in central government, these same forces are likely to be even more troublesome at the local government level. There is a high degree of voter apathy regarding local government, judging by the low voter turnouts in local body elections. Very few New Zealanders are well informed about the people on their local council, and where they stand on issues. In-depth media coverage of local body issues is limited. This makes local government especially prone to capture by special interest groups and activist politicians.

There are also fewer independent checks on the overall performance of a local or regional council than is the case with central government. Since 1984, free and open capital markets have been passing judgment on central government policy on a daily basis. This has acted as a valuable discipline, particularly on fiscal policy. Local governments do not face this scrutiny. Only with the passage of the new financial management legislation will they become subject to constraints of equivalent importance to those placed on central government by the Fiscal Responsibility Act 1994. Once again, the drive for this legislation came from central government, and many in local government tried to water it down.

While some local authorities show signs of having made a first principles examination of the activities they are involved in, others appear to have gone through no such exercise. Apart from their regulatory role, local bodies should only be providing those goods and services which economists call 'public goods'. A public good has the characteristic known as 'non-excludability': once such a good has been provided, it is infeasible to prevent those who do not pay for it from enjoying its benefits. This may

be either because it is technically impossible to exclude free-riders, or because the cost of doing so is simply too high. An activity may also be a public good through having the characteristic of 'non-rivalry'. In this case, once the good has been produced one person's consumption or use of it will not adversely affect the ability of another person to enjoy the good. National defence and streetlighting are standard textbook examples of services that are 'public goods' under both of these definitions.

Public goods are not likely to be provided, or will be provided in insufficient quantities, if left entirely to private sector initiatives. This provides a rationale for government intervention. It is important, however, that we understand precisely what intervention does and does not entail. It is up to governments - both central and local - to ensure that a necessary public good gets provided in sufficient quantity and at the right quality. To do this, however, there is no automatic need for the government or council to provide the good directly. Often it can just as easily - and at lower cost - arrange for the good to be provided by the private sector under contract.

Thus the proper role of local government should be to ensure that certain public goods are provided at service standards and levels that are justified in relation to costs. Open access parks, stormwater clearance, roads, footpaths and parking enforcement are examples of largely public goods which are the proper province of local government. Local government should not be involved in producing private goods, where there is no market failure to justify government intervention. Housing, parking buildings, marinas and sports stadiums are examples of private goods where there is little obvious reason for local government to be involved at all, and swimming pools, zoos, libraries and museums are more in the nature of private than public goods.

We should not forget that the financing of local government expenditure like the financing of central government spending - involves the compulsory imposition of taxes or rates on the community. Taxes represent a cost to the community, over and above the direct income loss to individual taxpayers. These 'deadweight losses' consist of the costs of collecting the tax, and - more importantly - the reduced incentives for individuals to work, save and invest resulting from the tax. Such costs are undoubtedly substantial in size, and they reduce potential national output and therefore living standards. For that reason, a dollar spent by local government needs to yield more than a dollar in benefits to the community. Clearly this will not be the case when ratepayers' funds go towards financing a private good which could equally well be produced by the private sector.

While this analysis implies a reduced role for local government, the tasks that remain are still important. Just as central government decided that there was a wide range of activities that it did not need to be involved in at all, or that it could contract out to the private sector, so local government can better concentrate on its core tasks if it sheds extraneous ones. A sculptor was once asked how he carved a beautiful horse from a block of wood. "First", he said, "I cut away everything that is not a horse". There is a good analogy here for local governments which seek to do their basic job well.

While change is occurring, many local authorities still produce a wide range of private goods, while public goods are often provided in an inefficient manner. There is scope for further large efficiency gains from rationalising and downsizing.

Once a local authority has taken a decision in principle to ensure the production of a good or service, there are a number of ways it can do so. These delivery mechanisms form a spectrum. The traditional and least satisfactory means of delivery is the council department, where the staff are directly employed by the council and face no competition for their product. There are very weak incentives for efficiency under this arrangement. Accountability is extremely poor: there is no proper accounting for costs such as the cost of assets used and the cost of capital employed. Often there is no charging for the service provided. With no capital structure, there are no market disciplines on the use of resources.

A better delivery mechanism is a business unit that operates within the council structure, but which contracts to deliver services to other council departments. Such a unit generally faces a more competitive environment, and thus has greater incentives to perform efficiently. However, a business unit is constrained to use council resources on council terms. In its accounting, its costs are unlikely to reflect true economic costs - particularly the cost of capital. A business unit still has no capital structure and thus no market disciplines. Its limited financial reporting further increases the difficulty of assessing its performance.

A Local Authority Trading Enterprise (LATE) constitutes a superior institutional structure to the business unit. Like an SOE, a LATE operates under the Companies Act 1993, and must pay tax to central government and dividends to its owners. A LATE has its own board of directors. Its accounts provide superior information for monitoring its performance. Incentives are plainly better under this arrangement. It is therefore disappointing that a great deal of local council work is still done through the traditional departmental structure, or through business units.

Even the LATE structure, however, has its limitations. As in the case of SOEs, there are still no genuine capital market disciplines on its performance. The threat of takeover is absent. Much depends on whether the owners of each LATE demand a market rate of return. Moreover, unlike the practice in central government, most councils take up their option to appoint two councillors or council staff to the board of a LATE. Where a board member is also a councillor, this can open the door to political intervention in commercial decision making. Given their potential conflict of interest, councillors who sit on LATEs need to appreciate that their board responsibility is solely to the LATE itself. Moreover, the appointment of councillors or council staff as directors is no substitute for the formal monitoring relationship between the LATE and the shareholding local authority.

Clearly LATEs are no more the last word in local government delivery than were most SOEs at the central government level. Direct contracting-out of service delivery or privatisation should usually be the preferred option for local authorities.

Many of you will be aware of the independent report on the contracting-out of professional services recently commissioned by your own organisation from the New Zealand Institute of Economic Research. The Institute report discusses the rationale for contracting out, and concludes that local authorities moving in that direction "are likely to realise major benefits to ratepayers in coming years". While as yet there is little hard data on experience in this country with contracting-out, the Institute notes that initial cost savings of 20-50 percent have been made overseas in connection with the contracting out of physical works, and that ongoing savings from professional services - while probably not in such a high range - should also be significant. A

recent official Australian report estimates that the economy-wide efficiency gains from wider use of competitive tendering and contracting in the delivery of government services could result in annual benefits to Australia of between 0.3 and 1.7 percent of GDP, or up to \$A7 billion.

Despite the compelling case for contracting out local authority services, we often hear excuses for not doing so that would never be accepted today at the central government level. Often local authorities see themselves as employment agencies, or as 'supporting' local economic activity. They fear jobs will be lost if competitive provision is allowed. Yet it is beyond the capacity of any government agency to increase jobs in total through such methods. Local government can create specific jobs for a specific group of people, but only at the cost of crowding out economic activity - and therefore jobs - elsewhere in their region. Living standards will be highest only when the resources in a region are being put to their most productive use. That will certainly not be the case when inefficient methods of delivery are adopted in the name of 'preserving jobs'.

Another argument put forward by some councils is that there would be insufficient contestability when work is contracted out, because the number of potential tenderers would be limited. However, intense competition can occur even when there are only a small number of competitors. Often the low number of market participants is itself a reflection of a council's historic approach of having work done in-house. It might also result from a council setting quality standards, e.g. for bus services, which create cost structures beyond the ability of a small operator to absorb. As the Institute report notes, "a policy of active tendering, even outside the larger centres, should lead to a concerted response from the market, and open up the potential for major savings".

A shift to contracting-out undoubtedly involves an initial learning experience for those involved. It can take time to develop best practices in specifying contracts. Many of the larger local authorities appear to have been among the slowest to move in this direction. However, the announcement last month by the Wellington City Council that it will be putting nearly all its services up for tender is a sign that positive change can also occur in larger councils.

Roading is one area of local government delivery where real progress is at last being made. As you will be aware, all physical works are now on a timetable to be contracted out using competitive pricing procedures. Moreover, last year's Transit Amendment Act requires local authorities to consider contracting out professional services. To date, local government has been slow to move on professional services. It must be hoped that as the benefits of contracting-out become increasingly obvious, the pace will pick up.

In respect of infrastructural services other than roading, local government in New Zealand is well off the pace. The provision of water and wastewater services, for instance, is an activity where incentives and market disciplines remain minimal. Here, we are lagging well behind developments overseas. In America, many local authorities are choosing to contract out the operation and maintenance of individual plants, or sometimes of entire water and wastewater systems. Private sector water companies are now common in many countries, not just in Britain as many in New Zealand seem to think. In respect of water, as with many of its privatisation

initiatives, Britain is not a particularly good model to follow but, despite its inadequacies, the overall balance sheet of its water reforms has been strongly positive.

Some \$6 billion worth of assets are tied up in water and sewerage in New Zealand - a huge investment. Yet the industry - which is run along traditional local government lines - appears to be performing poorly. Water quality can be low. Water restrictions are common in the summer months. Pipelines are often poorly maintained, leading to high water losses. Avoidable environmental damage occurs through system failures. Water permits are sometimes not allocated to those users who most value them. These and other problems in the industry will not be going away: substantial new investment will be needed in the years ahead.

Clearly the water industry is ripe for reform of the type that has brought abundant benefits elsewhere in central and local government. There are a number of options for proceeding, many of which would have both economic *and* environmental benefits. In water-short areas, greater use of tradeable permits would allow the rights to water to go to the highest valued uses. Charging should be introduced for domestic consumers in many parts of the country so that they face an incentive to conserve water. Water companies should be corporatised, and preferably privatised, so as to provide the best possible incentives to manage the services efficiently. However, if there is a preference to retain public ownership, substantial gains could still be made through contracting-out.

All of these options were canvassed in a recent Business Roundtable study. The reaction to it was typical of the response to many of our reports over the years - peremptory public dismissal of its ideas, followed by a large number of quiet indications that many people in the industry welcomed open and reasoned debate and were taking the ideas seriously. If that is how progress gets made, so be it. Our only concern is that substantial progress is made, and the signs on that score have at least improved.

The tendency for worthwhile local government reform to be driven by central government is illustrated by the continued involvement of local authorities in most of our port companies. These companies were, of course, set up under central government legislation aimed at reforming one of the most grossly inefficient areas of our economy. Huge improvements have occurred since the days of harbour boards, the Waterfront Industry Commission and the *de facto* rule of the Watersiders' Union. But most local authorities with shareholdings in ports have not taken the next logical step, which is to divest themselves of these holdings. There is no more point in local authorities retaining ownership of such assets than there was in central government owning a railway or a telephone company. The same is true of airports: even Australia, a laggard in most microeconomic reform, is ahead of New Zealand in its plans for airport privatisation.

Similar arguments apply to the many local authorities which still retain shares in electricity distribution companies. Moreover, councils which have decided to exit such businesses often do not return the proceeds to the true owners of the asset - the ratepayers - but reinvest the money or find creative ways to spend it. It was pleasing to see that the Wellington City Council recently decided to sell its 51 percent shareholding in Capital Power. The money from this sale should be returned directly

to Wellington ratepayers. Councils should not spend it on new trinkets and baubles, or assume new risks through investment activities.

As yet there are few signs of efficiency gains in local government flowing through to ratepayers in the form of reduced rates, contrary to the position in central government. This year the Wellington City Council has achieved a 4 percent rate reduction overall and reduced commercial rates even further, but Wellington is a rare exception and rates per capita in Wellington remain around the highest in the country. Rate increases this year by many councils are continuing to impose extra costs on businesses and households, and to put pressure on the exposed sectors of the economy. Perhaps more ratepayers should react like those in Nelson whose response to a proposed 15 percent rates increase was to march into their council chambers singing a chorus from *Les Miserables*. Imagine the outcry today if central government were to raise taxes by 15 percent - or indeed to raise taxes at all.

If the slow pace of local authority reform reinforces any general lesson, it is that the market economy and the role of the private sector still need their advocates. Despite the advances of the past few years, both here and abroad, too many people have still not understood the importance of market competition and private enterprise in raising living standards. Too many are inclined to ascribe abilities and powers to government - both central and local - that are simply not borne out by any evidence or analysis. If the gains we have made as a country in the past few years are to be consolidated and extended, it is up to all of us who believe in private enterprise to continue to make the case for it. That naturally includes organisations such as yours. Ideas have been an extremely powerful force in New Zealand since 1984. So long as we put forward clear, well-reasoned and high-quality arguments, we can hope to see progress, even in a lagging area like local government.