

LOCAL GOVERNMENT BUSINESS FORUM

Local Government Role and Funding

Paper for Local Government Business Forum

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Local Government Role and Funding

Background

This paper for the Local Government Business Forum is a resource document for the Forum's work on the role and funding of Local Government.

Research and analysis was requested on the following areas:

- Size of local government.
- Council activities and expenditure over time.
- Problems associated with using property valuation.
- What funding alternatives won't work?
- What funding alternatives might work?

The paper is divided into two parts:

Part One of the paper pulls together statistics on the size and growth of the local government sector and the activities it is undertaking.

Part Two looks at the problems associated with rates as the major revenue raising mechanism available to councils and investigates some alternatives.

The paper highlights that while there is some urgent need for expenditure in some areas (mainly in the area of infrastructure investment), there is also a great deal of unnecessary expenditure in local government which needs to be addressed. It also points out the weaknesses of property rates and discusses some alternative funding mechanisms that merit further investigation.

The paper concludes that central government should consider some of these alternative mechanisms and agrees with the brief that local government first needs to demonstrate it has got its own house in order and that it has a genuine and demonstrable need for additional resources before being given access to these alternative funding mechanisms.

About the Forum

The Local Government Business Forum comprises organisations that have a vital interest in the activities of local government. Its members include Business New Zealand, the Electricity Networks Association, Federated Farmers of New Zealand, New Zealand Initiative, New Zealand Chambers of Commerce, and Property Council New Zealand. It was established in 1994 to promote greater efficiency in local government and to contribute to debate on policy issues affecting it.

The Forum's members are each significant representatives of ratepayers in their own right but the Forum's perspective is to advance community welfare through the advocacy of sound public policy. We believe that local government can best serve the interests of the community and ratepayers by focusing on the efficient provision of public goods at a local level.

The Forum advocates policies that create a positive economic environment. Recognising the significant role of local government in private investment decisions, the Forum regularly produces publications addressing crucial issues relating to the performance of local government and legislative developments in that sector.

Part One - The Size and Role of Local Government

1.1 Key Points

Local government is big and getting bigger

- Ratepayers' equity in local government is a massive \$113 billion or \$24,300 per capita. This is more than the net worth of central government assets and just short of the market capitalisation of all the companies on the New Zealand Stock Exchange.
- Total rates collected in 2017 across the country were in excess of \$5.5 billion. On a per person basis they are more than two and a half times as much as they were in 1994.
- Local government operating expenditure increased 5.7% per year on average since 1994. Of this annual increase, 2.3% was driven by costs and 1.2% by population growth. The balance of 2.2% was the price-adjusted, per capita annual increase in new spending.
- In recent years, it's the volumes of new spending that have driven the increase more so than inflation and population increases.

Local government costs and inflation

- Since 1994, CPI inflation increased 58% in total but the local government component of the CPI increased 202%. As well as costing consumers, the inflationary pressures from the sector have kept interest rates higher than they otherwise would have been over much of the period according to the Reserve Bank which, in the past, has singled out rate rises for driving up inflation.
- Due to the mix of products it purchases (pipes, tar seal etc.), local government cost inflation increased faster than consumer inflation since 1994, but only marginally (65% vs 58%).

Comparisons with GDP and central government

- The local government sector is growing relative to both central government and the size of the economy. Between 2007 and 2017 its share of the economy grew from 3.3% of GDP to 3.8% and, over the same period, against the benchmark of central government spending, it has moved up from 10.6% to 13% – that's a 22.6% increase relative to central government.
- While governments of all colours have made it a virtue to constrain spending relative to GDP this is not the case in local government as a sector.
- There may be systems and practices used by central government that local government could adopt to improve council spending and accountability.

Variations across country

- While the sector is growing, not all councils are doing so at the same rate. There is wide variation. Between 2007 and 2016 total spending grew 68% but at one extreme, one council grew 147% (two and a half times) whereas another grew only 20%.

Local government staff numbers / salaries and wages

- Numbers employed in the sector have grown 42% since 2000. This compares with job growth of 34% for the economy as whole.

Broadening of scope

- There has been a broadening of scope and a shift away from traditional core business in recent years with spending on economic development, sport and recreation and community development increasing as well as new, previously uncategorised, items of expenditure. This is despite 2012 legislative changes intended to narrow the scope.
- This broadening scope isn't the main driver of growth though, as many of the new growth areas are coming off a low base but it is still significant and ongoing.
- Sometimes councils receive opportunist requests by private sector parties looking to game the system or exploit "cosy relationships", for example, seeking financial support for activities that would go ahead anyway even without the councils' support.
- It is important that local councils constrain their spending and do not stray outside core business. Local government is not well placed to provide many of the non-core services it is increasingly providing. Many of these services are better left to either central government or the private sector.

Why has local government grown?

- Infrastructure demands, cost rises, central government requirements, inefficiencies, broadening scope and community expectations have all contributed to growing local government expenditure.

Inefficiencies

- There seems to be significant waste in council operations. This is unsurprising given councils have a monopoly in the provision of many of their services and because much of their income is guaranteed by legislation.
- Recent examples of questionable expenditure / waste include \$437,000 spent on Rotorua's Mudtopia and Dunedin City Council spending more than \$8,000 on a street mural of Ed Sheeran.

Community expectations

- Often the broadening scope (and increased expenditure generally) is councils responding to what they say is community demand. Often this assertion is backed up by very little evidence.
- It is important that the community is made aware of the costs of these activities including the opportunity costs, for example the neglect in core infrastructure like water and waste water, and the costs are allowed to fall on the sections of the community benefiting from the activities (though targeted rates etc.).

Transparency

- Often the full cost of council services is not transparent to some groups of ratepayers who are often subsidised substantially by others who pay more than they use because they are deemed to be able to afford it.

- One important way to hold costs is to maximise transparency and to be sure that new activities are subject to close scrutiny. Councils can do this by itemising how rates are spent and being more open as to how rates are determined.
- Encouraging landlords to highlight the rates component of a tenant's rent would enable more scrutiny from renters (business and residents).
- Providing opportunities to enable comparisons across councils will provide incentives for councils to improve their practices
- Relative to national politics, there is apathy towards local government as evidenced by low voter turnouts and lack of media scrutiny. Voter turnout at the last local authority elections was 43% compared with 80% at the General Election one year later. Voter turnout for both has declined in recent years but the fall in local government turnout has been the most pronounced.
- Councils are also subject to much less scrutiny by the media and independent agencies than is central government.

Consultation

- A crucial mechanism to hold councils to account is consultation which is more than just informing people of decisions. Two-way engagement with communities, especially those directly affected by a proposal and providing good quality information on issues and options is crucial.

1.2 Introduction

Local government makes an important contribution to local communities and the country as a whole, but the size of the sector and the range of activities engaged in have expanded significantly in recent years. This has impacts not only in the growing cost to ratepayers, but also the performance of the wider economy.

Ratepayers' equity in local government is \$113 billion or \$24,300 per capita. This is more than the net worth of central government assets and just short of the market capitalisation of all the companies on the New Zealand Stock Exchange. Yet the sector doesn't have the scrutiny one would expect from the media or from the public at large given its size relative to business and central government. What is more, the sector is growing and growing faster than central government.

Increased spending means increased rates. But increased council spending has costs beyond the cost of higher ratepayer bills. There is a crowding out of the private sector as local government increases its share of the economy and a reduction in economic growth as activities are run less efficiently than the private sector would run them.

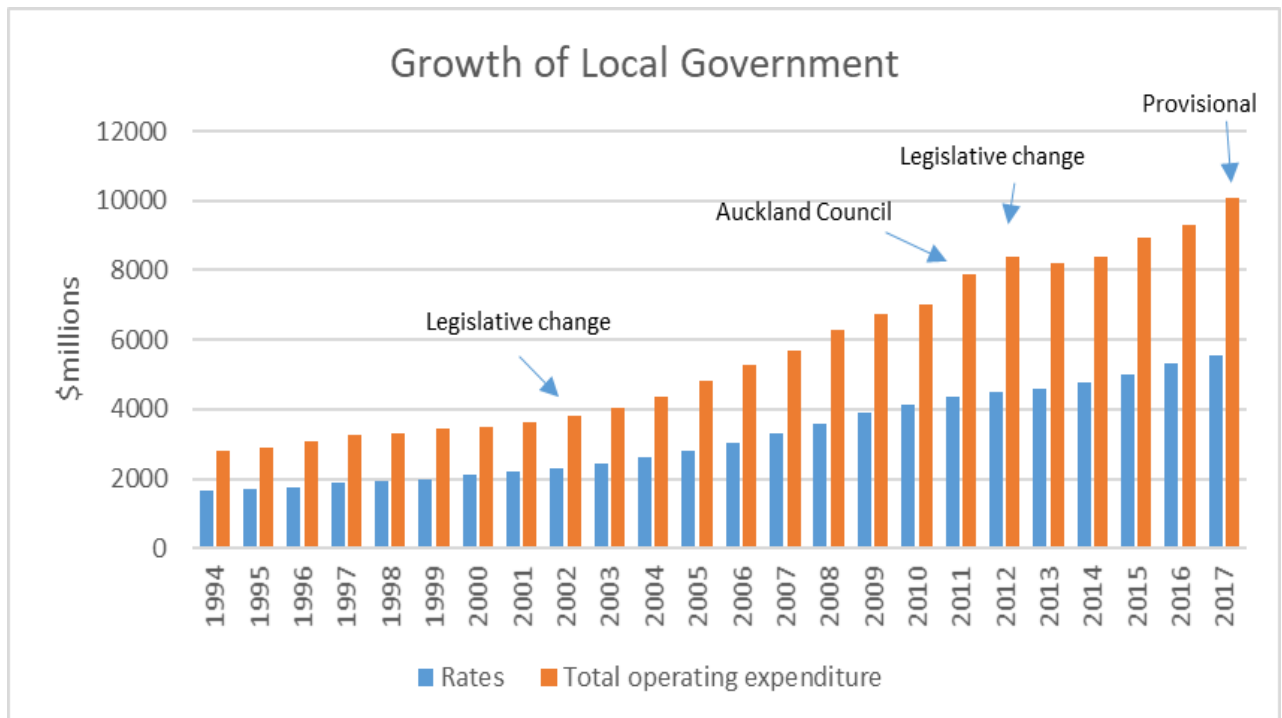
The average rate-rise last year (2017) across the country was 4.6%, much lower than recent averages and the 6.3% the previous year. It is too soon to estimate the coming year's increase but the 2018 Long Term Plans are revealing significant rate rises ahead. For example, Bay of Plenty Regional Council ratepayers face a 12.5% increase in the coming year based on the current draft; Tauranga City, 9.7%; Dunedin City, 7.3% and Queenstown Lakes, 7%. Rural communities in Manawatu District Council face a 23.5% increase.

While there is a genuine need for increased expenditure in some areas in some councils e.g. on new and renewed infrastructure, too often it seems bad choices are being made as to how rates are spent with too much focus on peripheral non-core areas.

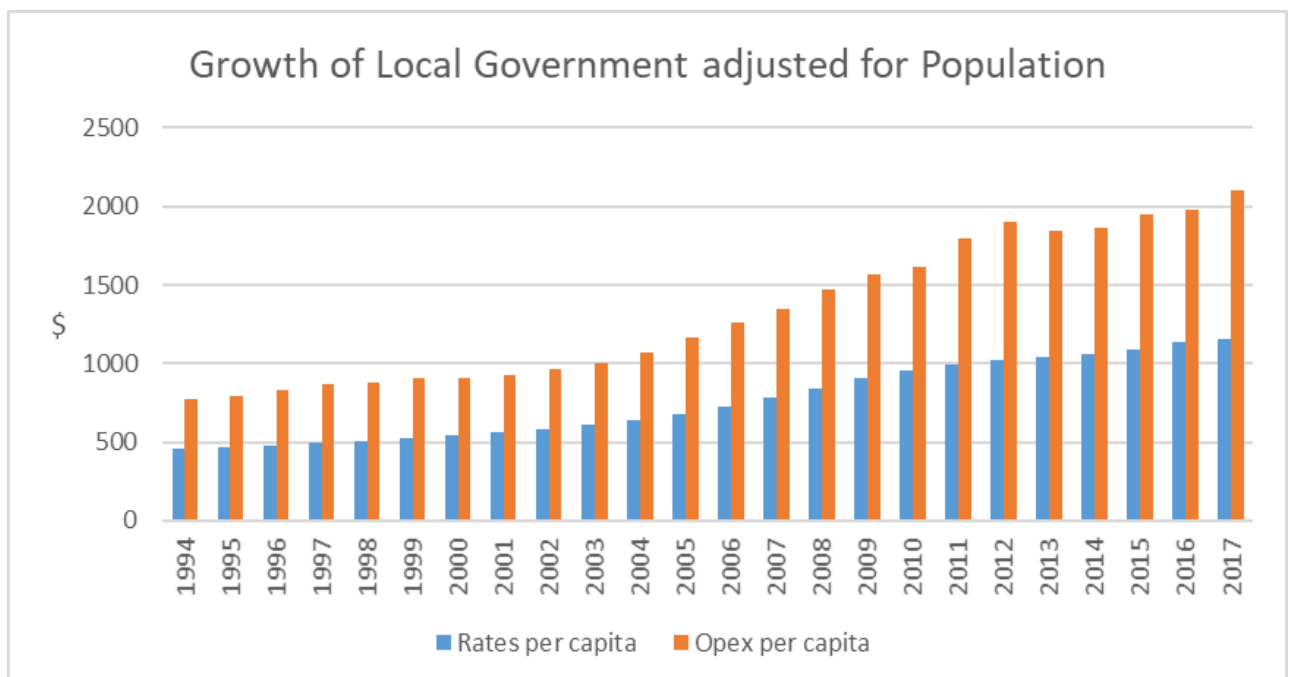
1.3 How has the sector grown in recent years?

The size, reach and scope of local government is expanding. This is true when measured against a number of benchmarks. Total operating expenditure and rates collected between the years 1994 and 2016 are plotted below. It shows expenditure picking up from 2004, likely due to the 2002 change in legislation which broadened councils' scope and purpose. The blip in 2011 and following years is driven by Auckland, (possibly due to reconfiguring of costs relating to the creation of the new council). After a brief flattening of expenditure, the strong upward trend looks as if it has resumed.¹

¹ There was another legislative change in 2012 which aimed to narrow the scope of local government activity, but as shown later, this isn't a reason for the flattening expenditure growth.



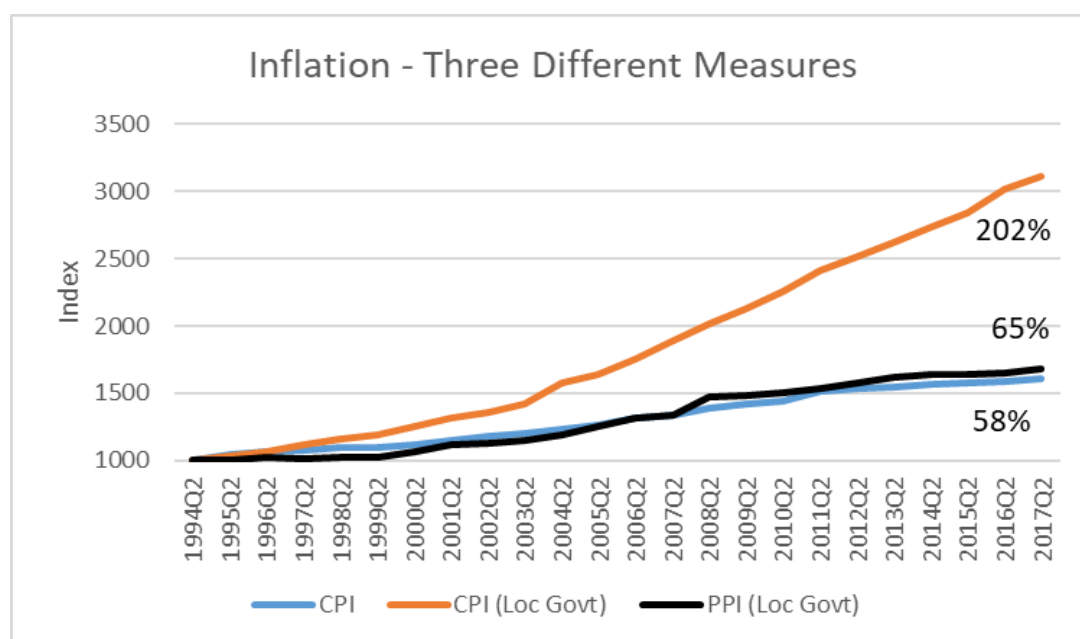
Total rates collected in 2017 across the country were in excess of \$5.5 billion. This was a 234% increase on 1994 or an average of 5.4% per year (6.1% since 2004). Adjusted for population, the growth is still quite substantial. Rates per capita increased 151% between 1994 and 2017 i.e. they are two and a half times as much as they were that year.



1.4 Local government costs and inflation

In comparing rate rises with inflation, a number of different inflation indices can be used. We are interested in movements from the consumers' perspective and also the price of councils' inputs and output over time. The consumer price index (CPI) measures the first of these and the Producers Price Inputs Index (Local Government Administration) the second. As a measure of Local Government output prices, we have used the CPI Local Authority Rates and Payments which are the price of local government outputs faced by consumers.

The following graph plots the three indices and shows that local government costs (black, 65%) have increased slightly faster than the CPI (blue, 58%), since the mid-nineties.



This difference is largely due to costs associated with infrastructure i.e. the price of materials that are used to create roads and pipes, petroleum based products, and construction materials etc having increased relatively more than consumer items. The local government sector likes to emphasise that its costs increasing faster than inflation justify its higher than average rate rises. But in actual fact there isn't that much difference in the scheme of things (65% vis a vis 58% over 23 years) and an even longer-term picture is likely to show a different picture again.

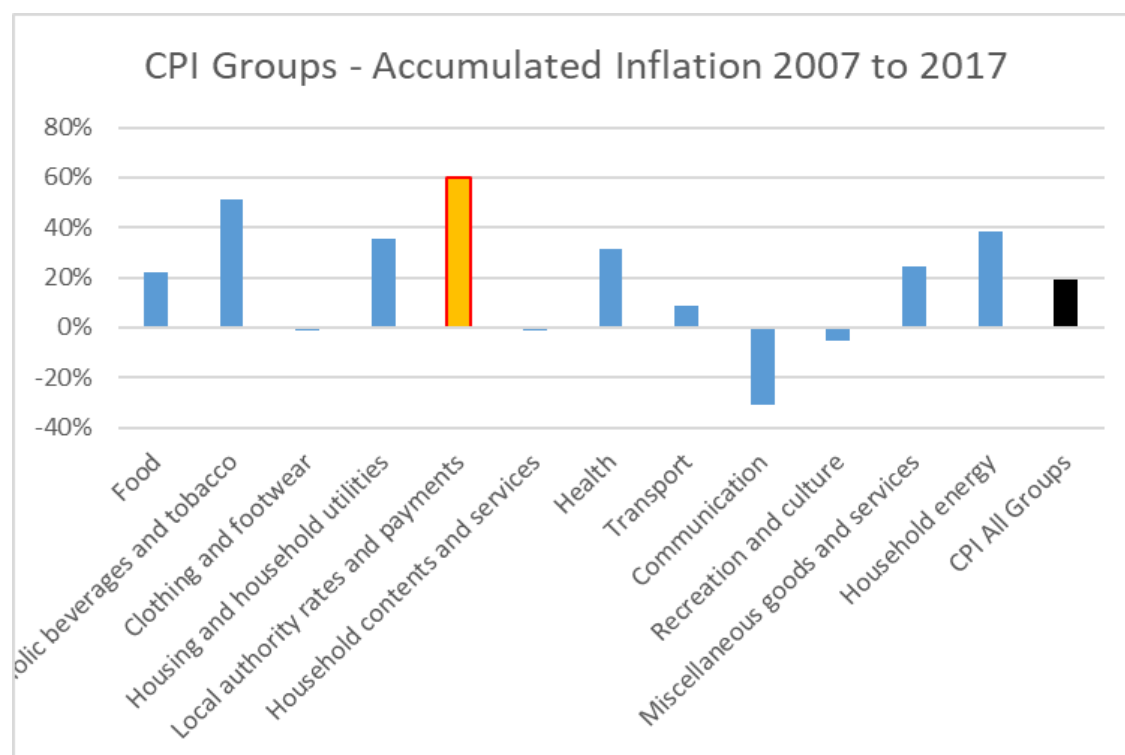
The sector also argues that the CPI is an irrelevant measure for local government. This argument misses the point that the CPI IS relevant to consumers and that it is local government rates that are at the forefront of driving up consumer costs and inflation generally.

The third measure of inflation, the local government component of the CPI (orange), shows how the price of local authority rates and payments for consumers are racing ahead of the other two, 202% (i.e. triple) since 1994 - much faster than both the CPI generally AND the price of local government inputs. This index isn't quite a proxy for output prices because it includes volumes of local government outputs but it emphasises the growing gap between it and consumer prices over all.

Since 1994, the CPI increased 58% but the local government component of the CPI accumulated by 202%! As well as costing consumers, the inflationary pressures from the sector have driven inflation

and kept interest rates higher than they otherwise would have been over much of the period according to the Reserve Bank.

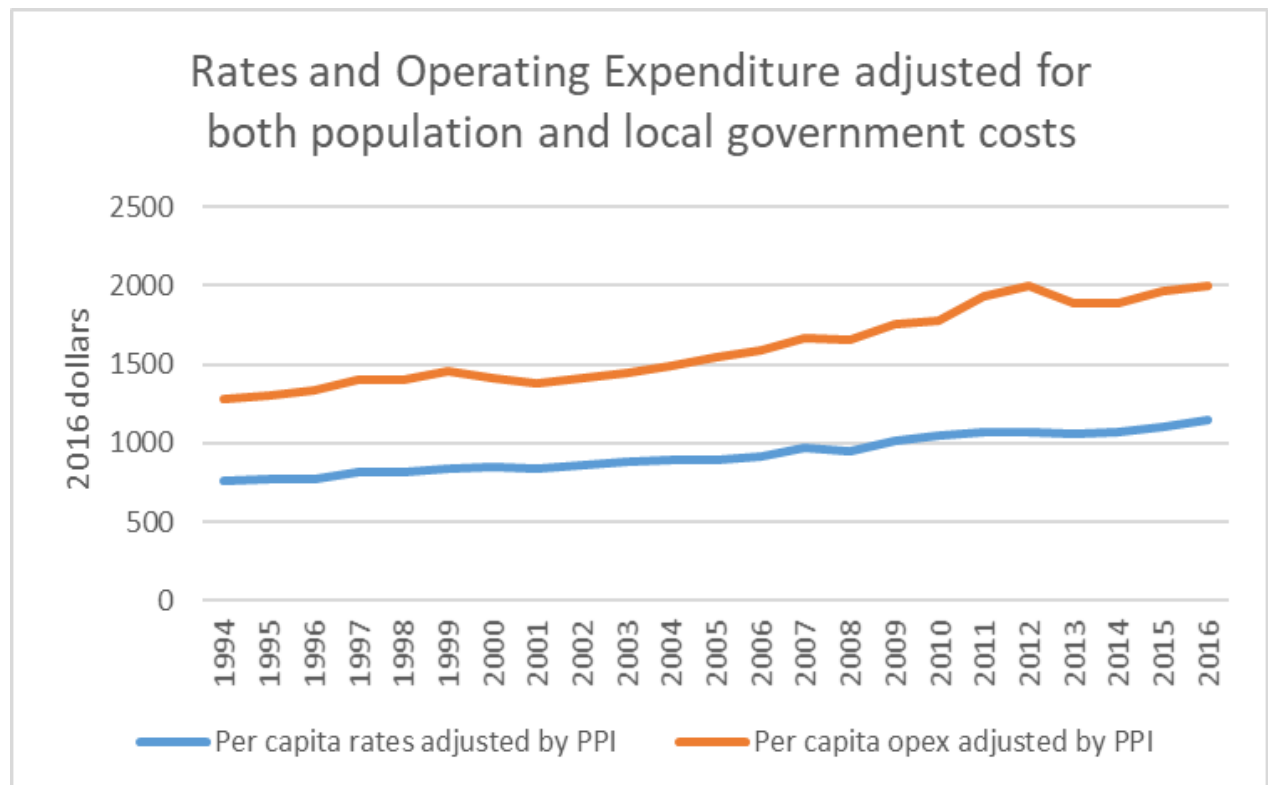
The graph below shows how the local authority component of the CPI has grown compared to the CPI as a whole and some of its other sub-groups over the last ten years. Local Authority Rates and Payments have increased just over 60% for the average consumer, much faster than the other sub-groups. It is significant that the local government contribution is greater than that of alcoholic beverages and tobacco where prices have been aggressively driven up by large ongoing tobacco excise tax hikes; and housing, which incorporates the fast-rising “home ownership” sub-group within it. Notwithstanding its relatively small weight, local government is one of the more significant drivers of inflation in New Zealand and is why the sector has in the past been singled out for criticism by the Reserve Bank.



1.5 Per capita, inflation-adjusted growth

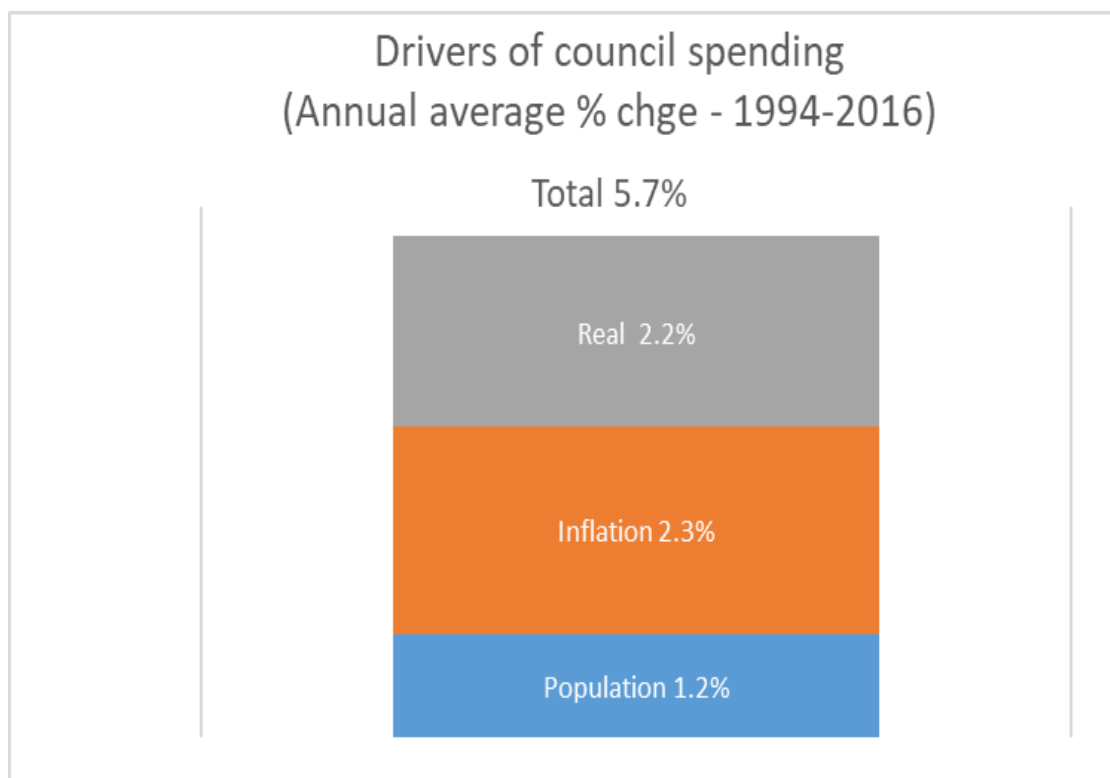
Going back to the per capita rates and operating expenditure increases calculated earlier (in section 2) these can be adjusted for inflation using any of the three measures discussed in section 3.

Using the PPI (which results in a more conservative track), the per capita rates and operating expenditure tracks adjusted for PPI inflation are graphed below. Between 1994 and 2016, they have increased by 50% and 56% respectively. Essentially this is an approximation of the increased cost of services paid by each person.

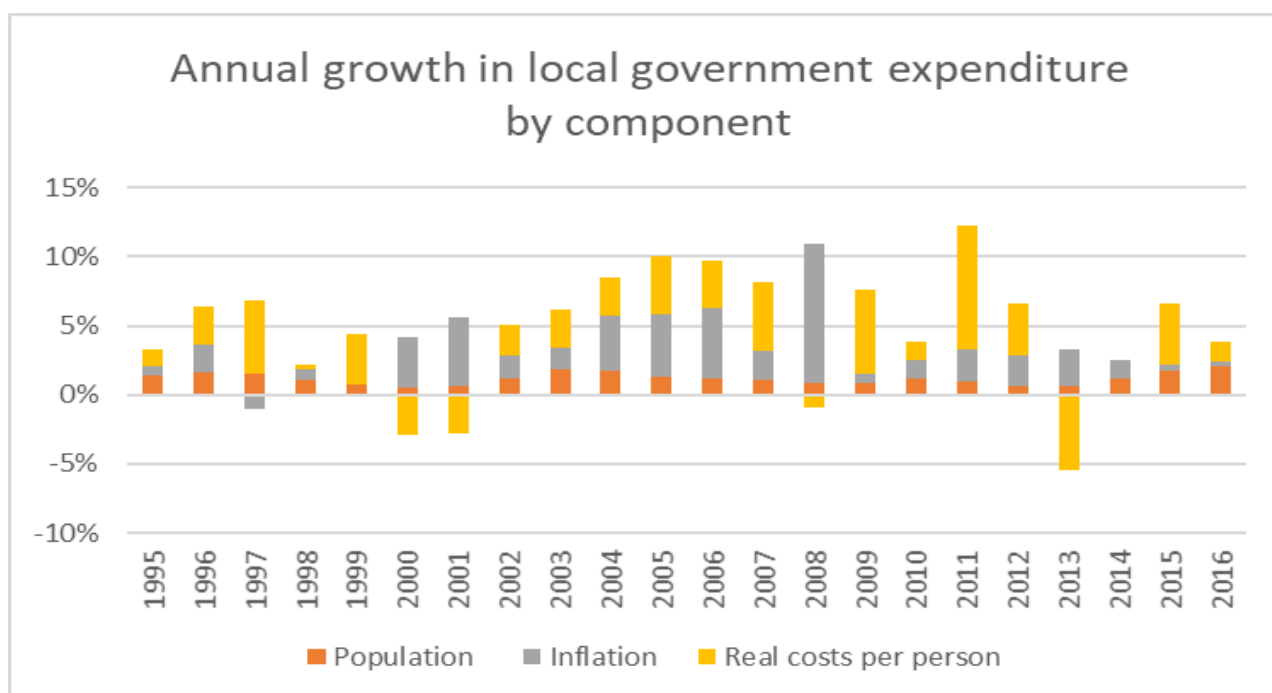


From all of this, we can break down annual expenditure growth into components of population growth, price increases and the residual being a proxy for cost of actual new expenditure per person.

The average annual increase in operating expenditure between 1994 and 2016 was 5.7%. This is made up of average annual population growth of 1.2%, average annual input price increases of 2.3% and an average annual residual of 2.2% approximating increased cost of services paid per person.



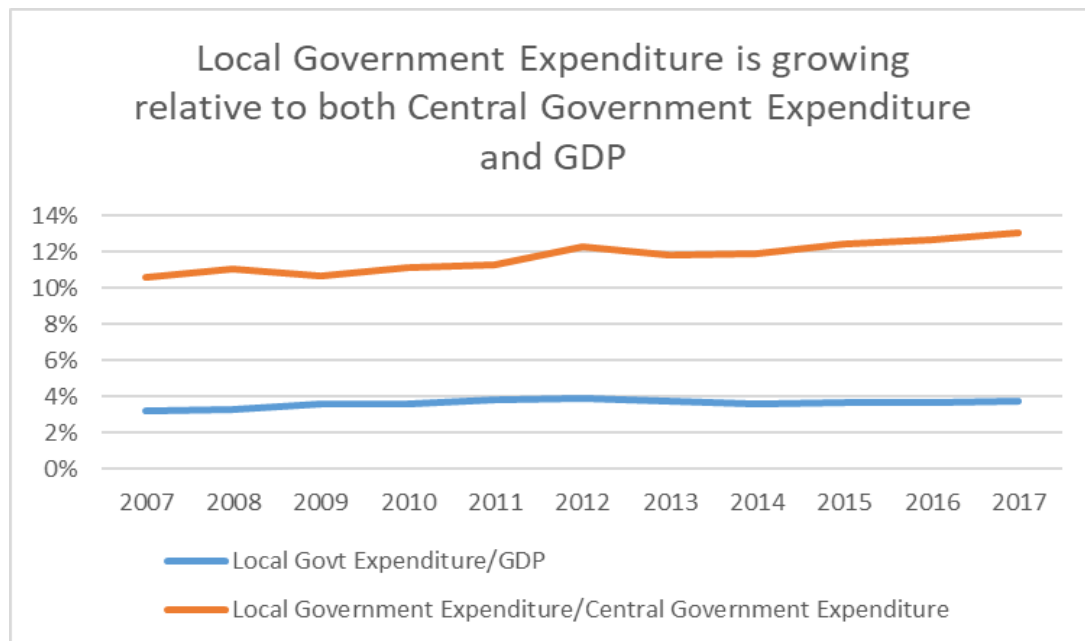
The respective figures are plotted below for every year since 1994. While intended to be just indicative, it is significant that the yellow boxes, i.e. volumes, are predominant from 2009 indicating that real per capita increases have been quite high since then and less driven by population increases and higher prices as was the case in the earlier years.



1.6 Government expenditure and GDP benchmarks

We can also measure local government expenditure against commonly used benchmarks GDP and central government expenditure.

The graph below shows local government expenditure as a percentage of GDP increasing from 3.3% to 3.8% of GDP over the last ten years, and from 10.6% to 13% of central government expenditure.

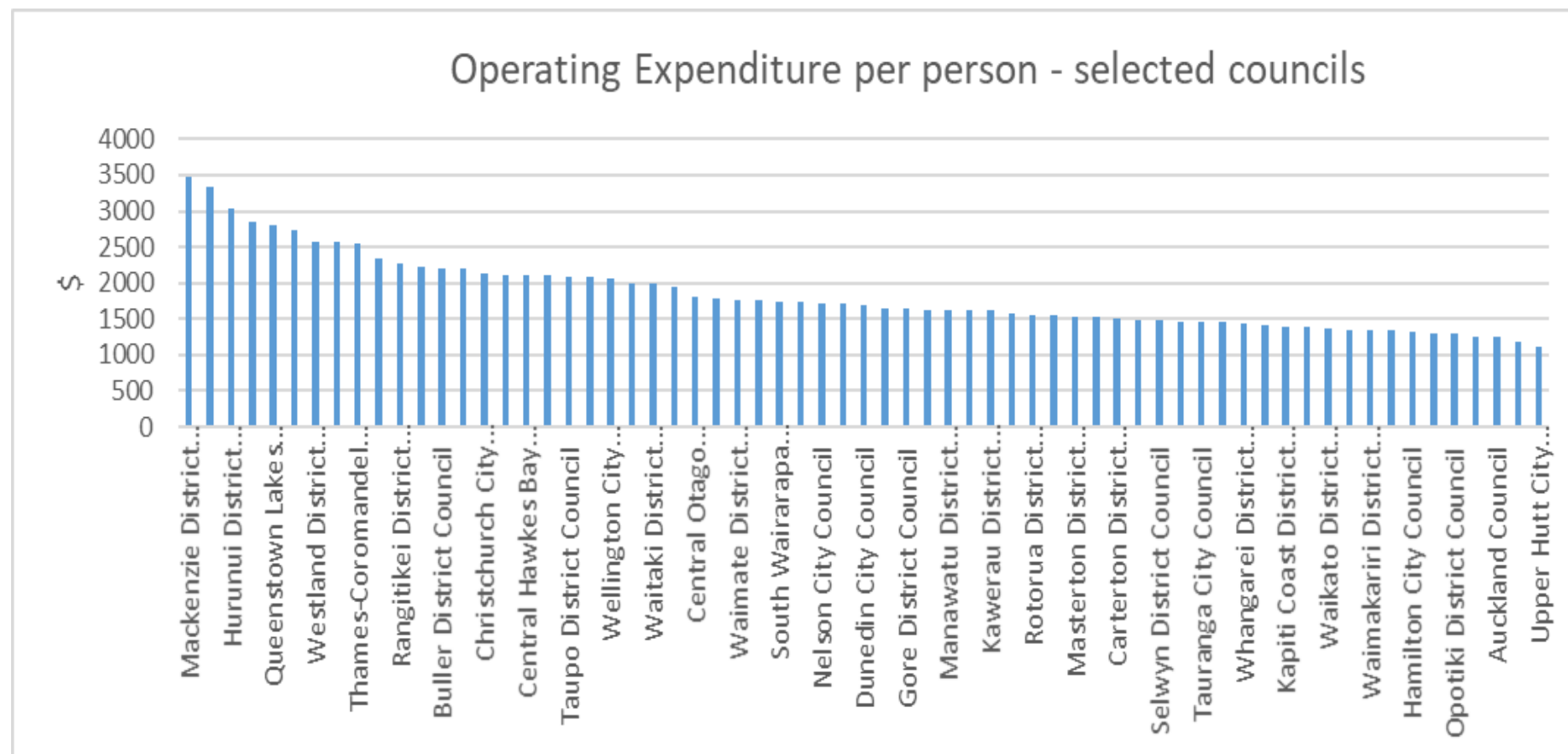


Local government's increasing share of the total economy, as measured by the GDP ratio, has negative implications for economic growth as resources are allocated away from business and activities are run less efficiently than the private sector would run them.

It is significant that local government is growing faster than central government. While governments of all colours have made it a virtue to constrain spending relative to GDP this has not been the case in the local government sector as a whole.

Also, central government has a much more rigorous approach to government spending with Treasury involved in scrutinising departmental votes and the Finance and Expenditure Committee providing additional checks etc. The fragmented nature of local government and the much smaller councils means that replicating something like this isn't possible without a major loss of autonomy, but there could be examples from central government practices as to how local government spending could be better controlled and accountability improved.

1.7 Variation across councils



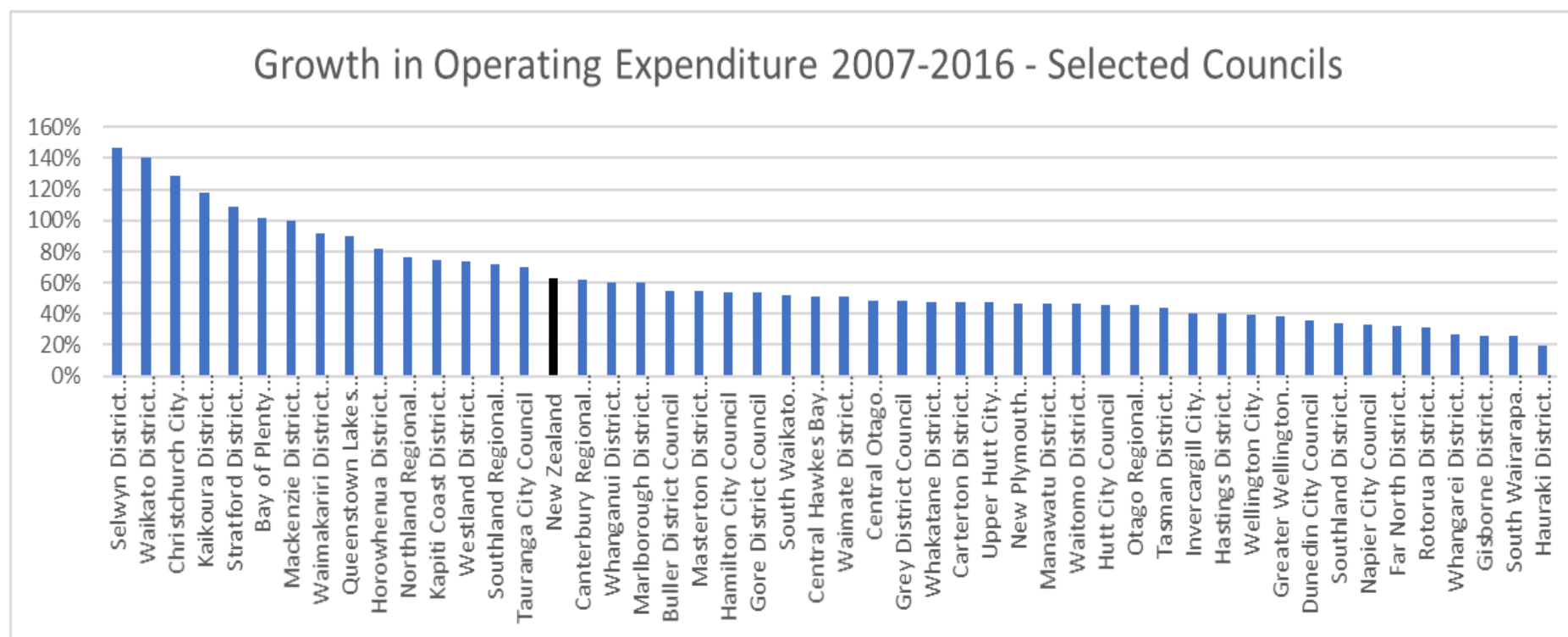
The graph above shows operating expenditure per capita for selected councils. A per capita comparison is chosen because it makes sense to adjust for size of population. Note this is not the same as per residential ratepayer. Councils with large business sectors can reduce the rates residential ratepayers pay but a per capita comparison captures all rates including those paid by business.

The wide variation across councils is unsurprising due to the diversity of councils and their different characteristics. Things like population growth, size of the rating base, rural urban mix, expected growth and relative wealth all play a major role in determining expenditure levels and funding challenges as much as council policy decisions and expenditure priorities. While many council decisions are seeing ratepayers' funds spent unwisely, at the same time there are genuine pressures (i.e. infrastructure) on many councils that need to be addressed and funded.

The larger cities tend to pay less per capita – pointing to the economies of scale that are available and the benefits of a large rating base to spread costs across. Councils which have experienced population decline tend to have high per capita spending.

This diversity also explains the wide variation in growth in recent years. The graph below shows growth in operating expenditure for some selected councils between 2007 and 2016. Total spending grew 68% over that period but at one extreme, one council grew 147% (two and a half times) whereas another grew only 20%.

A handful of councils have seen operating expenses more than double in the last ten years whereas others have been more constrained. Generally, population growth is the major determinant of differences in expenditure growth but there are some exceptions. For example, South Taranaki and Stratford have shown significant expenditure growth with relatively stagnant population growth. Some have good reasons for expenditure growth e.g. those recovering from earthquake but many are less obvious.



Figures have been aggregated for categories of councils as shown in the table namely; metro, provincial and rural, as well as separated Auckland out, and including the regional councils together. The table also shows forecasts based on the Long Term Plans of 2006/7 and it is interesting looking at how they bore out.

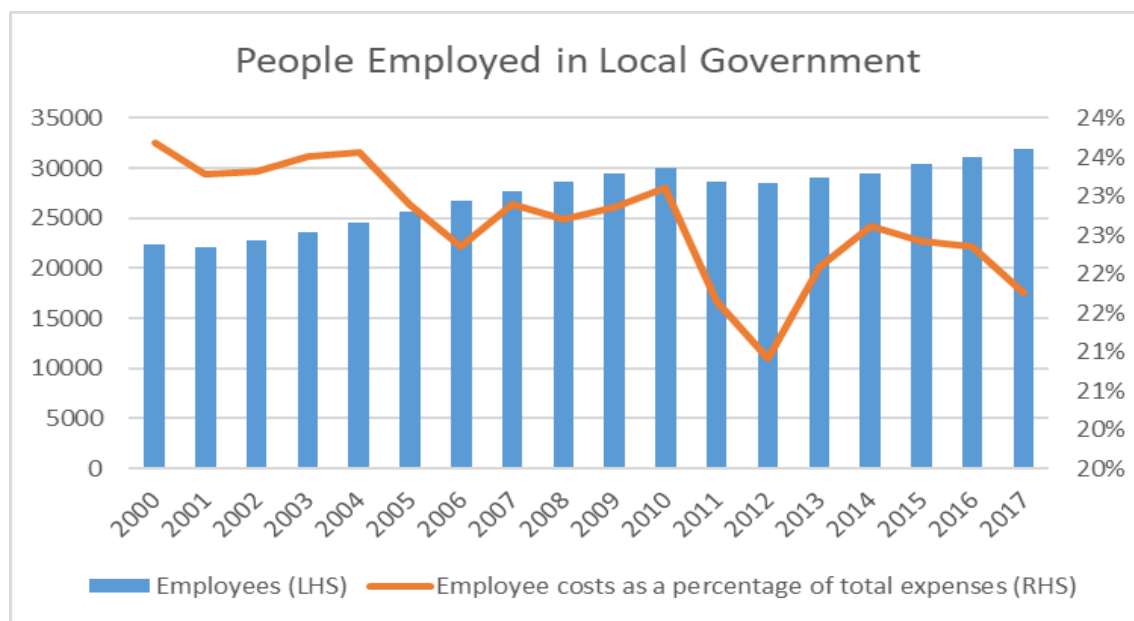
Table 1.1 shows that rural authorities had the smallest increases in operating expenditure and metros the largest – probably reflecting the size of their population gains. This relativity was predicted when operating expenditure was forecast in 2007 but the size of the increased expenditure has turned out to be much higher than that forecast. The relative shares of operating expenditure correspond pretty well to population shares with the exception of provincial authorities which can operate on lower expenditure per capita.

Table 1.1: Total Operating expenditure for local authorities categorised by population

	Number of Councils	Total Opex 2007 (\$m)	Total Opex 2016 (\$m)	% change 2007 to 2016 (Actual)	2007 Forecast. % change 2007 to 2016	% of total sector opex 2016	% of population 2016
Auckland	1	\$1,762.9	\$3,097.8	76%	n/a	33%	34%
Metro	8	\$1,271.2	\$2,148.8	69%	50%	23%	26%
Provincial	33	\$1,725.0	\$2,609.8	51%	40%	28%	34%
Rural	25	\$407.4	\$605.9	49%	30%	7%	6%
Regional	11	\$539.3	\$819.9	52%	35%	9%	
Total	78	\$5,532.3	\$9,282.1	68%	42%	100%	100%

1.8 Local government staff numbers, Salaries and Wages

Consistent with a growing sector, numbers employed in local government have increased significantly in recent years. According to Statistics New Zealand's Business Demography Database there are now 31,900 people employed in the sector across the country up 42% since 2000. The job growth in the sector is greater than that for the economy as a whole which was up 34% over the same period.



The increase in employee numbers is reflected in increased staff costs (up 64% since 2000) but it is significant that as a percentage of total operating costs, staff costs have been declining (see graph above). Also, as a point of comparison, it's notable that jobs in the local government sector have not increased as fast as the number of jobs in central government which is up 79.6% since 2000 according to the Business Demography Database.

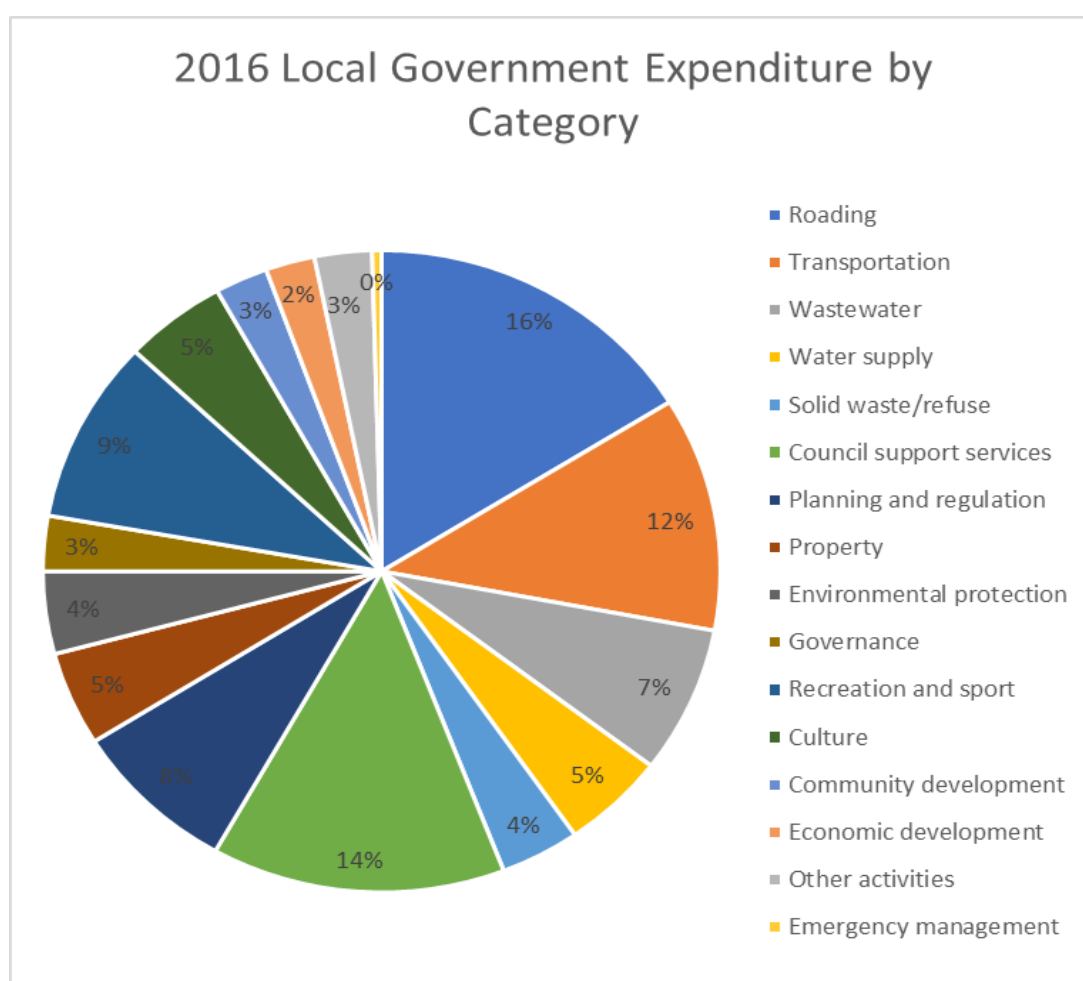
In terms of wages, the best published data is Stats New Zealand Labour Cost Index, which has been published since June 2009. This has the Local Government Administration sector ranked 16th out of 37 industries in terms of salary and wage growth between June 2009 (when the data begins) and June 2017. However, the 16.4% over 8.5 years is no evidence of excessive increases in local government wages.

According to research done by the Taxpayers Union, councils have 27,895 FTE staff in total and 11% (3,079 people) earn over \$100,000. 34% of those (1,055 people) are at Auckland City Council. Of councils employing more than 50 people, Waikato District has the highest percentage of people earning more than \$100,000, 16%, and Napier City the lowest at 4.9%.

There is no information to show how these numbers have changed as councils have got larger. The proportion of New Zealanders earning more than \$100,000 across the board is around 9% but this may not be on a strictly comparable basis.

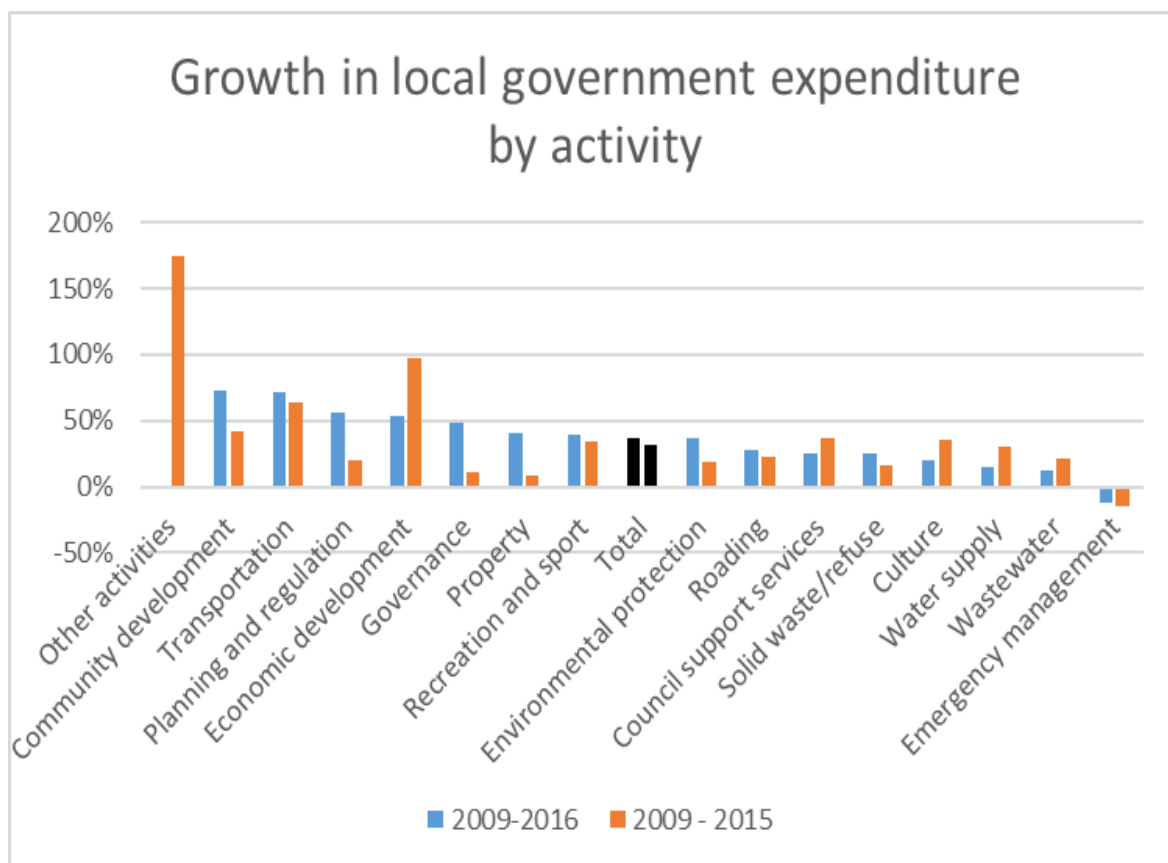
1.9 What activities are councils undertaking and how has this changed over time?

Statistics New Zealand collects local government expenditure data broken down into sixteen categories. The New Zealand-wide figures for 2016 are presented in the pie chart below. Roothing and transport together make up 28%. The three waters, water supply, waste water and solid waste make up 16%. The categories economic development; culture; recreation and sport; and community development make up 19%. Of course, there is lots of variation across the country.



The data has only been collected since 2009 under this categorisation but it shows some interesting changes since then. The following graph shows how spending by activity has changed since 2009 in percentage terms².

² Both 2015 and 2016 are shown compared with 2009 as 2016 seems to be an outlier on many fronts due to distortions created by one off spending changes in some large council areas.



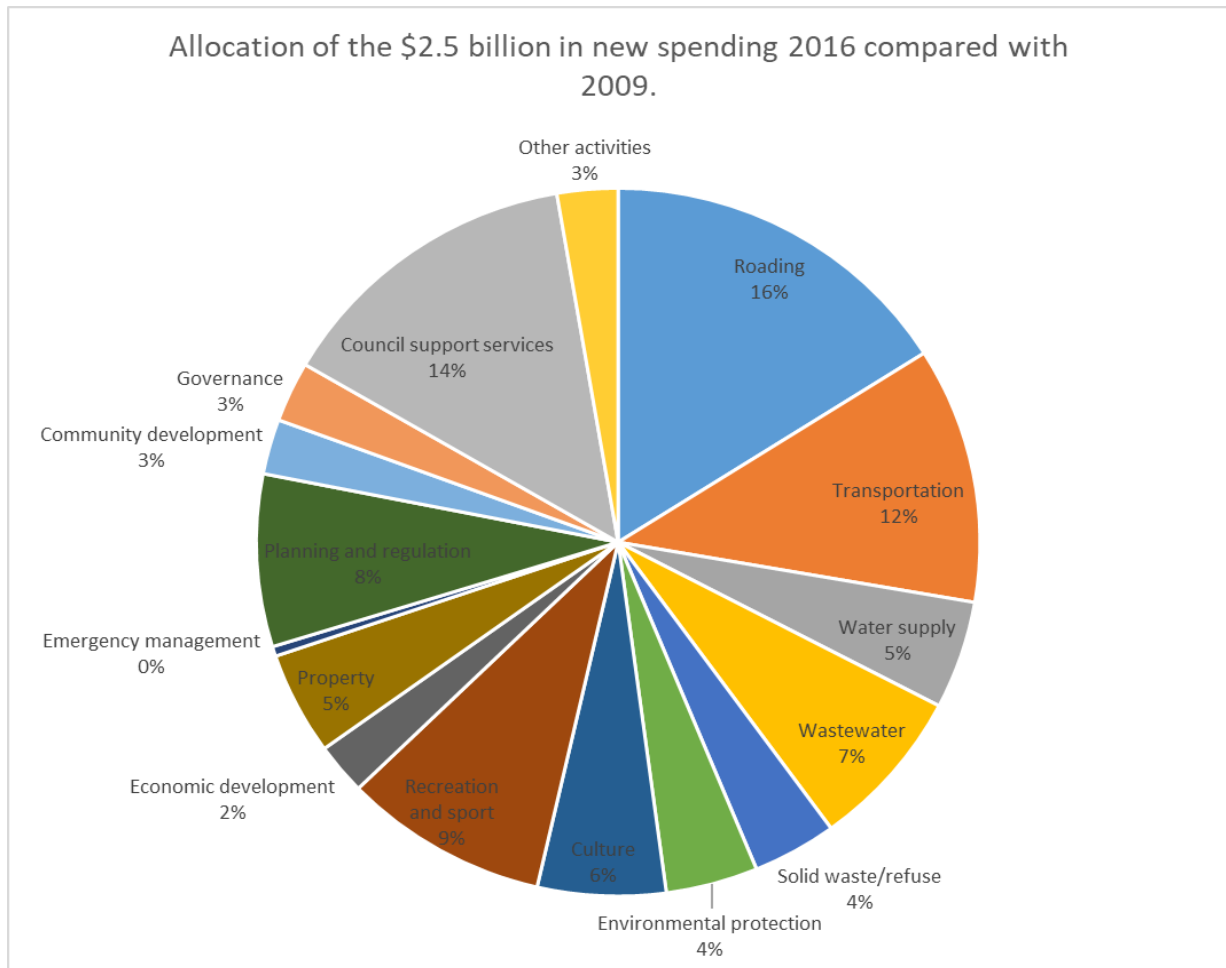
All those to the right of “Total” have had a declining share, the left an increasing share. Note that the share of traditional areas, sewerage, water, wastewater etc have all declined and “non-core” activities such as sport and economic development have grown the most. The biggest area of growth is the category “other activities” which could include all manner of activities not otherwise categorised.

This suggests a broadening of scope and it also suggests a shift away from traditional core business. Councils’ diversification away from traditional activities accompanied the 2002 change in legislation which broadened local government’s purpose.

It is worth noting that in 2012, in between the years being compared, reform of the Local Government Act sought to narrow the scope of local government activities by removing the promotion of economic, social, environmental and cultural wellbeing (the so-called four wellbeings) from the purpose of local government as set out in the Act. In spite of concern in local government circles it would seem that this change has not had the expected constraining influence and to the contrary the scope has broadened. Nevertheless, the new government has recently introduced a Bill to “restore” this purpose and put the four wellbeings back in. While the current Act hasn’t stopped councils spending on ‘non-core’ things, this change gives local government more explicit encouragement to do so.

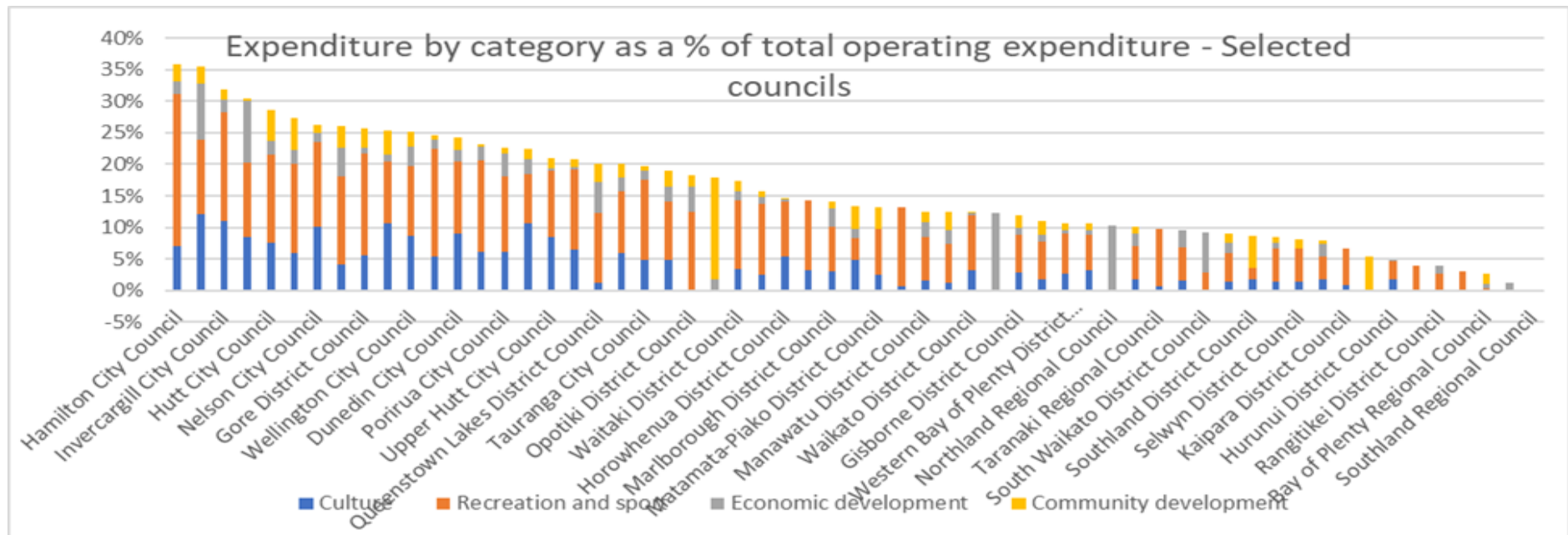
The role has widened but this isn’t necessarily the main driver of the *growth* in local government expenditure as many of the growth activities are off a small base and while the growth rates are large, they are relatively small amounts. E.g. Economic Development increased from 2% up to 3.1% of the total between 2009 and 2015. Nevertheless, the broader range of activities councils now get involved with is certainly making a contribution.

The pie chart below gives a better indication of the expenditure increases in dollar amounts as opposed to percentage increase. It shows a breakdown of how the total operating expenditure increase of \$2,500 million between 2009 and 2016 was allocated across categories.



1.10 What is Core-business?

The following graph looks more closely at the topical categories culture; economic development; recreation and sport; and community development. By some peoples reckoning these make up non-core business although this is a subjective term and it is too simplistic to make this assertion. There are also issues around how different activities have been categorised by different councils which could muddy the data.



The graph illustrates the wide range of variations across all councils and across each of the four categories. 35% of Hamilton City Council's expenditure is made up of the four categories, dominated by recreation and sport all the way down to Rangitikei's 4%. Regions spend the least, proportionality, on this type of expenditure; then districts; and cities spend the most.

A better definition of core business, or defining what is an appropriate role for local government is needed than this. The Local Government Forum says councils should focus on the provision of “public goods and services”³ where their provision will likely be inadequate, if left to the private sector due to a low or in the worst case, non-existent, return on investment. Or in other words things that would not otherwise be done by central government or by the private sector.

A wider definition would include activities that are supported by a group of ratepayers who wish to club together to fund a specific activity and it makes sense to do so through the local authority. For example, flood protection and tourism promotion. These activities are (or should be) funded by targeted rates paid by defined groups of ratepayers. If ratepayers support the nice-to-haves and the costs are known and transparent, then local government involvement might be acceptable but it is essential that the important, often boring, stuff (e.g. infrastructure) is done well first.

Local government is not well placed to do many of the things it is increasingly getting into - often being taken advantage of by private sector partners who know how to game the system or exploit “cozy relationships”. Property developments, airline incentives (beyond normal airport practice), financial support for selected businesses and approaches from sporting clubs are all examples of these. Sometimes councils receive opportunist requests by private sector parties seeking financial support for activities that would go ahead anyway even without the councils’ support.

³ i.e. the definition of public goods and services is based on the economics definition not goods and services deemed to be for “the public”, or “in the public good”.

1.10 What are the reasons for the growth in the local government sector over recent years?

The growth in local government spending in recent years can be attributed to the following drivers:

Infrastructure demands- Many councils are facing growing **population and visitor numbers** which are putting pressure on infrastructure. These are (usually) legitimate expenditure drivers which need to be funded. In some areas increases in *per capita* spending are driven by population decline (ie costs spread over fewer people.)

Cost rises- These were discussed earlier. There is no doubt that in the past local government input prices have risen faster than inflation generally but these movements only explain a small portion of higher expenditure. And it is important to remember that these higher input prices won't continue for ever.

Government requirements- Central government imposes some requirements on local government which carry costs. While these are often exaggerated by the sector, they are a legitimate driver of increased expenditure which have to be passed on to ratepayers. Consequently, a case could be made for small central government compensatory transfers to local government as discussed in the accompanying paper, Local Government Alternative Funding.

Inefficiencies- There seems to be significant waste in council operations. This is unsurprising given councils have a monopoly in the provision of many of their services and because much of their income is guaranteed by legislation. It is important that inefficiencies in the delivery of activities are not allowed to arise.

Broadening scope- As found earlier, the dollar values of new and non-core activities have increased but they are not the major drivers of the growth in total costs. They are however significant enough to be of concern especially if allowed to continue. The Briefing for the Incoming Minister singled broadening scope out as a driver of expenditure growth. Local government involvement in activities outside their scope has costs beyond rate rises in that they crowd out the generally more efficient private sector.

Community Expectations- Often the broadening scope (and increased expenditure generally) is councils responding to what they say is community demand or expectation. Often this assertion is backed up by very little evidence.

Often community expectation is an excuse given for pet projects or special interest group lobbying not from the community generally. Where it is, it is important the community is made aware of the costs of these activities and that the groups wanting the activity pay for it (though targeted rates). Increased transparency is key to flushing this out. See discussion below.

1.11 Transparency

One important way to hold council costs is to maximise transparency and to be sure that new activities are subject to close scrutiny. Councils need to provide simple information that shows ratepayers what they are paying for and how much. Itemising how rates are spent in the bills sent by councils would hammer home to ratepayers what services are costing and encourage questions to be asked.

In cities and districts where groups of ratepayers (for example, the business community or farmers) pay a high share of the general rates burden due to their high value properties, the size of their rating base and, in the case of the business sector, the high differentials they pay, other groups (for example residential ratepayers) are not fully exposed to the costs of the service they are receiving.

If this cross-subsidy were removed, residential households would become more exposed to high council spending (which they are currently shielded from) and the increased level of awareness and scrutiny would produce a wider constituency calling for councils to show more spending constraint. If it is too politically difficult to remove this cross-subsidy, councils – at the very least - must be more transparent in showing it exists, showing how their rates are determined so it is apparent who is paying what.

Currently councils can't be reliably compared because of different ways of reporting etc. Rectifying this and enabling comparisons across councils would provide incentives for councils to improve their practices.

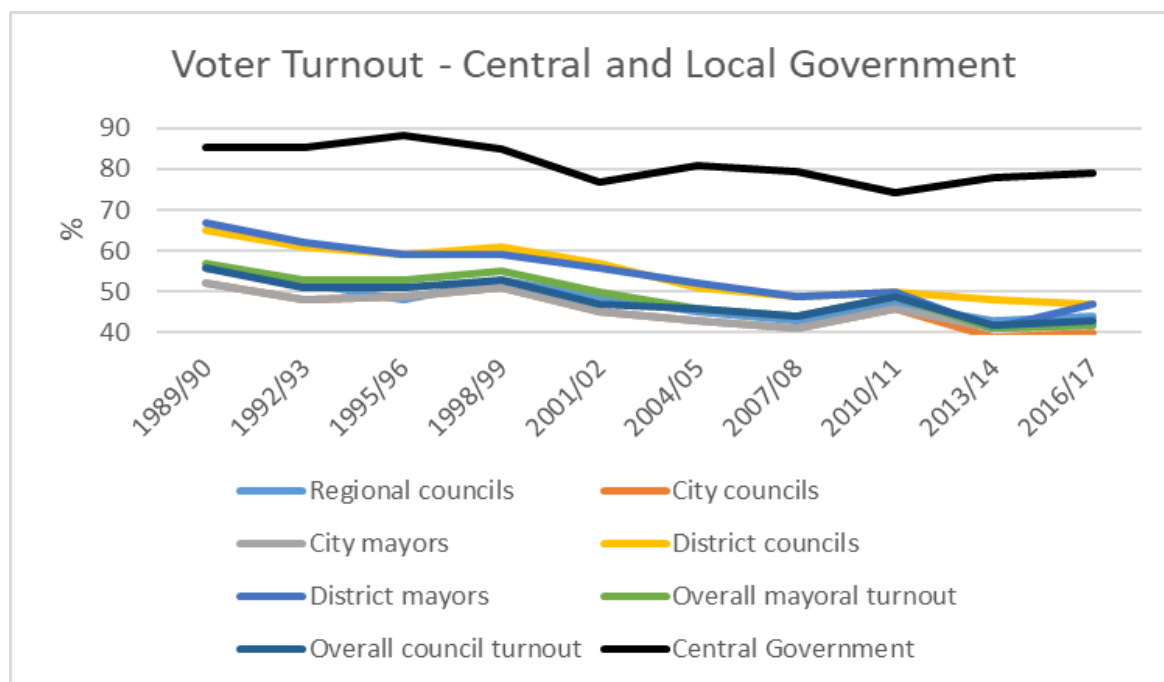
Finally, tenants are often unaware of the costs because although they pay the rates indirectly as part of their rent these are not made transparent by the landlord who simply passes them on. This applies to both business and residential tenants. More visibility here would show tenants how much they are paying and bring more scrutiny from a large and important section of the community.

Apathy towards local government

One factor allowing lack of transparency and contributing to why local government expenditure has been allowed to grow is the lack of interest shown in local government from the public and the media. Relative to national politics, there is apathy towards local government as evidenced by **low voter turnouts**. The graph overleaf⁴ shows the extent of the decline in local government election turnouts compared with central government (which is also declining but not by as much).

Voter turnout at the last council election was 43% (40% for cities) down from 56% in the 1990 election 52% for cities). Over the same period, the general election turnout fell from 85% to 80%. This disinterest has a direct bearing on the quality of council candidates as well as the election outcomes.

⁴ Higher turnout in the 2010 local government elections was partly attributable to increased local voting for the first Auckland "super city" election and increased voting in Christchurch following the 2010 Canterbury earthquake.



Councils are also subject to much less **scrutiny by the media** and independent agencies than is central government. Such scrutiny and interest provide a natural check on central government but in local government they are much less prevalent. For example, the Parliamentary Press Gallery plays an important role in bringing government to account which local government misses out.

In terms of media scrutiny, one measure of this is the number of times the following words appear in the media. It may not be very scientific but a simple google search revealed the following numbers of hits.

Table 1.2 Google Search for Local and central government terms

	No of hits in a Google media search
Government nz	3.1m
Local government nz	341k
Central government nz	1.64m
Council nz	1.51m
City council nz	449k
District council nz	177k
Beehive nz	17.7k
Phil Goff nz	300k
Lianne Dalziel nz	53k
Justin Lester nz	377k (Maybe a Wgtn bias in google because of my location?)
Jacinda Ardern nz	1.57M
Simon Bridges nz	645K

Central government terms and politicians feature far more heavily in spite of the fact that there are 78 councils being reported on.

1.12 Consultation

A crucial mechanism to hold councils to account is consultation.

Consultation is more than just informing people of decisions. It is about two-way engagement with communities, especially those directly affected by proposal and providing good quality information on issues and options.

Notwithstanding low voter turnout and apathy among the public for local government, councils are receiving more and more submissions. This might appear contradictory but many are circulars provided by interest groups. And the greater number of submissions means there is less quality time for submissions to be heard and considered.

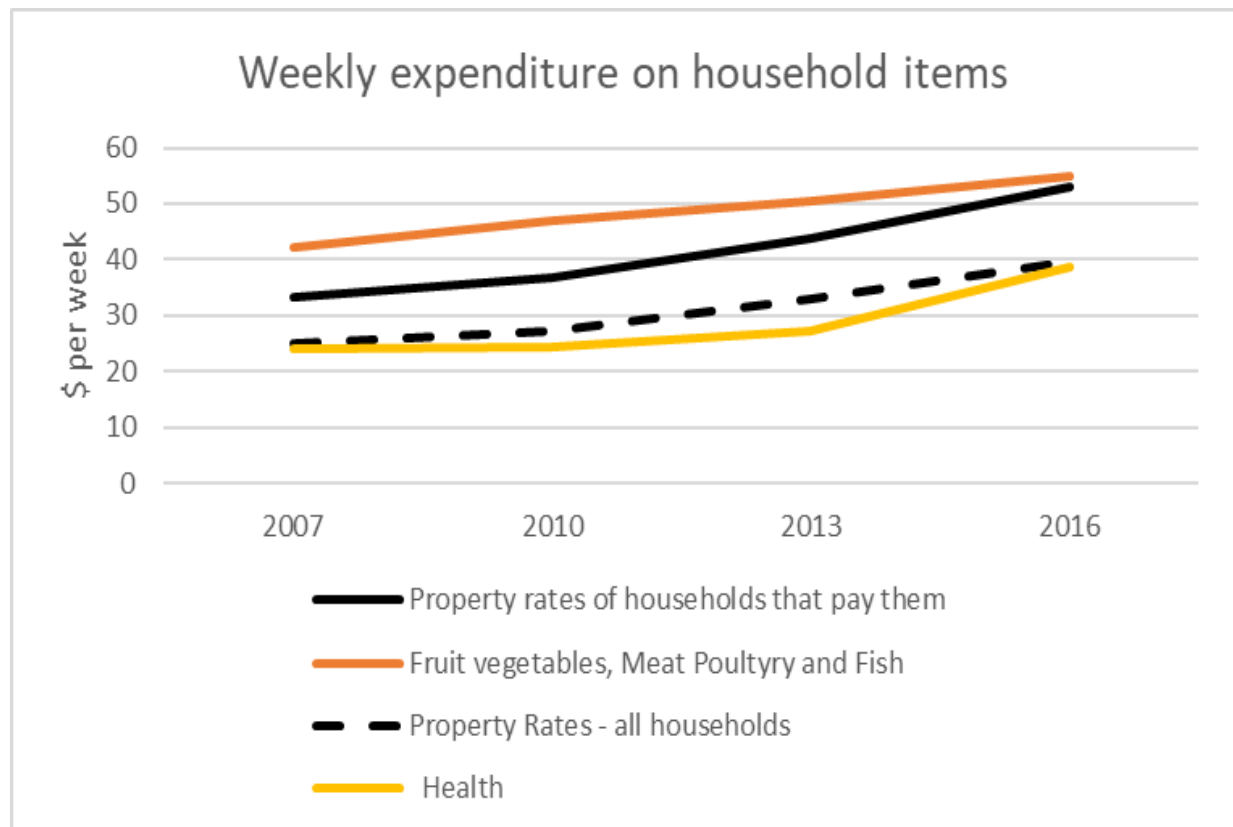
A 2014 amendment to the Local Government Act has resulted this year in some councils not consulting on their annual plans or only doing so in a perfunctory manner. At least five councils chose not to consult at all on their 2017 Annual Plans.

Improved methods of consultation would go a long way towards raising the level of engagement and reducing the apathy among ratepayers and the community and paving the way for an improvement of transparency and scrutiny of council activities.

1.13 Impact of Rates on Households

Rates are a significant item of household expenditure. According to the Household Expenditure Survey, the average household that pays rates⁵ spent \$53.1 weekly in 2016 the latest year the survey has been undertaken. When averaged over all households it drops to \$39.50 weekly but this figure understates the incidence because non-property owners still pay rates indirectly as they are built into their rents etc.

The graph below shows how these weekly expenditures have increased against essential household items; fruit, vegetables, meat, poultry and fish; and health.



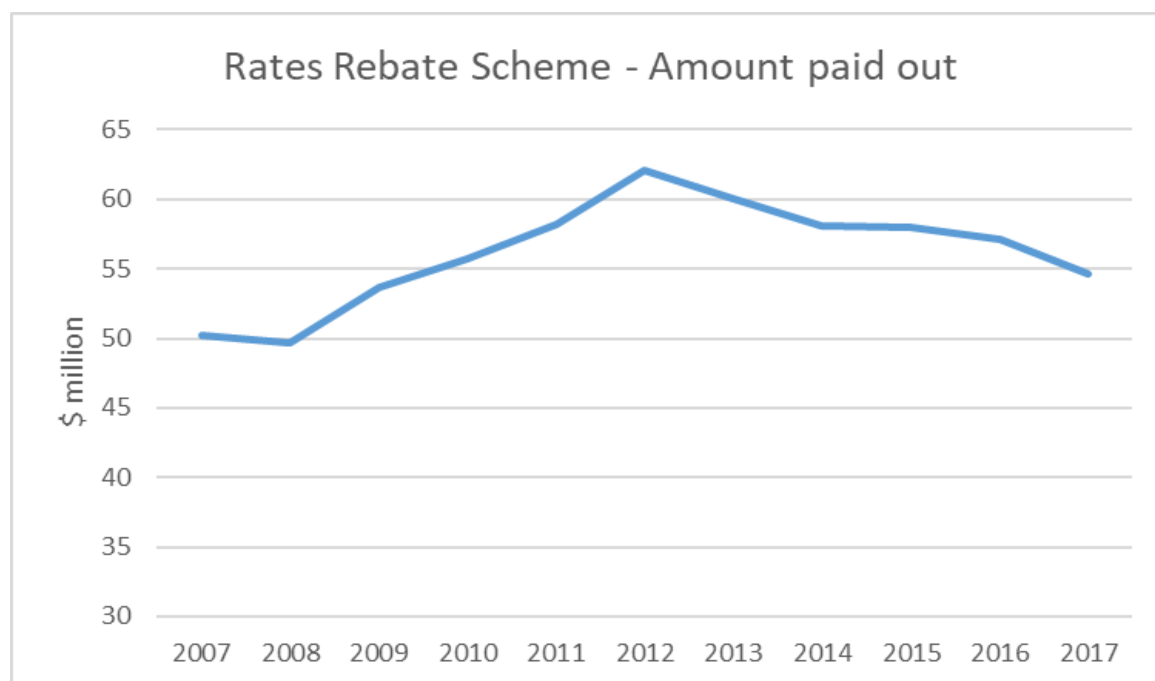
⁵ Households that don't directly pay rates, for example they may rent, are excluded from this average

1.14 Unaffordability

The rate rises experienced in the last ten years – well in excess of the rate of inflation and taking a growing share of household expenditure, are impacting detrimentally on some households. Many, particularly those on fixed incomes, are facing economic hardship. Rate rises are also contributing to increasing unaffordability of housing in New Zealand both rental and ownership.

The 2007 Rates Inquiry found affordability problems for some sections of the community, would increase over the next 10 years to the extent that rates would not be sustainable in 10 years' time. This was a key reason for its recommendation that they be reduced as a source of local government income. It is significant that in 2017, rates are still the dominant source of revenue and have increased as a percentage of operating income since then.

The Rates Rebate Scheme was established in 1973 to assist low-income and/or older ratepayers facing affordability pressures who wished to stay in their own homes but the scheme does not seem to be working well as the take-up is low and declining even as rates go up. Under the scheme low income earners are entitled to a rebate of \$620 per annum if their income is below a certain threshold (incomes of less than \$24,790 entitle ratepayers to the full amount). The fact that the payments and thresholds have not been adjusted for more than a decade, which means the entitlement is shrinking in real terms and getting harder to be eligible for, is one reason for this. In addition, the scheme is not well publicised either by central government or by councils themselves.



A revamp of this scheme is overdue, but the end of the day rates are unaffordable because councils are spending too much. The only sustainable solution to this is for councils to constrain their expenditure.

1.15 Other Issues

To build a constituency that is broader than business there may be other issues associated with the local government sector where there would be strong empathy from residents.

Here are some possibilities:

Length of Council term- Should there be a debate on the current **three-year term**? As with central government there is a case for increasing this to four years so that the election cycle doesn't get in the way of good decision making.

Number of terms- At the same time a time limit on serving for councils could be introduced. Perhaps three terms? This would help pave way for fresh ideas and could improve the quality of councillors by preventing lower performing councillors staying in office for too long which can happen with the current disinterest in local government where name recognition helps candidates win election.

Public perceptions of council performance- LGNZ's own three-yearly surveys reveal the general public have a dim view of local government and its spending decisions.

54% of the public, and 50% of businesses, believe the performance of local government has got worse in the last three years (32% and 31% thought it has got better). On LGNZ's measure covering performance, spending decisions, and value for money, the score has gone down from 28% in 2014, to 27% now.

Part 2 – Local Government Funding Mechanisms

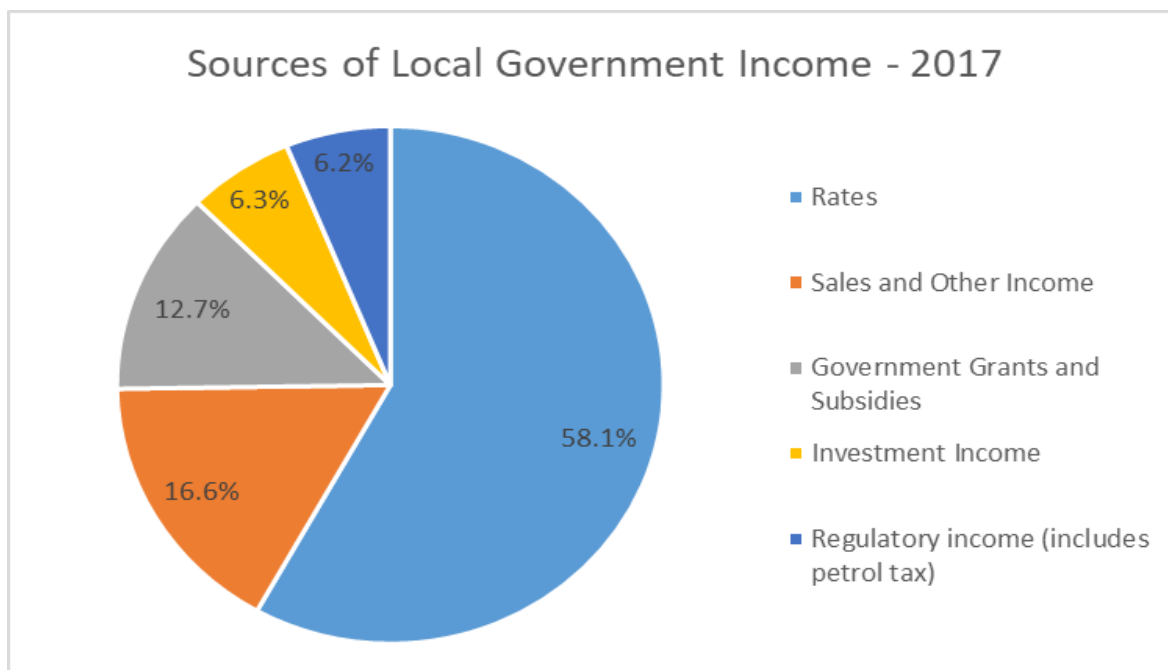
2.1 Key Points

- Property values are not a good indicator of wealth, income nor ability to pay. Many ratepayers, for example farmers and pensioners, may be asset rich but income poor. Neither is there a sound relationship between property values and the benefits received.
- Value-based rates incur high costs relating to the need to maintain a database of property values. Rateable Values are notoriously unreliable and can quickly become out of date which has significant implications for relative rates bills.
- Councils use of differentials to moderate value-based rates is arbitrary and highlights that property valuations are an unfair mechanism to raise revenue not reflecting either benefits received nor ability to pay.
- The 2007 Rates Inquiry recommended rates be reduced to 50% of operating income by 2017, down from 56%. Today rates are still the dominant source of revenue and have increased to 58% of operating income.
- Clever use of charging mechanisms, including likely differentials between local, non-local and international visitors, will reduce the need for bed taxes, accommodation rates and border levies as well as reduce the demands on ratepayers (and taxpayers) generally.
- Any central government transfers to councils in light of current population growth and tourism boom should be contestable; tagged for specific projects and funded out of general crown revenue.
- Crown land rating exemptions should be removed so government owned organisations pay their fair share towards council operations.
- The following alternative funding mechanisms have merit and further investigation is recommended.
 - Reimbursement of costs passed down from central government.
 - Contestable funding from central government tagged to specific infrastructure projects.
 - Value capture tax.
 - Regional fuel taxes to replace specific transport rates in Auckland (but electronic road pricing is better when technology permits.).
 - Congestion charges.
 - Infrastructure bonds.

2.2 Rates as a revenue source

2.2.1 What are rates?

Rates are the largest source of local government revenue. Around 58% of local government operating income comes from rates, as shown in the pie chart below.



Rates are a hybrid of a services charge and a tax on real estate property. They can be property value-based (around two-thirds of revenue comes from this source) but also non-value based associations with a property ie fixed charges (such as uniform targeted rates and UAGCs), volumetric charges, rates based on land area etc.

Rates are the only tax available to local government in New Zealand. Other countries with similar local government systems have a wider range of funding sources to complement rates. New Zealand's reliance on property value based rates is amongst the highest in the world.

The 2007 Rates Inquiry found that such a heavy reliance on rates was not ideal and it recommended reducing their relative importance by moving to other revenue sources. Specifically, it recommended that rates be reduced to the level of 50% of operating income by 2017, down from the 56% they were at the time. It is significant that in 2017, rates are still the dominant source of revenue and have increased to 58% of operating income.

Many (probably most) people think that rates are a tax on property in the sense that if their property values go up their rates go up. This is not (necessarily) the case. The rate take is determined by the level of expenditure a council decides to fund from rates. Property values are then used to apportion the rate take across ratepayers. This means the values are used to help determine ratepayers share of total rates collected along with the number of ratepayers (rating units). It does mean that a property that rises in value faster than the average will attract a higher-than-average increase in rates.

The extent to which non-value based rates are applied moderate the extent property values will determine a ratepayer's rates bill.

2.2.2 Evaluation of rates

This section provides a quick assessment of rates against the usual criterion used to assess taxes:

- Equity - ability to pay vs benefits received principle
- Efficiency
- Transparency
- Administration and compliance costs.

Ability to pay- property values are not a good indicator of wealth, income nor ability to pay.

They are not a good indicator of *wealth* because:

- Property is only one form of asset class. A wealthy person with their money in financial assets but an average property does not pay high rates.
- Property owners with a large mortgage on it can have a low net worth.
- The value is only realised when the property is sold.

In terms of *income*, it may be true that ratepayers with valuable properties tend to have high incomes but this is not always the case, and certainly the two are not directly related. Many ratepayers have reasonably valuable properties but low incomes (asset rich and income poor.) Farmers and pensioners are often in this category.

Admittedly, property value-based rates are likely to better reflect ability to pay than fixed rates or Uniform Annual General Charges.

Benefits received principle- There is no direct relationship between property values and benefits received from local government. Councils sometimes argue that property values go up as a result of the services they provide. This link is too tenuous for this argument to stand up although there may be occasional examples of council activity where direct benefits feed into property values. (See later discussion on value capture.) They are also known to argue that more expensive properties make a greater claim on council expenditure and infrastructure costs. Again, this is not always the case and where it is (for example, a more valuable property might be large and house more people and therefore might consume more water), a user pays system would better address this.

It has also been argued by academics that user charges and uniform targeted rates are the best way to fund private benefits received and that value-based rates ideally should fund services that have public benefits. These public benefits and service might include activities such as democracy. But still, the value of properties has no connection to these benefits and given they are likely to accrue uniformly to rate-payers, it would make more sense for them to be paid for by uniform charges not value-based rates⁶.

⁶ Also, implementing this to ensure private benefits are paid for by users of the service would require much greater use of user charges which would be an improvement on the status quo.

Efficiency- Property value-based rates are not efficient because they are more likely to distort decisions (about which property to purchase) than uniform charges or user pays.

Transparency- Unlike GST and PAYE income tax, property value-based rates are highly visible to property owners as they are presented in the form of a rates bill that must be paid. (In terms of how the money is spent, however, the level of transparency is low but that is another matter). While rates are visible to property owners, they are not visible to renters (residential and gross lease business tenants) who pay rates indirectly through their rents but are largely unaware of how much they are contributing to councils.

Administration and compliance costs- Value-based rates are complex and incur high costs relating to the need to maintain and update property databases with information on property values. Regular valuations were estimated in 2013 to total \$17 million each time. There are also costs relating to ratepayers' rights to object etc. UAGCs are the simplest rating tool in terms of administrative and compliance costs.

An example of the inadequacy of property values as a revenue raising mechanism is; if there are two identical neighbouring houses and one owner paints his house and the value goes up accordingly, he is up for a greater rates bill. The services received from council are no different and the ability to pay hasn't changed (if anything the painter's ability has gone down as a result of the outgoing) while he has improved the look and the value of the neighbourhood.

2.2.3 Rating differentials

Differentials are different rates in the dollar applied to different property categories. They are most often used to either increase the incidence of rates on business properties or reduce it on rural properties.

Although most councils assert that differentials reflect the relative benefit each ratepayer group receives, this is clearly not the case. Differentials are set arbitrarily historically designed to spread the incidence towards certain groups. There is also a distinct lack of consistency across councils in their use.

The 2007 Rates Inquiry found that businesses generally receive the same benefits as other ratepayers, and at a similar cost to the local authority and recommended that business differentials should be abolished.

The fact that councils use differentials to moderate value-based rates is testimony to the fact that property valuations are an unfair mechanism to raise revenue not reflecting either benefits received nor ability to pay. Rural differentials are used to ease the incidence of rates on rural ratepayers where large properties (e.g. farms) often have a high value and are less likely to use as many services as their urban counterparts. Business differentials are used because some councils think property valuations are not raising enough from a sector that they think can afford to pay more. In both cases, differentials are arrived at in an arbitrary fashion; just as the use of property values to determine pre-differential rates are arbitrary. It is almost as if the differentials are set to arrive at a predetermined outcome which councils think is appropriate.

In the event that differentials are outlawed, as the business sector thinks they should be, the inequity of high value rural properties contributing more in rates than they benefit from would need to be addressed. Councils could do this by making more use user charges, Uniform Annual General Charges and targeted rates.

2.2.4 Targeted rates

Targeted rates are applied to a particular group of ratepayers (e.g. in a particular area or category) who benefit from a specific service to pay for that service. They can be value-based or uniform. They are significantly more precise than differentials; are often a reasonable proxy for a user charge and are therefore preferable to differentials.

However, for targeted rates to be justified on both economic efficiency and equity grounds, the target group receiving the benefits needs to be clearly identified. And ideally, its consent should be sought before any targeted taxes are considered.

Fixed or uniform targeted rates are usually better than those based on property values for all the reasons cited earlier in terms of the weakness of rates based on property values generally. They tend to have less relationship with ability to pay than value-based targeted rates (to the extent property values reflect income which isn't always the case.).

The 2007 Rates Inquiry recommended greater use of targeted rates in place of business differentials.

2.2.5 Uniform annual general charges

Uniform annual general charges (UAGCs) are a fixed amount per rating unit, applied to all rating units, and used to fund or partly fund non-specified activities that are deemed to have similar benefits across all properties.

They are distinct from uniform charges which, as a form of targeted rate, are flat charges for certain services applied only to those households known to use those services.

As a flat charge, UAGCs are regressive. But at the same time, they are able to mitigate the inequity of rates falling more heavily on more valuable properties as opposed to being linked to benefits received. UAGCs are often set arbitrarily simply to alter the incidence of the rating burden away from property owners but this is no more arbitrary than property value based rates as a proxy benefits received.

The 2007 Rates Inquiry recommended abolishing UAGCs and replacing them with targeted rates.

2.2.6 Issues relating to valuations

A major drawback of property value-based rates is that they need to rely, by necessity, on an assessment of property valuations (as opposed to actual values). Rateable Values (RVs) arrived at are notoriously unreliable and can be demonstrated as being not well aligned to the actual market values. This would be less of a problem (from a rates collection perspective) if the variations from market values were the same for all properties but they are not meaning that different properties are being valued more or less than they should be relative to each other which has significant implications for relative rates bills.

While the overall cost of undertaking three yearly valuations is high, on a per property basis, the implied cost per 1.6 million properties is low and so the lack of accuracy is understandable given the resources devoted to the valuations. Valuation frequency has been reduced from annually to three-yearly to save costs but this has created a new set of problems.

As well as being unreliable and inaccurate, the RVs, which are a snapshot at the date of assessment, can quickly become out of date especially in an active property market. Not only does the gap between the market value and the RV widen the further out from the RV date, so too does the distribution of values meaning a greater the potential for outdated valuations producing outdated

and unfair rating apportionments. Then when the new three-yearly RVs are released there is an abrupt revaluation.

There are a number of good examples of where this has thrown up some perverse outcomes. In 2015 Hauraki District Council's revaluations produced a large divergence in rural and urban valuations compared with three years prior with rural values increasing a great deal more than urban values. This consequence of this was flat or declining rates for residential and commercial-industrial properties and rises in excess of 20% for some rural properties. The council had the opportunity to mitigate this imbalance, by adjusting the rural differential for example, but chose not to. It did not even consult on its annual plan

The impact of Auckland's revaluations of late 2017, which produced large divergence across suburbs, are described in the box below.

It is ironic that objectors to the RVs are usually seeking an increase in the rating value (presumably to influence resale value) which further skews the rates apportionment as others with similar value properties would not have objected.

Good valuations are usually done on a highest-value-use, potential sale price basis rather than a current-use basis but this probably isn't necessary in RVs given they are more rating assessments rather than true valuations and a value-in-use basis would provide some redress for any current inequities in the valuation of farm land.

Auckland Residential Revaluations

Auckland's massive residential revaluations released in late 2017 have highlighted the absurdity of linking property values to rates collection.

Rateable values were up an average 46% on the RV three years prior. There was a wide range of revaluations around this average. The average increase for the Otara Papatoetoe Board area was 62.0%, Great Barrier's was 11.0%. There was an even greater range of individual movements around these averages.

Property values are used to determine how rates are shared among rate-payers – they don't directly influence the rate bills. However, the large spread of revaluations (gains and falls) that the three-year exercise threw up means that when the coming year's rates are set, some ratepayers will be paying exorbitant increases in rates while others will face reductions.

Based on an assumed 3% rise in the total rate-take (set by council), anyone with a capital valuation gain of less than 42% will face a drop in their general rate. A rate payer with a 46% increase (i.e. the Auckland average) can expect a 3% rise. A household which received an 80% increase (not uncommon – perhaps they did some improvements or perhaps they were just "lucky") will face a 27% rise in general rates.

The presence of UAGCs and other fixed charges and targeted rates will take the edge of these extreme movements which is positive and perhaps a silver lining from the extreme valuations will be that Councils make more use of these as a result.

At a suburban level the average house in Parnell, whose valuations went up below the average, can enjoy a general rates reduction while the average Otara ratepayer faces a rise.

The wide range of valuation movements accentuates the unfairness of using property as a rates collection mechanism. Why should some ratepayers experience a sizable increase and others a drop when the services received haven't changed?

2.3 Existing non-rate funding tools

This section provides an overview of the following non-rate funding tools available to councils:

1. Development contributions
2. Central government transfers
3. User charges
4. Selling assets
5. Investment income / better returns from investments
6. Better / more use of debt

2.3.1 Development contributions

Development contributions from parties either subdividing or intensifying the existing use of land help local authorities meet the costs of capital expenditure associated with these developments.

Development contributions are appropriate for these purposes although increased transparency in how councils use development contribution income is needed given there is sometimes uncertainty around the links between development contribution income and actual development costs.

2.3.2 Central government transfers

Central government transfers can take a variety of forms. By far the largest source of central government transfers to local authorities is land transport funding.

Central government has access to more efficient taxes than local government and it may make more sense to use these than to rely totally on local sources.

On the other hand, the principle that policymakers make better decisions when they also bear the cost of their decisions would suggest that central government transfers should not be allowed to expand too widely.

Refer to Contestable Funding in next section for further analysis of central government transfers.

2.3.3 User charges

17% of local authority income came from user charges in 2017.

Charging for the use of local government services according to how much is consumed is the most efficient means of raising revenue. Putting a value on goods and services consumed provides incentives to use those goods and services efficiently. For example, volumetric charging for water and waste disposal encourages more judicious / careful use than funding such services out of rates which send limited signals to consumers as to the real costs of their consumption.

User charges do not score highly on ability to pay and so if used extensively raise the regressivity of the system but most reviews including the 2007 Rates Inquiry recommended increased use of user charges by local government.

Councils should be encouraged to make more use of user charges.

2.3.4 Selling non-core assets to reinvest in infrastructure

Councils own a wide range of assets adding up to around \$130 billion across the country. These include everything from road and water infrastructure to commercial assets such as forests, ports and airports.

Sometimes these commercial assets are held for commercial gain to ease rates pressures (see below). Sometimes they are held for supposed policy reasons e.g. to influence parking behaviour or ensure air connectivity. In general, ownership of commercial assets should be left to the private sector because of the private sector's superior ability to manage them.

In many cases commercial assets are held at the same time as other areas of infrastructure are lacking or in a varying state of repair. There is a strong case for councils to look at divesting shares in these assets and reinvesting the proceeds to improve core infrastructure.

With partial ownership, as is often the case, the risks include potential conflicts between the public and private sector shareholders due to non-alignment of commercial interests and policy goals. This means that optimal decisions may not always be made. For example, some ports' diversification into commercial property as a money-making venture may conflict with the public policy goals.

Just as councils should focus on their core business activities, they should avoid ownership of non-core commercial assets. Councils should be encouraged to sell non-core assets and reinvest into core infrastructure.

2.3.5 Investment income / better returns from investments

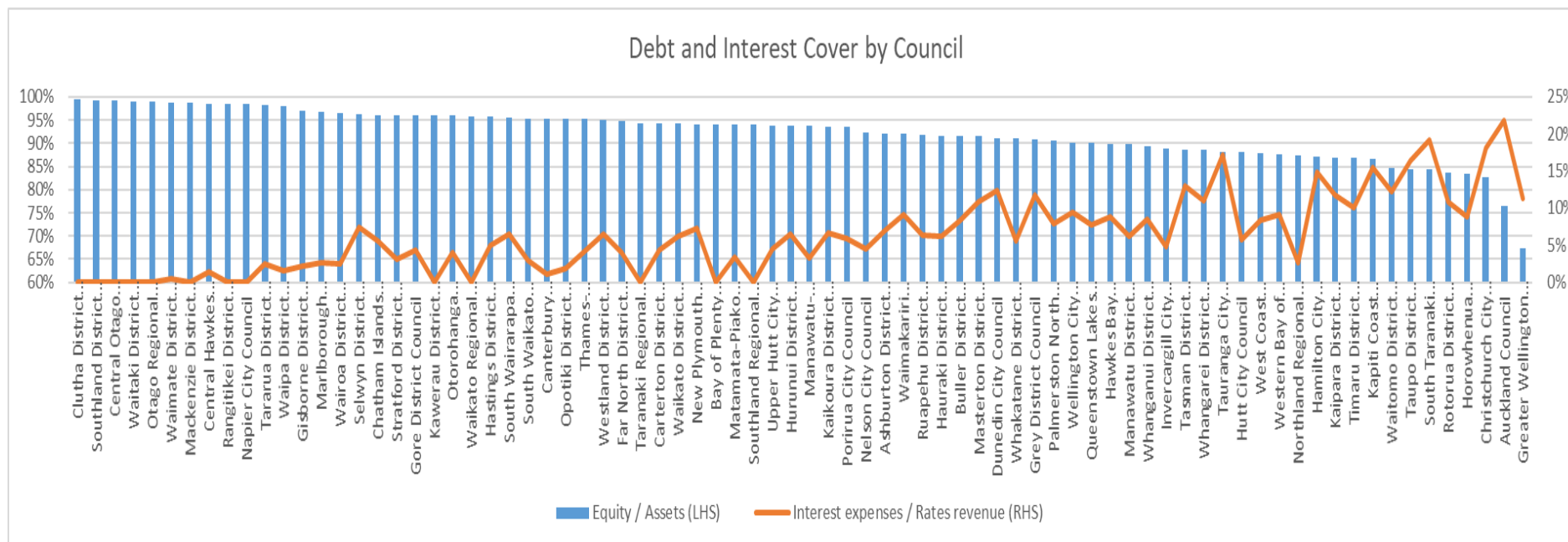
Councils often hold commercial assets and engage in trading activities because the income is welcome and ratepayers are persuaded by arguments that the dividends from these investments enables lower rates than would otherwise be the case.

However, such investments are not risk free and while some trading activities may be a good revenue source in a benign economic environment, ongoing profitability is not guaranteed. The same argument applies to long term investment assets generally (such as stocks and bonds) that some councils hold.

Encouraging councils to make better returns on investments as a means of relieving rates may give them reason to hold risky, non-core assets and so should be discouraged.

2.3.6 Better / more use of debt

Although there are exceptions, councils are generally lightly indebted. Aggregate ratepayers' equity is equal to 86% of total assets. There is a wide range across councils but only a handful are below the average and only two (Auckland Council and Greater Wellington Regional Council) are below 80% equity. However, debt levels are increasing with the aggregate equity ratio having declined from 94% in 2000.



Using debt to fund long term assets makes sense on considerations of intergenerational equity. Local authority capital expenditure on infrastructure provides benefits that are realised over a long time and so it is reasonable for the cost to also be spread. It is even more sensible where there is population growth.

Increased use of debt to fund long term infrastructure is an option for councils not close to funding limits (which take account of interest payments and rates revenue). Where councils are up against debt limits, infrastructure bonds tied to specific projects are discussed later in this paper.

For many councils greater use of debt to fund long term assets would enable reasonable rate reductions, or more likely a slower rate of increase than it would otherwise be.

2.4 Possible new taxes and revenue sources

So far, we have considered rates and other existing funding mechanisms available to local government. What are the alternative taxes and revenue sources? Are they any better? Will they work?

If local government is to reduce its dependence on rates as a funding source, alternative mechanisms are required.

Alternative taxes - including income tax, GST, fuel tax etc have been considered many times in public policy debates over recent decades. Some are being proposed in New Zealand now. They all have strengths and weaknesses when assessed against the usual criteria.

There are also some more innovative measures that are used overseas and could work well in New Zealand, particularly in the area of infrastructure funding. Finally, there are some non-tax sources that could easily be introduced by changing the way things are currently done.

This section briefly considers the following alternative taxes and revenue sources:

1. Citizens or poll taxes
2. Stamp duties and other transaction taxes
3. Local income tax and local GST
4. Payroll tax
5. Contestable subsidies
6. Royalties
7. Remove exemptions
8. Unfunded mandate
9. Value capture tax
10. Selective taxation, e.g., Environmental tax/ waste tax / congestion charge
11. Industry tax
12. Bed tax
13. Regional fuel tax
14. Infrastructure bonds

As per the Terms of Reference a view is offered as to which:

1. are simply not workable and not worth pursuing any further
2. could have merit and so further work is recommended.

There are also some that are recommended outright.

As outlined in Part One, there is still a lot of unnecessary activity and over-expenditure which needs to be contained. Local government needs to be able to demonstrate it has its house in order before being given access to new funding mechanisms.

2.4.1 Citizens or poll taxes

This is a flat dollar charge per person for general expenditure, set irrespective of the person's use of services or ability to pay. It does not significantly affect behaviour, and hence would have little economic distortions or cost. However, its highly regressive nature makes it very unpopular – the UK's experience with it, where it was quickly discarded, is well documented.

Assessment - Not worth pursuing any further

2.4.2 Stamp duties and other transaction taxes

Again, stamp duties and other transaction taxes are often used overseas to fund local government. These have been discontinued or rejected in New Zealand at the central government level due to the high economic cost relative to the amount of revenue raised. This would also be the case if applied at the local level.

Assessment - Not worth pursuing any further

2.4.3 Local income tax and local GST

In considering these we need to distinguish between taxes set and collected autonomously by local authorities and taxes set and collected by central government and distributed to the regions.

Both are well established central government taxes in New Zealand. They perform well on ability to pay criteria (income tax more so). GST is reasonably efficient - applied evenly across a broad base, income taxes less so given their disincentive to work more. Both are difficult to avoid and GST captures external visitors who benefit from services

However, if set locally, the administrative, enforcement and compliance costs are far too high to make either workable. Requiring a replication of IRD structures, most authorities do not have the scale to cost effectively administer them. In addition to this, they would introduce a new element of compliance costs for ratepayers and business. They would also compromise and undermine the effectiveness of central government taxes.

Even if they were set and collected nationally - for example a local authority surcharge on existing GST and/or income taxes - and then distributed back to the regions, there would be huge difficulties in attributing revenue to a particular geographic area. In the case of GST both output and input taxes would need to be accounted for and with income taxes, how would a company with a Christchurch head office, owned by shareholders in Dunedin, manufacturing in Wellington and selling in Auckland be treated, for example.

Most importantly the allocation back to the regions may not meet the expectations of the communities or politicians calling for this - especially those who may be expecting a windfall. For example, big cities where consumption is high would take a disproportionate amount of the GST returned, rural areas, where a lot of economic activity is zero rated exports would get very little.

Where it is set and collected nationally and allocated to the regions according to perceived need, perhaps on a contestable basis or based on a well-defined formulae, as opposed to being returned to the area it was collected using some best endeavours measure, there may be some merit. This is discussed further under the topic of **Contestable Funding** below.

Assessment - Locally set income tax or GST not worth pursuing any further

2.4.4 Payroll tax

A payroll tax is sometimes floated because it is used in some overseas jurisdictions. These are less costly to administer than a comprehensive income tax however they are easily avoided and distort economic activity towards capital intensive activities away from labour intensive ones and so are not favoured in New Zealand at either the national or local level. Also, there are significant administrative and compliance costs.

Assessment - Not worth pursuing any further

2.4.5 Contestable subsidies from central government

Currently, there are a number of different voices calling for increased government transfers to local government. Some are based on the misguided argument that a sector doing well is contributing to government coffers and therefore entitled to have some of it returned. Some are made in response to the growing regional disparity and see this as an opportunity to redistribute government taxes to those areas in need. Some are made in response to the growing infrastructure pressures, often due to population and tourism growth, that many local authorities are struggling to deal with. Returning a portion of royalties and GST to the regions have been proposed in this regard. Proposed Special Economic Zones⁷, which trial central government policy variations in certain council areas, would also share with participating councils a portion of new tax revenue generated by the Zones mainly as an incentive for councils to participate.

Money from central government could either be tagged to specific activities or for general uses although some in the local government sector seem to be lukewarm on proposals where councils would not have full control the funds.

Under the current economic environment of high growth and legitimate infrastructure pressures from population and tourism growth causing many councils to struggle, there does seem merit in central government supporting councils in these areas – but on a case-by-case basis. The Tourism Infrastructure Fund is one example of this that seems to be working well on a small scale. Under this scheme, funding for local tourism infrastructure is allocated to councils on a contestable basis out of general Crown revenue.

It is true that policymakers make better decisions when they also bear the cost of their decisions; and that clear links between tax revenue and expenditure create fewer opportunities for waste and maladministration. However, it seems worthwhile considering whether this model could be adopted for an expanded funding mechanism, at least for a limited time. Funding would be contestable; tagged for specific infrastructure projects and funded out of general crown revenue (which as we have acknowledged is more efficient revenue raising mechanism than property value-based rates or other alternative locally set taxes such as local GST or income tax).

Assessment – Might work. Further work recommended

2.4.6 Royalties

Returning a portion of the royalties central government takes from extractive industries – oil, gas, coal and mineral mining to local communities is argued for on the grounds it is local government that develops roads and provides much of the services that enable extraction and bear the clean-up

⁷ proposed by The New Zealand Initiative and supported by LGNZ and some councils

risk should something go wrong. (This was advocated by New Zealand First but notably did not make the Coalition Agreement).

The counterargument is that the royalties are owned by central government not local government and if there is a need for infrastructure investment or maintenance of a road say because of mining activity, the local authority should recover the cost directly from the miner.

As an indication of the amount of money at stake, in 2013 \$380m was paid to the government in oil and gas royalties, and \$22,000 in mineral royalties in Taranaki alone.

Given the current infrastructure constraints in some parts of New Zealand, there is an argument for a portion of this revenue being allocated to those communities to relieve these pressures. However, as proposed, royalties would not be allocated according to merit but instead be returned to where they came from as an automatic right.

It seems preferable that any proposals to central government for support of infrastructure projects related to mining be presented as part of the contestable Central Government funding idea discussed in 3.5 above. The royalty argument could be made in support of any applications but should not be seen as an unconditional right.

Assessment - Not worth pursuing any further

2.4.7 Remove exemptions

A number of categories of land are exempt from rates, the main one being Crown land. The total cost of exemptions could be equivalent to around \$220 million or 4% of total rates - spread unevenly between councils. There are some inconsistencies e.g. SOEs and CRIs pay rates whereas airports, universities and hospitals are exempt. Apart from the inequity of the situation with well-heeled organisations not having to bear the cost of council services and the shortfall needing to come from a narrow base of other ratepayers, the exemptions lead to inefficient use of assets and land.

There is no clear rationale for these historic rating exemptions. They may simply reflect the view that the Crown should not be bound by a lower level of government.

If the exemption were removed, and these organisations contributed to the running of their local councils, central government would have to take full responsibility for funding them but this is preferable than local government funding the gap “through the back door” which is effectively what is happening now.

The 2007 Rates Inquiry recommended the exemptions be removed with each council being allowed to determine what exemptions it wished to continue.

Assessment – Recommendation: Remove statutory exemptions on rating of Crown land

2.4.8 Unfunded mandate

Local government has long claimed it faces an increasing cost burden from increasing central government expectations and requirements which have to be passed on to ratepayers. While the 2007 Rates Inquiry concluded that the “unfunded mandate” claims are exaggerated, it said there were some instances where transfers were justified. It also acknowledged that where central government sets national standards that local government must meet they will almost always be higher than what some local communities would have chosen on their own.

Consequently, this is an area where a case can be made for small central government compensatory transfers to local government. One variant would be if central government won't fund it, then councils can opt out if a referendum reveals no support for the higher standards.

Assessment – Might work. Further work recommended

2.4.9 Value capture tax

This is a tax on the uplift in land values of specific groups of properties resulting directly from council actions. A value capture tax has been floated for council decisions including the rezoning of land (eg rural to urban) and investing in new infrastructure. (eg the windfall gains of properties located near a new railway station.) The Minister of Finance has recently raised the latter as a possibility as a central government tax.

Value capture may be a fair way to recover a portion of infrastructure costs from properties which clearly gain through value uplift as a direct result of the investment. Tools such as a targeted rate on the capital gain are used overseas to help fund large infrastructure projects. They enable direct beneficiaries of infrastructure investment (who benefit not necessarily through their use of it but through property value rises due to the proximity of the new infrastructure) to contribute to the cost. Arguments against it include the difficulty in identifying properties that would benefit, the inability to make a certain link between the capital gain and the council action and difficulty in quantifying the value. It is true that any property value gain will be captured in normal rates anyway but a specific value capture targeted rate would be confined to direct beneficiaries of the infrastructure and the revenue raised would be tied to funding it.

Taxing the capital gain on properties resulting from council rezoning decisions is another matter. Here the gain is simply due to a council stroke of a pen and shouldn't be entertained further. It is likely that the probability of such a rezoning had been built into the purchase price/ revaluation of the land and so the gain should not be taxed. The policy could even result in perverse incentives on council to effect zoning changes just to raise revenue for itself.

Assessment: Might work. Further Investigation recommended

2.4.10 Selective taxation

Selective taxation is often used where there is a public policy reason for encouraging or discouraging some activity. At a national level examples include excises on alcohol and tobacco. At a local level (and national) environmental taxes, waste taxes and congestion charges have been floated.

On the downside, they are administratively expensive; they do not raise much revenue if they are meeting their intended objectives of discouraging the activity in question; and they may simply encourage environmentally damaging activities to relocate to other areas where such taxes aren't present or kept low.

In general, these taxes are better left at a national level but some such as congestion charging are likely to be a useful tool at the local level for influencing traffic demand (not raising revenue) especially as the technology comes into play.

Assessment – With the exception of congestion charges, not worth pursuing any further

2.4.11 Industry taxes

Industry taxes are narrowly based taxes levied on a particular activity. They are used where there is a reasonably close relationship between the expenditure being taxed and the activity being funded by the tax and can be used to contribute to specific issues that are causing problems for local authority funding. Topical examples include visitor levies, bed taxes (see discussion on Auckland's and Wellington City's proposed "bed taxes" in the box below), and fuel taxes (discussed separately in 2.4.12). A downside is they can distort the pattern of production or consumption and, depending on the form they take and they can be expensive to administer (e.g., visitor levies).

Assessment – bed taxes and visitor levies not worth pursuing any further

Bed Taxes, Visitor Levies and User Charges

New Zealand is currently experiencing a tourism boom which is putting pressure on existing infrastructure. The growth in visitor numbers is not distributed evenly across the country.

Many of the councils in those parts of the country experiencing growth in visitor numbers are considering introducing some form of bed tax or accommodation levy. At the same time, central government is investigating options for tourism taxes and a visitor levy at the border – and how revenue raised would be spent. Currently central government's Tourism Infrastructure Fund is helping address the new pressures in some council areas on a relatively small scale.

Auckland and Wellington City Councils have both proposed new targeted accommodation rates.

Auckland Council intends to levy a rate which accommodation providers can pass on to hotel guests as a surcharge as they see fit. Amounting to between \$1 and \$6 per room per night, the revenue raised from this surcharge will be earmarked to cover about half the cost of tourism marketing and events. Wellington City Council's proposal is less developed but they are exploring similar options. Unlike Auckland's, according to the draft Long Term Plan, Wellington's would fund "a share of the costs of economic projects and visitor attractions" although how it is to be spent seems to be evolving.

In terms of tourism spending, there are three distinct broad categories of expenditure proposed;

- Marketing and promoting the area to tourists;
- Funding for new tourist attractions (which locals may also enjoy);
- Upgrading existing infrastructure to cope with increased visitors (tourists and other visitors).

Auckland's rate will fund the first; Wellington's rate the second. The third is an issue right across New Zealand.

It is assumed the costs of the rates will be passed on to guests (although the industry says they won't) but the beneficiaries / cost drivers of the proposed expenditure differ across categories. For example, hotel owners might benefit from destination marketing but their guests don't. And the case for charging business guests a fee to subsidise museum visitors is weak.

A number of other challenges with the proposals have been identified, including:

- The new rate could deter investment in new hotels which is the last thing needed given the existing shortage.
- The hotel sector and other accommodation providers are only one segment of the tourism industry, by their reckoning receiving only 10% of the total tourism spend. Why shouldn't the rest of the sector (tourism operators, cafes, retailers etc) contribute?
- Some councils already have a voluntary scheme where hotels club together to contribute towards destination marketing often matched by a ratepayer contribution. A new bed tax in addition to a voluntary contribution and existing targeted rates will not go down well and could result in hoteliers ceasing to pay the voluntary contribution.
- What about people who stay in private accommodation or use platforms like AirBnB. How would they be reached?

It is possible to argue that an accommodation rate is more precisely targeted than the existing targeted or differential rates used to fund tourism activities but the points listed above illustrate the link between beneficiaries and payers is still pretty loose.

For example, in Wellington City tourism and events are funded through rates which are targeted at businesses generally (CBD businesses in the case of tourism and businesses across the city in the case of events which is arbitrary in itself) i.e. not just hotels or even businesses in the hospitality and retail sectors but businesses across the board (manufacturers, IT firms, service providers etc).

The councils have said that there will be corresponding reductions in these existing rates if the targeted rates are introduced, which is essential, but the concerns listed above would also need to be addressed before the proposals are pursued further.

In terms of ratepayer (and taxpayer) funding of visitor attractions, the best solution lies in better use of user charges. Getting these, and the associated incentives they provide, right can provide huge gains in terms of optimal use of the asset, savings for ratepayers (and taxpayers) and a better experience for visitors. Councils (and government agencies) need to put more effort into addressing this, including consideration of charges for DOC land and museums. Clever use of charging mechanisms, including likely differentials between local, non-local and international visitors, will reduce the need for bed taxes, accommodation rates and border levies as well as reduce the demands on ratepayers (and taxpayers) generally.

2.4.12 Regional fuel tax

In Auckland it is proposed to replace the existing \$114 annual transport levy with a new 10c/litre regional fuel tax (11.5c/L including GST) to fund local transport infrastructure. This has been opted for because a user pays model is considered fairer than one which charged the same \$114 per household irrespective of use of the network or ability to pay.

The major difficulties with such a tax are that it would be hard to target at a certain area only and consequently easy to avoid by purchasing fuel in neighbouring council areas (leakage). Price spreading (where fuel retailers raise the price of petrol around the country to compensate for the tax) is likely to occur to a degree. The tax would also be administratively difficult for the Council to collect. And it would blur the accountabilities between central and local government.

Currently, as one of a plethora of fuel taxes and levies, an existing local authority fuel tax is levied on petrol and other fuels at between 0.33 and 0.66 cents in the dollar and distributed to local authorities by central government. Total taxes on petrol currently amounts to 66c/l plus an ACC levy and GST. The Auckland Regional Fuel Tax would be in addition to this. Councils need permission from central government to levy an individual regional fuel tax. Only Auckland has approval - recently granted by the new government.

Notwithstanding the weaknesses (leakage, price spreading, admin costs etc) this tax is borne by users, unlike the levy. It is fairer in terms of use and ability to pay and may influence consumption which the levy couldn't do. Therefore, until the technology for proper road user charging and congestion charging is fully available, the regional fuel tax is an ok alternative. But it is another tax and it would be essential that it does indeed replace the levy, is not syphoned off for non-transport use and that there is transparency on what it is spent on.

As with other fuel taxes, there would need to be allowances for farmers and the fishing industry for off-road usage (which shouldn't have to pay the tax) and so perhaps should be applied on RUC rather than diesel.

Assessment: Might work. Further Investigation recommended

2.4.13 Infrastructure bonds

Councils issue bonds to pay for specific infrastructure projects which are serviced by targeted rates paid for by beneficiaries of those projects. Referenda of affected property owners (potential payers of the targeted rate) can be undertaken in advance as a guard against unwanted projects.

The debt is essentially quarantined from general debt and tied to the specific projects. This has the advantages of avoiding debt funding being diverted to other less-deserving proposals and enabling otherwise stretched councils to do something that has genuine merit they otherwise wouldn't be able to fund.

The idea has been proposed as a means of funding Auckland housing developments but could be applied more widely. By using infrastructure bonds, councils can reduce up-front costs to homebuyers and use their strong credit ratings to borrow at cheaper rates. Normally (housing) developers would have to pay big contributions up front that are passed on to buyers.

Assessment: Might work. Further Investigation recommended

3.0 Conclusion

A number of alternative funding mechanisms have been identified which could have merit. Further work on these should be done but before they are implemented, there is still a lot of unnecessary council activity and over expenditure which needs to be addressed. Local government needs to be able to demonstrate it has its house in order before being given access to any new mechanisms.

4.0 Summary Table

Possible New Taxes and Revenue Sources

<p style="text-align: center;">Recommendations</p> <ul style="list-style-type: none">• Constrain council spending• Abolish business differential (and increase user charges and targeted rates in return)• Increase user charges• Increase use of targeted rates (in place of general rates) but more scrutiny required• Measures to increase transparency• Sell non-core assets and reinvest proceeds into core assets• For some councils, increased debt funding for long term assets• Remove exemptions on crown land
<p style="text-align: center;">What won't work!</p> <ul style="list-style-type: none">• Locally set income tax• Locally set GST• Payroll tax• Poll tax or citizens tax• Stamp duty/transactions tax• Selective environmental taxes should be left at the national level• Returning a portion of royalties from extractive industries to where extraction occurred• Bed taxes and visitor levies.
<p style="text-align: center;">What might work!</p> <p>NB -These aren't necessarily supported but further investigation is recommended</p> <ul style="list-style-type: none">• Central government transfer to cover costs passed down. (Unfunded mandate)• Contestable funding from central government tagged to specific infrastructure projects• Value capture tax• Regional fuel taxes to replace specific transport rates in Auckland (but electronic road pricing is better when technology permits.)• Congestion charges• Infrastructure bonds